

Public vs. Private: A Very Blurry Line

For financial-reporting purposes, the distinction between “public” and “private” entities is often important, but it’s rarely straightforward.

Accounting standards setters routinely consider differences among reporting entities when setting standards. These distinctions serve various purposes, such as determining:

- ◆ Whether a particular entity is included in or excluded from the scope of a standard;
- ◆ Which recognition, measurement, presentation, or disclosure requirements or options apply to a particular entity; and
- ◆ The date on which a particular entity must or may adopt a new or revised standard.

Defining useful distinctions among entities, however, has been challenging for standards setters such as the U.S. Financial Accounting Standards Board (FASB). This has been especially true with regard to the distinction between “public” and “private” entities. As a result, preparers, auditors, and users of financial statements find themselves dealing with a very blurry dividing line. This month’s column will examine the issue of “drawing the line” between public and private entities and why it

remains a challenge despite—and in some cases because of—current developments in the U.S. financial-reporting environment.

A Word Problem

The challenge of defining and applying distinctions between “public” and “private” entities starts with the words that we use. For example, the English language contains many different pairs of adjectives and adjectival phrases that we use to make distinctions between entities, such as:

- ◆ Public vs. Private
- ◆ Public vs. Nonpublic
- ◆ Publicly Held vs. Privately Held
- ◆ Publicly Traded vs. Not Publicly Traded
- ◆ Publicly Accountable vs. Not Publicly Accountable
- ◆ Listed vs. Nonlisted
- ◆ Quoted vs. Nonquoted
- ◆ Regulated vs. Nonregulated

There also are a few noun pairs that we can add to the mix:

- ◆ Issuers vs. Nonissuers
- ◆ Filers vs. Nonfilers
- ◆ Registrants vs. Nonregistrants

This diversity in terminology raises an important question: Do all these words/phrases represent the same binary distinction, or

does the dividing line between entities depend on the specific words/phrases that we use? For example, is a “publicly held” entity necessarily the same as a “publicly accountable” entity?

The answer is no. Each variation in terminology usually places the dividing line somewhere different, which means that the side of the line on which a particular entity lies could vary depending on the terminology used. For example, it’s possible for a particular entity to be *privately held* yet *publicly accountable*. So we must grapple with the fact that imprecise use or interpretation of these words/phrases, as is common in practice, blurs the line that distinguishes “private” entities from “public” ones.

Adding to our confusion are similar terms that represent significantly different distinctions, such as “public sector” vs. “private sector.” To be clear, a public-sector entity is generally understood to be a governmental entity, whereas a private-sector entity is generally understood to be nongovernmental in nature. Yet, as these terms are used in the United States, *public* companies are part of the *private* sector. And if that weren’t enough, the common meaning of some words can change profoundly

when crossing international borders (e.g., U.S. expatriates quickly learn that *public* schools in much of the United Kingdom would be called *private* schools back home).

It's obvious that using different words and phrases as if they mean the same thing—when in fact they don't—can lead to confusion. But we also run into the opposite problem when attempting to draw distinctions between “public” and “private” entities. U.S. Generally Accepted Accounting Principles (U.S. GAAP), as documented in the FASB *Accounting Standards Codification*® (ASC), illustrates this problem quite well. Within the ASC, the term *publicly traded company* is defined in two different topics (270 and 932), *public entity* in three (280, 718, and 740), and *nonpublic entity* in five (105, 715, 718, 740, and 825). But the definition of each term varies depending on the topic in which it's defined. Thus, using the same words/phrases to refer to different distinctions makes the line between “public” and “private” entities even blurrier.

Then there's the problem of simply using the wrong words. For example, we might presume that the International Accounting Standards Board's (IASB's) *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs) is intended for, well, small and medium-sized entities. But as I explained in my September 2009 column, the scope of the IFRS for SMEs isn't based on an entity's size at all. Instead, the standard is targeted at entities that lack “public accountability,” as defined in the standard, regardless of size. There were even

two alternate names proposed for the standard before it was issued in final form—*IFRS for Private Entities* and *IFRS for Non-publicly Accountable Entities*—either of which would have conveyed the standard's entity scope more accurately. But the IASB had its reasons for choosing the final name, contending that it would actually be less confusing than the alternatives, especially when translated into certain other languages and used in certain countries.

Changes in the United States

The FASB recently began to address the issue of diverse entity definitions in U.S. GAAP. On March 7, 2012, FASB Chairman Leslie F. Seidman announced the addition to the Board's agenda of a project to reexamine the multiple definitions of *nonpublic entity* that are currently present in the ASC. The agenda decision was based on comments from stakeholders requesting clarification of existing definitions as well as tentative definitions being used in the FASB's various projects, especially the Private Company Decision-Making Framework that the Board's staff has been developing. Interestingly, rather than committing to a single, pervasive, “bright-line” distinction, Seidman indicated in a March 12, 2012, webcast that the FASB might decide on a baseline definition but add entities to or subtract entities from it in specific standards. A discussion paper on this project is expected to be issued for public comment in the third quarter of 2012.

On April 5, 2012, U.S. President Barack Obama signed the Jumpstart Our Business Startups (JOBS)

Act into law. Among its many provisions, the JOBS Act “blurs the line” by allowing public companies to act like private companies for many financial-reporting purposes. The Act does so by defining a new class of public company: the Emerging Growth Company (EGC). Under the Act, the U.S. Securities & Exchange Commission (SEC) can't require EGCs to:

- ◆ Present more than two years of audited financial statements,
- ◆ Comply with any new or revised financial accounting standard until such date that private companies are required to comply,
- ◆ Obtain an external auditor's attestation with regard to the effectiveness of the company's internal control over financial reporting (ICFR) as otherwise required by Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), and
- ◆ Comply with certain rules of the Public Company Accounting Oversight Board (PCAOB).

Nevertheless, an EGC may elect to be required to do those items. If so, it must make the election upfront when it first has to submit reports to the SEC, must forgo all JOBS Act exemptions, and must stick with its election permanently.

Regardless of the changes that these developments may bring, there are three things that participants in the financial reporting supply chain can do to keep the public-private entity distinction from becoming blurrier than it already is. Specifically, we can:

- ◆ Choose our words carefully,
- ◆ Define them rigorously, and

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- ◆ Use them consistently in accordance with their definitions.

Otherwise, we'll find ourselves continuing to grapple with a very indistinct distinction between "public" and "private" entities. **SF**

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