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# Definitions of Private Company and Public Business Entity

*A Discussion Paper of the*

## AMERICAN BANKERS ASSOCIATION


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**Qualification**: ABA does not give financial reporting, legal, or accounting advice and our views on these issues are not authoritative. Facts, circumstances, and interpretations may also change. ABA advises bankers to discuss these issues with their auditors and examiners prior to making decisions related to financial reporting.

## Summary

Under generally accepted accounting principles (GAAP), the terms "private company" and "public business entity" (PBE) can be important for smaller banks and savings associations:

- Private companies are often given additional time to implement new accounting standards or other FASB updates.
- Private companies are sometimes exempt from certain GAAP disclosure requirements.
- Private companies are sometimes provided options to follow certain private company accounting alternatives.

Similarly, for Call Report purposes, an institution can only use these special FASB private company alternatives if it meets the GAAP definition of a private company.

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-12, "Definition of a Public Business Entity" in December 2013, adding this term to the Master Glossary in the Accounting Standards Codification (ASC). This ASU states that a business entity that meets any one of five criteria set forth in the ASU is a PBE for reporting purposes under U.S. GAAP, and, thus, would not qualify for the private entity (also referred to as "non-PBE") privileges just noted.

Upon issuance of ASU 2013-12, there was a general understanding by certain FASB members and staff, as well as by certain auditing firm representatives, that the new definition would result in many banks newly qualifying as PBEs. Banks that may otherwise be viewed as a private entity are, thus, urged to review FASB's definition of a PBE with their auditors to determine whether their corporate structure or product offerings will disallow the private entity GAAP definition. Banks that may believe they are private entity based on traditional definitions, but are at risk of being considered a PBE under FASB's definition include:

- Banks of any size that have issued debt or equity securities that can be traded by a broker in a public market
- Stock-chartered (both C Corp and S Corp) banks with over $500 million in assets that are not registered with the SEC
- Banks with over $500 million in assets that have issued debt or specific depository products that can be considered securities

Bankers should first determine whether any issued equity or debt is traded on over the counter markets (OTC). In our view, mutual institutions are considered private entities, unless they have issued debt securities that can be traded without restriction in a public market. Banks filing under the taxation status of S Corporations may be considered non-PBEs, though they must also ensure that effective restrictions on their stock are in place. S Corporations that have issued debt must determine whether the debt is traded on public markets, such as some OTC markets.

Some have questioned whether certain funding vehicles that banks issue, such as Trust Preferred Securities (TruPS) or brokered deposits, will preclude meeting the definition of a private entity.

In relation to TruPS, PBE status will depend on which entity in the corporate structure issued the TruPS. We believe that the issuance of TruPS will not normally result in a bank qualifying as a PBE[1]. Bankers are urged, however, to evaluate each situation separately, as well as to consider the other issues discussed in this paper before concluding on their public versus private status.

We believe that holding brokered deposits does not affect whether a bank will meet the definition of a private entity, and, for most banks, their issuance of TruPS will not necessarily prevent them from meeting the definition of a private entity. We also believe issuance of negotiable certificates of deposit or other deposit products that can be sold by brokers could, in substance, qualify as an unrestricted debt security that is issued by a bank (and result in PBE treatment); however, the markets in which those products are traded must be considered "public" in order to qualify a bank as a PBE. As noted above, bankers should discuss these issues with their auditors before determining whether their institution qualifies as a private entity.

**Updates from previous versions of this Discussion Paper**: This paper was originally published in May 2016. In September 2016, certain language in this paper was revised to correctly describe Call Report instructions issued by the U.S. banking agencies that applied to the PBE definition.

More importantly is that prior to 2017, ABA and personnel from various auditing firms believed that criteria D and E of the PBE definition could cause the majority of banking institutions in the U.S. to qualify as PBEs. This interpretation was based on public comments and private discussions conducted with FASB members and staff. At the heart of the discussion were: 1) the nature of the market in which a bank's securities are traded and the impact that market has on the definition, and 2) a "form versus substance" analysis of the PBE definition and how it should be applied to multiple entities in a corporate structure.

During February 2017, per discussions ABA has conducted with certain members of the American Institute of CPA's Depository Institutions Expert Panel (DIEP) regarding the PBE definition interpretation, ABA now believes the number of banking entities that will qualify as PBEs will be significantly lower. However, ABA urges banks (those that wish to qualify as private) to conduct detailed and periodic reviews in order to determine whether they qualify as PBEs.

[1] The PBE qualification depends on which entity within the corporate structure issues the TruPS and is subject to "form versus substance" analysis of the PBE criteria.

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## BACKGROUND

As defined in ASU 2013-12, a business entity is a public business entity if it meets any one of the following criteria:

A. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
B. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
C. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
D. It has issued debt or equity securities that are traded, listed, or quoted on an exchange or an over-the-counter market, which includes an interdealer quotation or trading system for securities not listed on an exchange (for example, OTC Markets Group, Inc., including the OTC Pink Markets, or the OTC Bulletin Board).
E. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

## U.S. BANKING AGENCY GUIDANCE

The Call Report instructions provide guidance clarifying how the FFIEC interprets the FASB definition. The regulators mainly focus on Criterion E: whether privately held banks that have no debt securities outstanding will qualify as "private." Criterion E has two conditions, of which the second condition is satisfied for those banks with greater than $500 million in assets. Per FDICIA, banks with greater than $500 million in assets must file GAAP financial statements to the FDIC and make them available for public inspection. Call Reports are not GAAP financial statements and, thus, the filing of Call Reports is irrelevant. (We note that Call Reports are not GAAP financial statements, nor is any portion of them considered to be GAAP financial statements, because they do not include all the GAAP-required footnote disclosures. It is this reason that Criterion E parenthetically emphasizes that GAAP financial statements must include footnotes in order to satisfy the second condition of Criterion E.)

The Call Report instructions also note that many banks are subsidiaries of bank holding companies (BHCs) and that BHCs are not subject to FDICIA. Therefore, BHCs (no matter the size) do not have the FDICIA requirement to file GAAP financial statements for public inspection. Since banks are often wholly-owned subsidiaries of BHCs, an implied restriction on the transfer of the bank shares exists. Therefore, the bank itself is not a PBE (as it does not satisfy the first condition of Criterion E, since the shares are restricted) and the BHC is not a

PBE (as it does not satisfy the second condition of Criterion E, since it is not required to file GAAP financials for public inspection).[2]

## ABA OBSERVATIONS

### Requirement to File Financial Statements with a Regulatory Agency

Many bankers are concerned that the requirement to file Call Reports essentially qualifies a bank, by default, to be a PBE and, thus, disqualifies it from the private company reporting privileges. For example, Criterion B states a company that is "required by the Securities Exchange Act of 1934 (the 1934 Act), as amended, …to file of furnish financial statements with a regulatory agency other than the SEC…" is a PBE. The Call Report instructions also parenthetically emphasize that a "regulatory agency other than the SEC" can be a banking agency. With this in mind, however, the combined 1933 and 1934 Acts do not require banks that are regulated by the U.S. banking agencies to file financial statements with their regulatory agency unless they first qualify as an SEC registrant through those Acts. Requirements to prepare and submit Call Reports, for example, generally come from the FDIC Act of 1933, as amended. Therefore, requirement Criterion B is generally not applicable to non-SEC-registered banks (though it can be applicable to certain bank subsidiaries).[3]

### Banks with non-SEC Registered Securities

A company that has securities traded over the counter, including through brokers and agents that employ pink sheets or bulletin boards, is considered a PBE per Criterion D (which disqualifies the entity from the private company accounting privileges noted above). It is possible that many of these companies have historically considered themselves to be "private" for GAAP reporting purposes since they were not registered with the SEC. Some of these companies may also consider themselves private, due to the relatively new SEC rules that increase the shareholder threshold test for determining whether a company must register with the SEC. The key point here is that if a company has debt or equity traded through an outside broker, then it should review the markets in which its securities are traded to determine whether it would be considered a PBE and, thus, would not qualify for the private company alternatives for GAAP purposes.

Banks that have issued debt, even those that are mutual banks or are privately-held, are at risk for being considered a PBE. In the past, many believed that such debt would not be considered to be "publicly-held." However, the debt markets have evolved over the past several years. For example, the FINRA TRACE (Trade Reporting And Compliance Engine) system records virtually every trade of a debt security that is performed by a broker. Until 2017, ABA staff and certain personnel from auditing firms believed that, considered broadly, the mere entry into the

[2] This analysis does not change if the bank subsidiary provides the BHC financial statements in lieu of its own in order to satisfy specific financial statement user requirements. The entity with the filing requirement has restriction on its shares and, thus, does not satisfy the first condition of Criterion E and would not be considered a PBE.

[3] Footnote #1 in the Basis of Conclusions within ASU 2013-12 also specifically points out that Call Reports are not considered U.S. GAAP financial statements.

FINRA TRACE system could effectively mean that any bank with traded or transferred debt could qualify as a PBE. Based on subsequent discussions with the Depository Institutions Expert Panel (DIEP) of the American Institute of CPAs, the reference to "over-the-counter market" within Criterion D is meant to be interpreted narrowly and in context of a *public* market. Since FINRA TRACE will record trades of securities within both private and public markets, it is important to use judgment to determine whether the related transfer(s) occurred within a market that is considered "public". Trades, listings, and quotes on an exchange (as noted in Criterion D) should be used as reference points when evaluating whether such a market is public.[4] Therefore, the existence of a trade of its securities being recorded in FINRA TRACE does not make a company a PBE by default. Bankers are advised, however, to use the FINRA TRACE data, among other things, to help evaluate whether the market in which their securities are traded would be considered "public".

## S Corporations

Some bankers have asked about why a Subchapter S Corporation (Sub S), in which stock ownership is, by its very nature, limited, could be considered a PBE. Sub S status is a tax election made for taxation purposes and not a status made for other legal or regulatory purposes. Therefore, the traditional Sub S limitation on stockholders (currently at 100 shareholder households) might not be based on a documented contractual agreement between shareholders to restrict transfer of the company shares of stock. While it is common that Sub S equity shares contain restrictions on their transfer in order to initially qualify for Sub S status, such restrictions are not necessary on an ongoing basis.

We believe that contractual restrictions attached to a company's securities must have substance. However, such restrictions do not necessarily need to be physically attached to the securities themselves (they do not need to be defined on the physical stock or bond certificate). Supplemental agreements among all security holders and properly administered restrictions on transfers noted in the company bylaws can qualify as substantial restrictions within the spirit of the standard, resulting in allowing private entity treatment for those S Corp banks that have no debt securities outstanding.

## TruPS

ABA has been asked whether Trust Preferred Securities (TruPS) issued by banks (not those held as investments) can result in a bank being considered a PBE, as it may appear to satisfy the first condition of Criterion E of the definition of a PBE. TruPS are often packaged within structured securities, such as Collateralized Debt Obligations (CDOs).

TruPS are normally issued by bank holding companies (BHCs) and not by the subsidiary banks. In these situations, as deduced by the FFIEC Call Report instructions, it is possible that neither the BHC nor the subsidiary bank would qualify as a PBE. The subsidiary bank, if it has over

[4] Discussions with FASB staff indicate that trading activity as referred to in Criterion D was expected to be interpreted similarly to previous practice.

$500 million in assets, has the requirement to issue GAAP financial statements for public inspection. However, its securities (being 100% held by the bank holding company) have a substantial contractual restriction on transfer (In this case, the first condition in Criterion E is not satisfied and the company is not considered a PBE). The BHC that issues the TruPS has unrestricted securities. However, it may not have the requirement to issue GAAP financial statements available for public inspection (In this case, the second condition in the Criterion E is not satisfied and the company is not considered a PBE).

Upon the FASB's issuance of the PBE definition, based on public comments made by certain FASB members, as well as private discussions with auditing firm personnel and FASB staff members, we believed that a "form versus substance" review of Criterion E could qualify many TruPS-issuing BHCs as PBEs. In other words, while the form of the TruPS issuance (as discussed in the previous paragraph) would not qualify the bank as a PBE, looking through the substance of the corporate structure may result in PBE treatment. However, ABA staff, FASB, and the DIEP have since had further discussions, clarifying that the PBE definition is intended to be form-based, with no "look-through" required, and it is to be applied on an entity-by-entity basis. In essence, in contrast to principles-based guidance normally given in its accounting standards, FASB elected to define PBE with detailed, specific criteria that are intended to be precisely followed.

With all this in mind, entities that wish to qualify as private and whose banks or BHCs have issued TruPS (or other similar debt instruments) should review their corporate structures to determine whether the applicable entity issuing the TruPS has satisfied the related criteria of the PBE definition and then discuss this situation with their auditing firms. Further, bankers should be mindful that the debt that is transferred by the BHC into the special purpose entity that issues the TruPS could have been bifurcated, with other portions owned and traded by third parties. In this situation, bankers should evaluate the markets, if any, on which the related debt is traded to determine whether they are considered to be public markets.

## Brokered Deposits

ABA has been asked whether brokered deposits should be considered, in substance, securities and whether such deposits would satisfy the PBE criterion that the company has securities whose transfer are not subject to contractual restriction. This concern stems from the fact that certain brokered deposit programs are registered products with the SEC and the broker often performs certain investment advisor services for its investors, including screening the creditworthiness of banks that hold the deposits. In some cases, the broker may maintain a secondary market for the investors.

Of course, customer deposits are not securities in themselves and fulfillment through deposit brokers, no matter how the brokered end-product is marketed to the public, does not change their legal status. We believe that any end-market product sold to investors has no impact on whether the deposit itself should be considered a security. If the deposit were to be considered a security merely because it is included in an investment program, then any cash account that is maintained

by a bank for an investment company or trust account could then be, in substance, considered a security. Such an interpretation seems highly unlikely.

Some contend that a brokered deposit program has qualities of investment securities.[5] It is true that screening the creditworthiness of CD issuers is an important service performed by some deposit brokers, and if there is a secondary market for such investments, then such programs (whether registered with the SEC or not) have traits that are similar to securities. However, the brokered deposit (or any deposit instrument that is sold to brokers, dealers, or underwriters) should be considered separate from the brokered deposit programs, which are issued and marketed by registered brokers and not the bank. Therefore, we believe in addition to not being a legal security, subject to the discussion below related to certain brokered certificates of deposit, the brokered deposit should not be considered a security for the purpose of determining whether a bank should be considered a PBE.

**Certificates of Deposit Issued by a Bank**

Some CDs may qualify as marketable securities, as defined within the Glossary within the ASC. In particular, some brokered CDs and negotiable CDs, which can be sold in a liquid secondary market, may be considered as debt securities that have no restriction on transfer. In our opinion, banks with outstanding brokered CDs, negotiable CDs, or any other deposit product that can be sold in a secondary market, should review the structure of these programs to determine whether Criterion 4 of the PBE definition is satisfied[6], and, thus, the bank is considered a PBE that does not qualify for private company accounting.

**Periodic Review Required**

While a company is not expected to move in and out of PBE status on a quarterly basis, ABA recommends periodic review to determine whether a bank qualifies as a PBE. Specifically, certain events should cause reconsideration of the PBE status:

1. Changes in governing documents or contractual arrangements with holders of its securities.
2. New products or the issuance of specific debt or equity securities or other products that could be considered securities.
3. New legal, regulatory, or registration requirements.

It is currently unclear in GAAP as to whether a newly-qualifying PBE bank should implement PBE accounting and disclosure requirements on a retrospective basis (restatement of prior year financial statement and disclosure amounts as though PBE accounting was applied), a modified

[5] Brokered certificates of deposit with FDIC are generally not considered securities under Federal securities law. However, the GAAP definition of security does not consider Federal securities law.

[6] As previously noted, the secondary market must be considered a public market for the issuing bank to be considered a PBE.

retrospective basis (beginning of the year adjustment to retained earnings, with no restatement of prior year amounts), or prospective basis (accounting and disclosures adjusted only in the current year and going forward, with no change to prior year amounts or beginning retained earnings). However, ABA recommends that non-PBE banks collect and maintain the data that enables PBE accounting and disclosure on a retrospective basis. That is, while it may eventually be determined that a change in accounting on a retrospective basis is not required, banks should be ready to address possible applicable questions by investors whose activity caused the change to PBE status.

**Appendix A: Applicable FFIEC Call Report Instructions Excerpt**[7]

The Master Glossary also explains that if an entity meets the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC, but not for other reporting purposes or for Call Report purposes.

If a bank or savings association does not meet any one of the first four criteria, it would need to consider whether it meets both of the conditions included in Criterion E to determine whether it would be a public business entity. With respect to the first condition under Criterion E, a stock institution must determine whether it has a class of securities not subject to contractual restrictions on transfer, which the FASB has stated means that the securities are not subject to management preapproval on resale. A contractual management preapproval requirement that lacks substance would raise questions about whether the stock institution meets this first condition.

If an institution is a wholly owned subsidiary of a holding company, an implicit contractual restriction on transfer is presumed to exist on the institution's common stock; therefore, if the institution has issued no other debt or equity securities, the institution would not meet the first condition of Criterion E. A mutual institution that has issued no debt securities also does not meet the first condition of Criterion E. In all other scenarios (e.g., a closely-held bank or a Subchapter S bank that is not a wholly owned subsidiary of a holding company), an institution should assess whether contractual restrictions on transfer exist on its securities based on its individual facts and circumstances.

With respect to the second condition under the Criterion E, an insured depository institution with $500 million or more in total assets as of the beginning of its fiscal year is required by Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC's regulations, "Annual Independent Audits and Reporting Requirements," to prepare and make publicly available audited annual U.S. GAAP financial statements. In certain circumstances, an insured depository institution with $500 million or more in total assets that is a subsidiary of a holding company may choose to satisfy this annual financial statement requirement at a holding company level rather than at the institution level. After further evaluation of this feature of the audit and reporting requirements and the ASU, the agencies have determined that an insured depository institution of this size that satisfies the financial statement requirement of Section 36 and Part 363 at either the institution level or the holding company level would meet the Criterion E's second condition.

[7] This was first included in the December 2015 supplemental call report instructions. Slight changes in wording were made to those instructions.

## Appendix B: Definition of a Security (Excerpt from FASB Accounting Standards Codification 320-10-20 Glossary)

### Debt Security

Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:

a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor
b. A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's statement of financial position
c. U.S. Treasury securities
d. U.S. government agency securities
e. Municipal securities
f. Corporate bonds
g. Convertible debt
h. Commercial paper
i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits
j. Interest-only and principal-only strips.

The term debt security excludes all of the following:

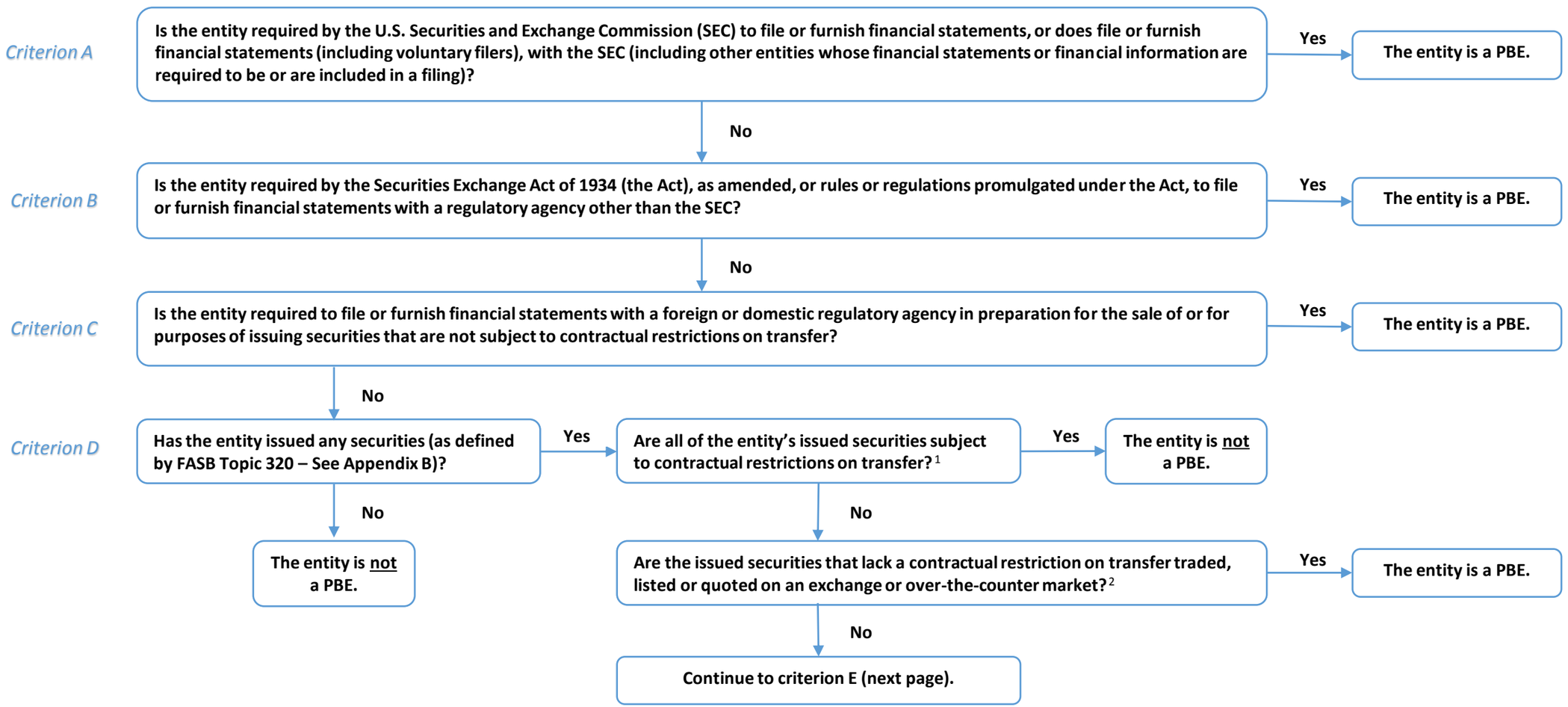
a. Option contracts
b. Financial futures contracts
c. Forward contracts
d. Lease contracts
e. Receivables that do not meet the definition of security and, so, are not debt securities (unless they have been securitized, in which case they would meet the definition of a security), for example:
    1. Trade accounts receivable arising from sales on credit by industrial or commercial entities
    2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions.

### Equity Security

Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

a. Written equity options (because they represent obligations of the writer, not investments)
b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
c. Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

# Appendix C: Public Business Entity Decision Tree for Financial Institutions

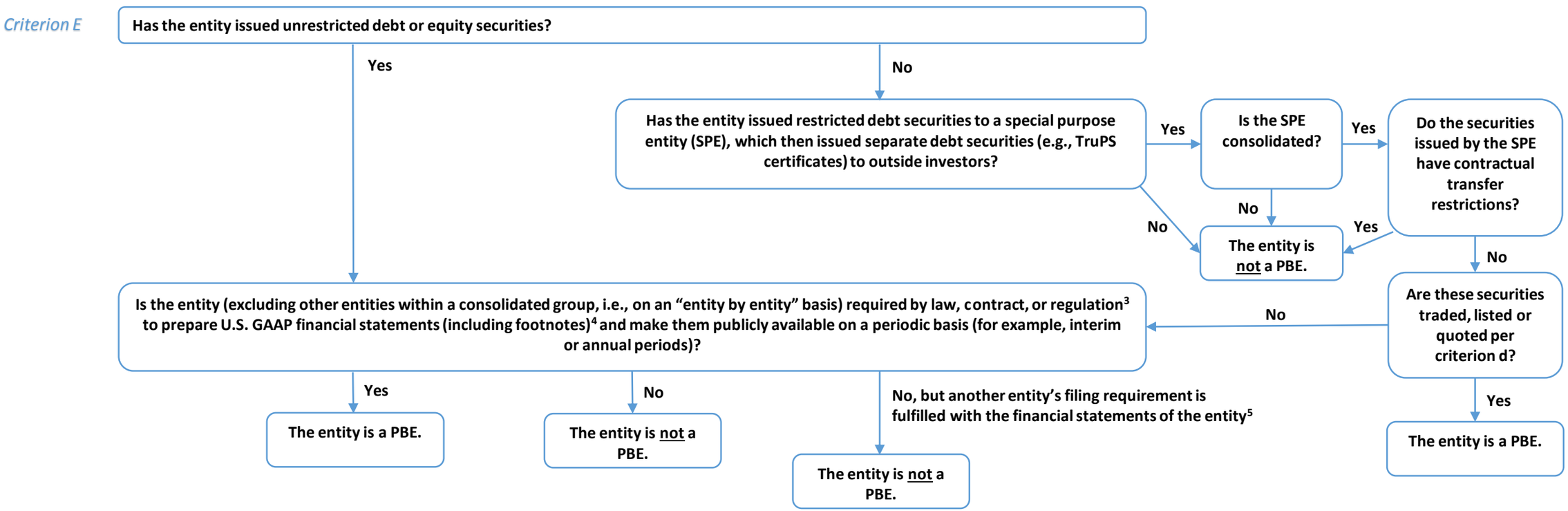



**Footnotes**

1 An example of a contractual restriction on transfer is a requirement for management preapproval on resale. S-corporations are one type of entity that commonly have contractual transfer restrictions on their shares; however, entities must ensure that restrictions are documented in company bylaws or other organizational documents, and are in effect on an ongoing basis. Another type of transfer restriction is where 100% of a bank's common equity shares are held by a bank holding company, in which case an implied transfer restriction exists. If the securities with an implied transfer restriction are the only securities issued by the entity then the answer to this question would be yes.

2 "Over-the-counter market" is intended to include *public* markets where information on trading, listing or quoting activity is made publicly available.

# Appendix C (Cont.): Public Business Entity Decision Tree for Financial Institutions




**Footnotes**

[3] Examples of regulations that may trigger this requirement for financial institutions are Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC's regulations, "Annual Independent Audits and Reporting Requirements". Per these regulations, banks with greater than $500 million in assets must file GAAP financial statements to the FDIC to make them available for public inspection.

[4] Reports of Condition and Income (call reports) that are required by the federal financial institution regulators are not considered U.S. GAAP financial statements for purposes of this definition because they, at a minimum, do not require compliance with all of the footnote requirements under U.S. GAAP.

[5] For example, a bank subsidiary is the entity with a filing requirement, but files the parent company's financial statements to fulfill the requirement.