

Discussion Paper

Financial Reporting by Private Enterprises

prepared by:
Accounting Standards Board

ACSB

Financial Reporting by Private Enterprises

DISCUSSION PAPER

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EXECUTIVE SUMMARY

The question of whether private enterprises should have accounting standards different from those developed for publicly accountable enterprises is not new. In the 1980s, several groups, both in Canada and the United States, considered this issue and decided that two sets of GAAP were not warranted. In the 1990s, however, the mood changed. The United Kingdom's Accounting Standards Board issued the "Financial Reporting Standard for Smaller Entities" (FRSSE), while Canada's Accounting Standards Board (AcSB) commissioned a research report to examine the financial reporting burden borne by small business enterprises. In 2002, the AcSB issued Section 1300, *Differential Reporting*. Then, in 2003, the International Accounting Standards Board (IASB) began developing an International Financial Reporting Standard for small and medium-sized entities (IFRS-SME), publishing an Exposure Draft in February 2007.

The AcSB's strategic plan, adopted in 2006, stated that it would pursue separate strategies for Canada's major categories of reporting entities: publicly accountable enterprises, private enterprises and not-for-profit organizations. It noted that:

"... one size does not necessarily fit all; it may not be possible to address the divergent needs of different categories of reporting entities properly within a single strategy. Each category deserves a strategy that specifically addresses the particular needs of the users of financial statements of entities in that category."

As has already been widely publicized, the AcSB concluded that the basis of reporting for publicly accountable enterprises should be International Financial Reporting Standards (IFRS).

AcSB indicated that, with respect to private companies, it would undertake, as a matter of urgency, a comprehensive examination of the needs of the users of private enterprise financial statements and to determine what financial reporting approach would best meet those needs. Owners and chief financial officers of private enterprises were surveyed to ascertain who they thought were the main users of their GAAP financial statements. More than two-thirds of the respondents identified lenders, particularly the Canadian banks, as the main group of external users. The other main group of users they identified was themselves – the owners and company management (i.e., internal users).

The AcSB consulted with a number of external users to identify their financial information needs and how GAAP financial statements help them meet those needs. The need for a separate set of accounting standards for private enterprises was an important component of those consultations. The AcSB received two key messages. First, at the lower end of the credit scale, lenders do not require GAAP financial statements. Second, external users did not specifically demand a separate set of standards for private enterprises. They were, however, generally aware of the problems their private enterprise clients had in the preparation of financial statements from both a cost and complexity standpoint, and were sympathetic to the development of a separate or modified set of accounting standards for such enterprises, provided this continued to meet their information needs.

The AcSB has now begun to consider what might be the most appropriate standard-setting approach for private enterprises.

The AcSB has decided that the conceptual framework should apply equally to both publicly accountable and private enterprises. The implications of that decision may, however, require further research.

A key issue is the type of enterprise that accounting standards are developed for. Many enterprises do not have any external users of GAAP financial statements. Since GAAP financial statements are intended for external users, the Discussion Paper suggests that one possibility might be the development of a simplified set of non-GAAP standards for the use of such enterprises.

The AcSB has identified three possible approaches for ensuring high-quality, general purpose GAAP financial statements for private enterprises:

- (a) A top-down approach based on standards for publicly accountable enterprises (i.e., IFRS). This approach would entail eliminating and modifying IFRS requirements much as is done under the current differential reporting model, although not necessarily with the same results.
- (b) An approach based on the IASB's proposed standard for small and medium sized entities — the IFRS-SME. This approach entails adopting the IFRS-SME, perhaps with some modification to address Canadian circumstances.
- (c) An independently developed set of Canadian accounting standards for private enterprises. This approach could involve, to a large degree, a fresh start, but it would share the same conceptual framework that underpins current GAAP and IFRS. The sources for the development of such standards have yet to be determined.

This Discussion Paper identifies the pros and cons of each of these approaches.

Once it has decided on the appropriate strategy, the AcSB will proceed with developing accounting standards for private enterprises. Before finalizing such standards, drafts will be exposed for public comment.

The AcSB also wants input on the importance of GAAP financial statements to minority shareholders who are not private equity or venture capital investors, relatives of the owners or employees of a private enterprise. For various reasons, it seems that such shareholders do not frequently use financial statements, but the AcSB is trying to confirm whether this is, in fact, the case.

INTRODUCTION

- 1 This Discussion Paper analyzes issues the Accounting Standards Board (AcSB) is considering in its strategic review of financial reporting by private enterprises.¹ The topic is not new. It has been of interest and concern for more than a quarter of a century. Appendix A provides an overview of the history of this issue.
- 2 The number and complexity of accounting standards have increased significantly over the past 25 years. To some extent, this is unavoidable, due in part to the increasing complexity of business and increasing demands of the capital markets for transparent financial information. Complex accounting standards are sometimes necessary to achieve a fair presentation of the transactions and events that businesses become involved with.
- 3 All this has placed increasing demands on the accounting profession. Important changes in assurance standards (for example, on quality control and audit risk) and independence rules have also added to those demands. Assurance standards apply to the performance of all assurance engagements, regardless of the nature and size of the entity involved. Yet, as is the case for accounting standards, there has been a perception that auditing standards are designed primarily for larger enterprises.
- 4 The new independence rules the professional accountancy bodies issued in 2003 and 2004 can impose special difficulties for small and medium sized private enterprises. Those rules significantly restrict the range of accounting and financial advice that public accountants can give their audit and review clients, in particular, preparing their clients' financial statements on their behalf. Because many private enterprises have only limited accounting and financial expertise, they are likely to view their public accountant as an accounting and financial advisor. Rather than incur the increasing costs of engaging other qualified personnel to prepare their financial statements, many private businesses have chosen to abandon audit and review engagements, particularly if external users are prepared to accept a lower level of assurance.
- 5 Concerns are, therefore, not related solely to accounting standards and their increasing complexity.
- 6 In January 2006, the AcSB decided to examine the needs of users of private enterprise financial statements and then to determine the most appropriate financial reporting approach to meet those needs. The AcSB intends the result of the strategy review to be enduring; it seeks an approach that will guide the development of accounting standards for this sector in future. Issues considered include:
 - the information needs of the users of private enterprise financial statements;

¹ For consistency, the term “private enterprise” has been used throughout the Invitation to Comment and Discussion Paper. For this purpose, it is a synonym for “private company,” “private business,” “non-publicly accountable enterprise” and any similar term.

- whether those information needs justify accounting standards different from those for publicly accountable enterprises;
- whether a common conceptual framework should be the basis for developing accounting standards for both publicly accountable and private enterprises;
- the basis for private enterprise accounting standards;
- whether private enterprise standards should apply to all private enterprises; and
- whether accounting standards generally relevant to private enterprises should be linked to those for publicly accountable enterprises.

To assist respondents in forming their views, the AcSB has identified three possible approaches to developing accounting standards for private enterprises. These approaches and related issues are discussed in the sections that follow.

DIFFERENTIAL REPORTING

- 7 Canadian GAAP currently allows for differences in accounting treatment for private enterprises in the form of differential reporting. Differential reporting has been a part of Canadian GAAP since 2002 and will continue to be so until the results of this strategy review have been implemented. The differential reporting model uses the cost-benefit constraint in the conceptual framework (Section 1000, *Financial Statement Concepts*) to justify differences in accounting treatments. Differential treatments are in the form of options — qualifying enterprises may choose the available different treatments. To be eligible for differential reporting, an enterprise must be non-publicly accountable and obtain the unanimous consent of its owners. Appendix B discusses differential reporting further, including feedback the AcSB has received on experience gained from its application in practice.

ARE ACCOUNTING STANDARDS NEEDED FOR PRIVATE ENTERPRISES?

- 8 The initial question considered by the AcSB was whether there was any need for standards for private enterprises. The 2005 Invitation to Comment on a draft of the AcSB's Strategic Plan² solicited views on this fundamental issue. Respondents strongly supported the proposition that accounting standards have an important role to play in financial reporting by private enterprises.
- 9 Many financial statement users have clearly stated that there is a definite need for high-quality accounting standards to produce general purpose financial statements for private enterprises. Some users who rely on financial statements prefer GAAP, since it allows assurance to be provided on the statements and also provides high-quality information on a

² *Accounting Standards in Canada: Future Directions — Draft Strategic Plan* (Toronto: Accounting Standards Board, March 2005).

consistent, comparable basis. Further, the Canada Business Corporations Act and Regulations and the corresponding legislation of most of the provinces and territories require that financial statements be prepared in accordance with Canadian GAAP.³ GAAP is, however, developed independently of the legislative, regulatory and other requirements of particular jurisdictions.

- 10 There seems to be general agreement, both in Canada and internationally, that some differences from the accounting standards followed by publicly accountable enterprises are justified for private enterprises.
- 11 The AcSB has concluded that private enterprises issuing general purpose GAAP financial statements for their external users should follow a prescribed set of accounting standards.

WHICH PRIVATE ENTERPRISES ARE INCLUDED?

- 12 The objective is to develop a GAAP standard for all private enterprises having significant external users. The AcSB believes that the exclusion of enterprises based on a size test is not appropriate.

Significant external users

- 13 Section 1000, *Financial Statement Concepts*, says that GAAP applies to general purpose financial statements that meet the common information needs of a range of external users. Many enterprises do not have significant external users of their financial statements and therefore GAAP is not intended to apply to them. Such enterprises may, if they wish, apply either the standards applicable to private enterprises with external users or the standards applicable to publicly accountable enterprises.

GAAP and external users

- 14 Paragraph 1000.01 notes that GAAP is designed for external users of financial information:
“Such financial statements are designed to meet the common information needs of external users of financial information about an entity. ...”

Further, paragraph 1000.09 states:

“Ownership of profit-oriented enterprises is often segregated from management, creating a need for external communication of economic information about the entity to investors. For the purposes of this Section, investors include present and potential debt and equity investors and their advisers. Creditors and others who do not have

³ “Canadian Business Corporations Regulations,” 2001, section 71. The definition in section 70 states that Canadian GAAP means generally accepted accounting principles as set out in the Handbook of the Canadian Institute of Chartered Accountants, as amended from time to time. While this, and other legislation, requires GAAP as a basis of accounting, the AcSB is aware that many (perhaps most) enterprises do not follow GAAP.

internal access to entity information also need external reports to obtain the information they require....”

- 15 This is consistent with IFRS. Paragraph 6 of the IASB Framework notes that GAAP is intended for external users who rely on financial statements as their major source of financial information.
- 16 Paragraph 1000.12 reflects this as follows:

“Investors and creditors of profit-oriented enterprises are interested, for the purpose of making resource allocation decisions, in predicting the ability of the entity to earn income and generate cash flows in the future to meet its obligations and to generate a return on investment.”
- 17 The research conducted during the course of the private enterprise strategy (see Appendix E) examined how external users use financial statements. The following summarizes the research results, which support the classification of certain users as not being “significant external users.”
- 18 An enterprise’s managers, including owner-managers, are not external users. They can obtain any information they desire. While some managers find GAAP financial statements useful, as they provide a confirmatory function, they do not need to rely on GAAP financial statements as a major source of financial information. Clearly, management is an internal user.
- 19 Taxation authorities are not external users either. Taxation authorities have the power to obtain any information they wish. Current Canadian tax legislation does not base taxable income on GAAP net income, but rather looks to profit, which the courts view as not being determined by GAAP. Taxation authorities accept GAAP income as a starting point in determining taxable income but, in practice, many adjustments are made to it. Taxation authorities also accept income as reported in non-GAAP financial statements as a starting point in determining taxable income.
- 20 Creditors are not always significant external users of private enterprise financial statements. The 1999 research report, *Financial Reporting by Small Business Enterprises*,⁴ noted that, at that time, creditors lending amounts of \$100,000 or less generally did not rely on financial statements for capital allocation decisions. More recent research (see Appendix E) found that this continues to be true. Currently, private enterprises can often borrow at lower levels (generally varying from up to \$100,000 to up to \$250,000, with one institution using a maximum threshold of \$500,000) on the basis of credit scores and personal guarantees. One financial institution indicated that it is considering increasing its threshold for requiring GAAP financial statements to loans of more than \$2 million. Creditors at lower levels are making lending decisions based on a portfolio risk approach, and have no need for GAAP financial statements.

⁴ *Financial Reporting by Small Business Enterprises* (Toronto, CICA, 1999), chapter 3, paragraph 12

- 21 Although financial statements were considered useful even at the lower lending levels, this comment was virtually always made in the context of non-GAAP financial statements, typically those including a “Notice to Reader” report by a public accountant. GAAP financial statements are generally not required until a loan’s dollar amount exceeds the above-noted thresholds.
- 22 Some have characterized the lender acceptance of non-GAAP financial statements as a pricing issue rather than a standards issue. While some bankers noted that they would reduce the cost of capital if the financial statements were prepared in accordance with GAAP and assurance was provided by a public accountant, this would not seem practicable at lower lending levels. The cost of obtaining assurance would exceed the potential reduction in the cost of capital. This situation might argue for the establishment of a non-GAAP basis of accounting for smaller enterprises. Creditor acceptance of non-GAAP financial statements also appears to be a risk assessment process that takes into account collateral pledged and other factors beyond the financial statements in making the decision to extend credit.
- 23 There are approximately 2.2 million private enterprises in Canada. If creditors who do not rely on GAAP financial statements are not considered to be significant external users, many enterprises would have no significant external users. The Survey of Suppliers of Business Financing⁵ shows that approximately 1.7 million enterprises (86% of total SMEs) borrowed less than \$250,000.

A non-GAAP solution

- 24 As noted above, it appears that many enterprises have no significant external users and GAAP is therefore not intended to apply to them⁶. There may be a case for developing non-GAAP standards or guidance designed for these enterprises. Such a system could share some of the basic requirements of GAAP financial reporting — for example the definitions of assets, liabilities, revenues and expenses — but expressed in a basic fashion. Such an initiative appears to be supported by some who are dissatisfied with non-standardized aspects of current non-GAAP financial statements.
- 25 A non-GAAP solution opens up a wide range of possibilities. A tax basis of accounting, a modified cash basis of accounting, a less complex version of GAAP —all are possible under such an initiative. The United Nations Conference on Trade and Development (UNCTAD) has issued guidance for such enterprises. The approach proposed is “a simple accruals-based accounting, based on that set out in international accounting standards, but closely linked to

⁵ SME Financing Data Initiative, www.sme-fdi.ic.gc.ca.

⁶ Such enterprises are sometimes referred to as ‘micros’. The AcSB does not believe that this term is appropriate in the context of this discussion paper, since it implies enterprises that are small in size. Enterprises without significant external users can be of any size.

cash transactions.”⁷ Other countries have established simpler SME standards. Examples of these include:

- The Eastern, Central and Southern African Federation of Accountants “Guidance on Financial Reporting for Small and Medium Sized Entities” (see www.ecsa.org);
- The Hong Kong Institute of Certified Public Accountants “Small and Medium-sized Entity Financial Reporting Standards” (see www.hkicpa.org.hk); and
- The Institute of Chartered Accountants of Pakistan “Draft Accounting and Financial Reporting Standard for Small-Sized Entities” (see www.icap.org.pk).

26 Non-GAAP standards or guidance could be developed by either the AcSB or another body, in which case the AcSB would support such an initiative.

Size tests

27 Some jurisdictions use a size test to stipulate who is eligible to use different standards. Those who favor a size test believe that quantitative criteria are a good surrogate for assessing the cost-benefit trade-off. The AcSB examined this issue in detail prior to implementing Section 1300, *Differential Reporting*. A number of practical difficulties are associated with defining “big” and “small” enterprises (for example, defining arbitrary cut-off levels, periodic updating and the risk of enterprises resorting to “threshold management” to qualify). For the following reasons, the AcSB decided not to adopt a size test:

- Regardless of their size, all private enterprises share a common feature that distinguishes them from publicly accountable enterprises: a lack of public accountability.
- Some argue that the financial health and performance of large private enterprises are of such importance to society that their financial statements should be prepared on the same basis as publicly accountable enterprises. This does not appear to be a public policy issue in Canada. The size of a private enterprise is not a factor in any requirement to make its financial statements publicly available.
- Any private enterprise would have the option of reporting using IFRS and it is expected that many large private enterprises will choose to do so because their peer group includes public companies or they may aspire to become a public company at some point.

THE CONCEPTUAL FRAMEWORK

28 The AcSB has tentatively concluded that a common conceptual framework should be applied to private and publicly accountable enterprises. This is a key decision and has far-reaching implications. This decision does not rule out differences in accounting standards between private and publicly accountable enterprises; while they will share a common framework, it may be applied differently for private enterprises.

⁷ *Accounting and Financial Reporting Guidelines for Small and Medium-Sized Enterprises (SMEGA), Level 3 Guidance* (New York and Geneva: UNCTAD, 2003). Preface, pp. 4 and 5.

- 29 When this Discussion Paper refers to “the conceptual framework”, it is referring to the IASB’s Framework for the Preparation and Presentation of Financial Statements as set out in IFRS. Section 1000, *Financial Statement Concepts*, has essentially the same objective and is considered to be consistent with the IASB Framework in all material respects. The conceptual framework, and in particular its application, are not static. The IASB and FASB currently have a joint project underway, supported and monitored by the AcSB, which seeks to improve and converge the conceptual frameworks of those two organizations. Paragraphs 30-44 set out the key aspects of the framework, in the context of the private enterprise strategy. Appendix C contains a more detailed analysis of the framework and the AcSB’s decision that a common framework should apply to private and publicly accountable enterprises.

Objective

- 30 The conceptual framework states that the objective of GAAP financial statements is to provide information useful to a wide range of external users in making economic decisions. It notes that such economic decisions include assessing the stewardship of management, the accountability of management for the resources entrusted to it, and deciding whether to reappoint or replace management.⁸ The research to identify the users of private enterprise financial statements and their needs, as set out in Appendix E, supports the AcSB’s conclusion that the objective of financial statements is the same for all enterprises, regardless of public accountability.

Basic definitions

- 31 The definitions of assets, liabilities, income and expenses, as set out in the conceptual framework, are based on current and future economic benefits that may flow to and from an entity in various ways.⁹ The research on user needs supports the AcSB view that these definitions apply equally to public and private enterprises. Users agreed virtually unanimously that having different definitions of assets, liabilities, revenue and expenses is unwarranted and would be unworkable.

Recognition

- 32 The conceptual framework establishes general criteria for recognizing assets and liabilities (namely, the probability that any future economic benefit associated with an item will flow to or from an entity, and the item has a cost or value that can be measured with reliability).¹⁰ Those criteria apply equally to private and publicly accountable enterprises. This does not preclude recognition differences in developing a set of standards for private enterprises.

⁸ IASB Framework, paragraphs 12 and 14 (cf. *Financial Statement Concepts*, paragraph 1000.15).

⁹ IASB Framework, paragraphs 53-64 and 74-80 (cf. *Financial Statement Concepts*, paragraphs 1000.29-.34 and 1000.37-.38).

¹⁰ IASB Framework, paragraphs 82-88 (cf. *Financial Statement Concepts*, paragraphs 1000.41-.52).

Differential reporting currently includes recognition differences based on cost-benefit considerations.

Measurement

- 33 The conceptual framework describes measurement as “the process of determining the monetary amounts at which the elements of financial statements are recognized and carried in the balance sheet.”¹¹ It sets out a number of different measurement bases employed “to different degrees and in varying combinations” in the financial statements, and notes “historical cost” as the one most commonly adopted. It does not specify when the different basis of measurement should be applied.
- 34 Measurement has undergone considerable change since the various conceptual frameworks were issued in the 1980s. For example, accounting standards for financial instruments now require greater use of fair value measurements. Increased use of fair value as a measurement basis is an issue of some concern to both preparers and users of private enterprise financial statements. It is, however, an “application” issue rather than a “framework” issue, since the framework does not prescribe which measurement basis should be adopted. A number of the differential reporting options permitted under current Canadian GAAP allow differences in respect of measurement.

Benefit versus cost

- 35 The conceptual framework notes that the benefits derived from information should exceed the costs of providing it. It also notes that the evaluation of benefits and costs is a judgmental process, and that the costs are not necessarily incurred by the users who enjoy the benefits.¹² Although the cost-benefit constraint applies to reporting by all enterprises, some feel that it affects private enterprises differently than publicly accountable enterprises. The concern relates more to the costs than the benefits. It is generally acknowledged that the work effort and costs of complying with certain accounting standards is proportionately more burdensome, and may be somewhat overwhelming, for private enterprises. Further, fewer users are likely to reap the benefits of the information produced than is the case for publicly accountable enterprises.
- 36 The AcSB’s experience with differential reporting demonstrates that applying the cost-benefit constraint to the particular circumstances of private enterprises can result in different accounting.

Relevance

- 37 The conceptual framework indicates that:

¹¹ IASB Framework, paragraph 99 (cf. *Financial Statement Concepts*, paragraph 1000.53, which states that “measurement is the process of determining the amount at which an item is recognized in the financial statements”).

¹² IASB Framework, paragraph 44 (cf. *Financial Statement Concepts*, paragraph 1000.16).

“to be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.”¹³

- 38 Some question whether all of the information accounting standards require is relevant to external users of private enterprise financial statements. According to the conceptual framework, relevance has both confirmatory and predictive aspects, which are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavor to predict the ability of the entity to take advantage of opportunities and its ability to react to adverse situations.
- 39 Some maintain that certain items, such as goodwill and future income taxes unlikely to reverse in the foreseeable future, are not relevant to users of private enterprise financial statements. These items do not have any predictive value and do not play a confirmatory role for past evaluations, given the way financial statements are typically used. External users will often ignore such items.
- 40 The AcSB has noted that preparers and users of publicly accountable enterprise financial statements have expressed similar concerns about the relevance of certain financial statement items. While recognizing that individual users will have to assess the relevance of a particular financial statement item in terms of their particular circumstances, relevance to users in general is an issue that is assessed in developing individual accounting standards.
- 41 The conceptual framework does not state what is relevant. Standard setters determine relevance when applying the conceptual framework to specific issues. Relevance is related to decision-usefulness. If information is relevant to the users of publicly accountable enterprise financial statements, but not the users of private enterprise financial statements, application of the relevance characteristic may result in different accounting standards.

Matching

- 42 The conceptual framework notes that expenses are recognized in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events. The application of the matching concept does not, however, allow the recognition in the balance sheet of items that do not meet the definition of assets or liabilities.¹⁴ The AcSB believes that this prohibition applies equally to private and publicly accountable enterprises.

¹³ IASB Framework, paragraph 26 (cf. *Financial Statement Concepts*, paragraph 1000.20).

¹⁴ See IASB Framework, paragraph 95. Although *Financial Statement Concepts*, paragraph 1000.51, currently allows for matching, the AcSB, subject to comments received, is currently proposing to delete this paragraph.

Implications of having the same framework

43 Each of the alternatives considered in this Discussion Paper assumes that the same conceptual framework would apply to the development of accounting standards for both private and publicly accountable enterprises. Sharing the same framework does mean that certain suggestions for modifying current standards could not be accommodated. The following is a list of modifications that do not appear to be possible if the same conceptual framework were to be shared. This list is not intended to be exhaustive and has been prepared for illustrative purposes only:

- Using a cash basis of accounting. Several constituents have suggested that standards for private enterprises should be based on a cash basis of accounting. As noted in *Financial Statement Concepts*, paragraph 1000.46, the conceptual framework is based on accrual accounting.
- Non-recognition of stock based compensation under any circumstances. Never recognizing stock based compensation, particularly when the award is cash-settled, would be inconsistent with the definition of an expense.
- Treating defined benefit pension plans as defined contribution plans. The difference in the accounting for these two types of plans reflects the significant differences in their economic characteristics. Treating defined benefit plans as if they were defined contribution plans would be overly simplistic to the point of obscuring the true nature of the plan itself.
- Treating all leases as if they were operating leases. There is widespread agreement that the accounting model for leases requires fundamental revision. The FASB and IASB have launched a project on lease accounting. The results of this project would presumably apply equally to publicly accountable and private enterprises. Treating all leases as operating leases violates the conceptual framework in the same fashion as treating all defined benefit pension plans as defined contribution plans.

As illustrated in the above discussion, however, the conceptual framework has a considerable amount of flexibility in terms of its application.

44 The AcSB believes that there should be only one conceptual framework. The framework is flexible enough to address the circumstances of private enterprises separately from those of publicly accountable enterprises by focusing on the needs of external users and what is relevant to them.

FINANCIAL STATEMENT USERS AND USER NEEDS

45 In its draft strategic plan issued in March 2005, the AcSB indicated that it would “undertake a comprehensive examination of the needs of [private] business’ financial statements and then determine the most appropriate reporting model to meet those needs.” A project to implement this examination was launched in November 2005.

Identification of users

- 46 In November and December 2005, owner-managers and CFOs of private enterprises were surveyed to determine whom they regard to be the significant users of their financial statements. A summary of the survey results is set out in Appendix D. In addition, the accounting literature on this issue was reviewed. Both the survey results and the literature review indicated the primary users of private enterprise financial statements are (i) bankers and other lenders and (ii) owners and managers.

Financial information needs of users

- 47 Users of private enterprise financial statements were consulted in the first eight months of 2006. A staff report on these discussions, presented to the AcSB in September 2006, is set out in Appendix E. The AcSB agreed that further consultations were unlikely to elicit significantly different views than those already obtained.
- 48 As noted in paragraph E1 of Appendix E, discussions with various constituents confirmed that bankers and other lenders are the primary external users of private enterprise financial statements. Representatives from Canadian banks, credit unions, venture capital and private equity companies (which, usually, are also equity investors in their private enterprise clients), leasing companies, and bonding/surety companies, all of which, in varying degrees, perform a lending function for their clients, were consulted.
- 49 Based on the discussions with users, there is no specific demand for a separate set of accounting standards for private enterprises. Users generally prefer a single set of accounting standards for all enterprises. Many of those consulted indicated, however, that they adjust or ignore some items in GAAP financial statements to meet their specific needs, but consider this to be entirely within their prerogative as users of the financial statements. They were also generally aware of the problems private enterprises had in the preparation of their GAAP financial statements in accordance with current accounting standards, from both a cost and complexity perspective. Based on these factors, many external users appeared to be sympathetic to a separate or modified set of accounting standards for private enterprises, provided this continued to meet their information needs.
- 50 Consultations also included discussions with owners and management (primarily CFOs or their equivalent) of private enterprises and their advisers (public accountants), both to obtain their perspective as preparers of financial statements and to learn how useful they think their financial statements are to external users. The owners and managers attributed varying degrees of utility to their own GAAP financial statements. They generally considered those statements to be of little help in running their businesses, but some noted that the GAAP financial statements were confirmatory, that they provided the structure for internal financial statements and that they were the “final report card.” The owners and managers had mixed views on the usefulness of their GAAP financial statements to external users. Their main concern was the increasing cost of producing the statements. Many of them also felt that some of the information that now has to be included in their GAAP financial statements is redundant, not only from their perspective, but also from that of their external users, particularly their bankers.

- 51 Despite extensive efforts, it was possible to have only limited discussions with minority shareholders who are independent of company owners and management and are not private equity and venture capital investors. It appears that such minority shareholders are uncommon in the private enterprise sector, possibly due to the lack of marketability of their shares. The few independent minority shareholders consulted indicated that GAAP financial statements are very important to them.
- 52 Taking into consideration the views expressed during the consultation process, the AcSB concluded that there is sufficient justification to proceed with its investigation of which reporting approach might best satisfy the financial information needs of the various users of GAAP financial statements of private enterprises.

POSSIBLE APPROACHES FOR DEVELOPING ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES

- 53 There are two types of approaches that can be adopted in developing accounting standards for private enterprises.
- A stand-alone approach. All of the relevant accounting requirements are contained in a single document. Material that is irrelevant or seldom applicable is excluded. References to other documents are avoided or, at least, minimized.
 - A top-down approach, similar to differential reporting. In this Discussion Paper, the term “differential” applies to requirements specifically for private enterprises that modify the general standards in certain narrowly circumscribed respects, but which have to be interpreted and applied in the context of those general standards. This is also how the term is used in Section 1300, *Differential Reporting*, but any future criteria developed for a differential reporting approach might result in differential treatments quite different from those currently permitted by Section 1300.
- 54 Some consider that a substantial reduction in the volume and complexity of accounting requirements is an important objective of a stand-alone approach. This objective can be achieved by condensing and simplifying the standards applicable to publicly accountable enterprises.
- 55 In view of the AcSB’s decision to adopt IFRS for publicly accountable enterprises, a further issue is whether private enterprise standards should in some way be linked to IFRS. The IFRS-SME is linked to IFRS in that it is derived directly from the full set of IFRS. The current Canadian differential reporting approach is another example of an approach linked to the set of standards applied by publicly accountable enterprises, albeit in a stronger fashion than the IFRS-SME.
- 56 The arguments for such a linkage include the following:
- Some users and user groups are proponents of consistency and comparability between private enterprises and publicly accountable enterprises.

- Preparers, users, auditors, advisers and others would have to become familiar with only one basic system rather than two.
- Education and training costs would be less with just one system.
- Many private enterprises have international transactions and connections; consequently, some degree of compatibility with IFRS would be desirable.
- The ongoing maintenance of the standards will be the responsibility of the IASB. Canadian involvement would be limited to reviewing and commenting on any proposed changes.
- It would minimize differences between standards applied by publicly accountable enterprises and those by private enterprises

57 The arguments against linkage include the following:

- IFRS may not reflect Canadian circumstances, so there would be no reason to link to them.
- Canadian standard setters would lose control over accounting standard setting, at least to some degree. While this may be justifiable for publicly accountable enterprises because they deal with global capital markets, this is not necessarily the case for private enterprises.
- Comparability with enterprises in other countries, with the possible exception of the United States, may not matter to many Canadian private enterprises.

Although some of the arguments against linkage might not stand up under an approach that modifies IFRS or the proposed IFRS-SME to suit Canadian circumstances, they may not be overcome completely.

58 With these considerations in mind, the AcSB identified three approaches that it feels merit further consideration as the basis for GAAP financial reporting by private enterprises:

- (a) A top-down approach based on standards for publicly accountable enterprises (i.e., IFRS).
- (b) A stand-alone approach based on the IASB's proposed IFRS-SME.
- (c) An independently developed set of Canadian standards, based on various sources, including, but not necessarily restricted to, IFRS and Canadian accounting standards.

TOP-DOWN APPROACH BASED ON IFRS

59 This approach would start with public company GAAP (i.e., IFRS) and embed within it certain different treatments available only to private enterprises. This approach is similar to the differential reporting model that is currently a part of Canadian GAAP.

60 The US Financial Accounting Standards Board (FASB) recently set up a committee to make recommendations on whether there should be differences in accounting standards for private enterprises. It appears that this committee is contemplating a top-down or differential approach.

61 Readers are asked to assess the differential reporting approach based on IFRS with an open mind, setting aside their opinion of the current Canadian differential reporting model and without focusing on any specific private enterprise modifications to IFRS. Such an approach opens up all aspects of the current differential model for debate. A differential approach based on IFRS could differ from the current differential reporting model quite significantly in its specific features.

Pros and cons

62 Supporters of a top-down approach based on IFRS maintain that:

- It is logically consistent with the AcSB decision to adopt IFRS for publicly accountable enterprises, in that it simply applies an approach already established under Canadian GAAP to IFRS.
- “The credibility of the GAAP financial statements is maintained and the confusion that could be created by two sets of standards is avoided. Many SBE financial statement users have a limited understanding of accounting rules and could have trouble distinguishing one set of GAAP from another.”¹⁵
- It would reduce the risk of different interpretations of standards that apply equally to publicly accountable and private enterprises, since the wording will not change and there will be no condensation or simplification of such standards.
- The particular needs and circumstances of private enterprises would be accommodated within a single set of accounting standards, enhancing consistency and comparability between private and publicly accountable enterprises.
- Very few circumstances would merit differences from standards for publicly accountable enterprises, hence no need for a major restructuring or recreation of GAAP. A differential approach would be the most efficient method of addressing private enterprise financial reporting needs in these circumstances.
- The standard-setting infrastructure and resources required in Canada would be reduced because the IASB will be responsible for the ongoing maintenance of the IFRS.
- Some private enterprises have international transactions and connections; consequently, some degree of compatibility with IFRS would be desirable.
- It could significantly reduce additional training and education costs and, stakeholders would benefit from the knowledge and experience gained from our current system of differential reporting, as well as from the knowledge and experience gained in applying IFRS to publicly accountable enterprises.

63 Those who do not consider this approach to be appropriate maintain that:

¹⁵ *Financial Reporting by Small Business Enterprises*, Chapter 5, paragraph 27.

- It would not deal with concerns about accounting standards overload. Current IFRS may cover topics or options that are not relevant to many private enterprise constituents. IFRS also have to cover issues relevant to other countries that are not necessarily relevant to Canada. Further, the considerable amount of explanatory information and guidance accompanying IFRS often deals with complexities that most private enterprises never encounter. The volume of current accounting standards is already intimidating for many private enterprise constituents, and would not be reduced under this approach.
- Differential reporting puts a burden on private enterprises to justify different standards from those applicable to publicly accountable enterprises. Experience with the current differential reporting model indicates that it can be difficult to justify differences. The proposed IFRS-SME is further evidence that a stand-alone approach is likely to result in standards that are more appropriately tailored to the particular needs of private enterprises.
- It would require those involved only with private enterprise financial statements to familiarize themselves with the full IFRS just to put differential reporting items into context.
- Canadian accounting standard setters would lose control over standard-setting decisions, at least to a large degree. While this may be justifiable for publicly accountable enterprises because they operate in the global capital markets, this is not necessarily the case for private enterprises.

64 An important decision if a differential approach were to be applied to IFRS is whether each differential treatment should be elected individually, as is presently the case under Section 1300, *Differential Reporting*, (“mix-and-match”), or whether an enterprise using differential reporting should apply all of the differential treatments available (“all-or-nothing”).

65 The advantage of choosing differential options individually is that it enables private enterprises to decide whether a permitted option or the pertinent basic standard best meets the needs of their external users. For example, some external users of private enterprise financial statements find non-consolidated financial statements to be more useful whereas others prefer consolidated financial statements. Also, a mix-and-match approach allows private enterprises to apply only the options that best reflect their particular circumstances, minimizing the extent of differences from full IFRS for publicly accountable enterprises.

66 On the other hand, financial statement users have expressed some concern about the flexible aspect of differential reporting. They note that this characteristic hampers comparability, not only with publicly accountable enterprises but also among private enterprises.

STAND-ALONE APPROACH BASED ON IFRS-SME¹⁶

The proposed IFRS-SME

- 67 In 2003, the IASB began its project on accounting standards for small and medium-sized entities (SMEs). In deciding on the content of the IFRS-SME, the IASB's focus was on a typical SME with about 50 employees. The IFRS-SME does not include a quantified size test; it is up to each jurisdiction to decide which entities are eligible to use the standard. They must, however, be non-publicly accountable (as defined by the IASB) if their financial statements are to be described as being in accordance with the IFRS-SME. The IASB published an Exposure Draft of the IFRS-SME in February 2007, for comment by October 1, 2007. The IASB has also published a Basis for Conclusions on the IFRS-SME that, among other things, sets out the IASB's rationale for accepting certain differences and rejecting others. The IFRS-SME and the Basis for Conclusions can be found at www.iasb.org.
- 68 The following briefly summarizes the IASB's approach in developing the proposed standard.
- Physically, it is a stand-alone document intended to contain, as much as possible, all the accounting standards an SME will normally require.
 - Concepts and pervasive principles that are consistent with those included in the *IASB Framework for the Preparation and Presentation of Financial Statements* are included.
 - Material deemed irrelevant to a typical SME has been omitted. Cross-references to the related IFRS are included for omitted material in the event it is required.
 - All IFRS accounting policy options are also available to SMEs; only the ones private enterprises are most likely to follow, however, are included in the proposed standard (for example, it includes the following accounting methods: expense all borrowing costs as incurred and use the indirect method for operating cash flows in the cash flow statement); the other options are incorporated by a cross reference to the related IFRS.
 - Several recognition and measurement simplifications are included (for example, for financial instruments, there are two classifications rather than four, and the "continuing involvement approach" for de-recognition has been dropped; for hedge accounting, a short cut and more simplified approach has been adopted; for goodwill, a full impairment review is required only if there is an indication of impairment; for research and development, all such costs are to be expensed as incurred; for investments in associates and joint ventures, the cost method is permitted; for agriculture, the fair value requirements are reduced (only if "readily available"); for first-time adoption, less prior data is required).

¹⁶ "International Financial Reporting Standard for SMEs," Exposure Draft (New York: IASB, February 2007); <http://www.iasb.org/Current+Projects/IASB+Projects/Small+and+Medium-sized+Entities/Small+and+Medium-sized+Entities.htm>.

- A GAAP hierarchy is included. When an accounting issue is not covered, the SME must try and find answers in the IFRS-SME by analogy and by using the concepts and pervasive principles included in the IFRS-SME standard.
- SMEs may look to full IFRS as a safety net if an answer cannot be found otherwise, but this is not mandatory.
- The IASB is planning to update the standard every two years.

The project is now at the exposure draft stage. The Exposure Draft proposals could undergo significant change as a result of exposure. The IASB currently expects to issue a final standard in 2008.

Why not adopt the IFRS-SME without alteration?

- 69 In light of the AcSB’s decision to adopt IFRS for publicly accountable enterprises, it is logical to consider also adopting the IFRS-SME. A preliminary review of a draft of the IASB exposure draft, and views expressed by Canadian stakeholders in the deliberation of the various differential options permitted under Section 1300, *Differential Reporting*, have led the AcSB to tentatively conclude that the positions taken on some important technical issues in the proposed IFRS-SME are unlikely to find general acceptance in Canada, such as the treatment of “high-low” redeemable preference shares issued in tax planning arrangements.
- 70 The adaptation process would likely trigger some reassessment of the appropriateness of current differential reporting options, perhaps introducing additional differences. Until now, relatively few instances justifying differential reporting options have been identified, and this is unlikely to change unless new arguments justify broadening the evaluation process for assessing a potential differential reporting option.¹⁷ It is also possible, of course, that the final Canadian standard, after respondents have commented on specific technical issues, will not differ materially from the IFRS-SME.

Pros and cons

- 71 Many of the pros and cons of this approach are similar to those discussed for the top-down approach. Supporters cite the following advantages:
- To the extent that differences are warranted, this approach would focus on issues pertinent to most private enterprises.
 - It would force standard setters to look at the various accounting issues in a private enterprise context.
 - Those responsible for preparing the financial statements, as well as external users and practitioners who have no public company clients, would need to deal only with

¹⁷ See CICA Handbook – Accounting Section 1300, “Differential Reporting, Background Information and Basis for Conclusions” (Toronto: CICA, 2002), paragraphs 65-68.

accounting standards applicable to this sector. Material that is relevant only, or primarily, to publicly accountable enterprises would be excluded. However, given the availability of electronic media with search functions, the size of the set of standards may not be a major issue in Canada.

- Condensation and simplification would provide a more manageable reference document for internal management and external users of private enterprise financial statements, many of whom do not have a strong background in financial accounting.
- It could place greater emphasis on principle-based standards and the need for professional judgment, with less reliance on detailed rules.
- It would have international credibility and would allow some degree of global comparability, particularly if the number of differences from the IFRS-SME were kept to a minimum.
- It would not be reinventing the wheel. It would be using, as a starting point, a well-reasoned document that has gone through an extensive due process. The ongoing maintenance of the standards will be primarily the responsibility of the IASB. Canadian involvement would be limited to reviewing and commenting on any changes proposed by the IASB and updating the draft to reflect Canadian circumstances.

72 Those against this approach maintain that:

- Condensation and simplification often eliminate information and guidance that would be helpful to private enterprises. This could be particularly problematic for standards that tend to be complex (generally the standards dealing with more complex transactions and circumstances on which more guidance might be particularly helpful). Condensed standards may not necessarily cover all the issues and events facing private enterprises.
- A “condensed standard” could be interpreted differently than a “full standard” when this is not the intent. Different interpretations result in diversity in practice, both among private enterprises and among private and publicly accountable enterprises, which would adversely affect comparability and consistency. As noted in Appendix E, users were quite clear in expressing their need for consistent interpretation of the same fact pattern and also their desire for high-quality financial reporting.
- Amending the IFRS-SME for private enterprises is inconsistent with the decision to adopt full IFRS without any amendments for publicly accountable enterprises. It would diminish the ability to compare Canadian private enterprises with those in other countries, especially if a large number of differences were allowed. On the other hand, proponents of this approach maintain that comparability with enterprises in other countries, with the possible exception of the United States, is not really an issue for the vast majority of Canadian private enterprises. External users of private enterprises, particularly bankers and other lenders, are primarily domestic.
- The IFRS-SME does not require mandatory fallback to full IFRS when a SME has a particular issue that is not addressed under the IFRS-SME. This could also result in inconsistent interpretations, which would reduce comparability.

- The IFRS-SME could evolve to be quite different from full IFRS over time. This would diminish its usefulness to those who want consistency and comparability with information produced in accordance with full IFRS.

73 A critical issue in the stand-alone approach is the relationship and interaction between the IFRS-SME and full IFRS. The proposed IFRS-SME includes a GAAP hierarchy that differs in some important respects from the corresponding GAAP hierarchy in full IFRS. When the IFRS-SME does not deal with a particular matter, as will sometimes be the case, a private enterprise is permitted, but not required, to refer to any relevant material in the full IFRS. This presents both advantages and disadvantages. On the one hand, it enables condensation and simplification to be effective, with greater reliance on principles and the exercise of professional judgment. On the other hand, it creates the considerable risk of diversity of practice both among private enterprises and among private and publicly accountable enterprises. The gulf between practices in the private and publicly accountable sectors could widen over time.

74 Diversity in practice may not be particularly troubling for those involved only in private enterprise financial reporting. Why should they be expected to be aware of the detailed requirements of full IFRS? It could, however, be more of a problem for those actively involved in the financial reporting of both private and publicly accountable enterprises. For example, public accountants might be uncomfortable being associated with private enterprise financial statements when they know, or may be expected to know, that certain accounting treatments are not consistent with the more detailed requirements of full IFRS.

75 Condensation and simplification do not necessarily compromise the robustness of the standards or the quality of the information provided. Indeed, the draft IFRS-SME arguably produces superior information in some cases because of stricter adherence to principles. For example, the section on post-employment benefits requires that pension assets and obligations be measured in the same way as for publicly accountable enterprises, but does not allow the corridor method or any other mechanisms that defer and amortize gains and losses over future periods. Some may find it rather ironic that private enterprises would be held to a higher standard than publicly accountable enterprises, at least as matters stand under current IFRS and the proposed IFRS-SME.

INDEPENDENTLY DEVELOPED STANDARDS

76 This approach would, to a large degree, be a fresh start but it would share the same framework underpinning the IFRS (see paragraphs 28-43). The sources for the development of such a standard have yet to be determined.¹⁸

¹⁸ Some have suggested that a version of the CICA Handbook – Accounting that predated the introduction of some of the more lengthy and complex accounting standards (such as those relating to financial instruments and employee future benefits) could be “frozen” and used as a starting point for the development of accounting standards for private enterprises. The AcSB has decided that this is not an option. Refinements to most accounting standards have been made over the years and these apply, in the main, to all enterprises.

- 77 A possible source would be the Canadian accounting standards set out in the current version of the CICA Handbook – Accounting, including differential reporting. A vast amount of intellectual capital has been invested in developing these standards. They have been developed in the context of Canadian circumstances, so there is no need to “Canadianize” them. Since Canadian private enterprise constituents are already familiar with these standards, they would not have to spend time learning new requirements. Canada could follow an approach similar to what IASB took with its IFRS-SME, condensing the accounting standards included in the Handbook, thereby making them somewhat less intimidating for private enterprise constituents. It might also consider a more grass roots approach.
- 78 Canada might want to analyze the differences between full IFRS and the proposed IFRS-SME and other issues covered in the IFRS-SME’s Basis for Conclusions. It might also review the experience of the UK Accounting Standards Board in its work on *Financial Reporting Standard for Smaller Entities* (FRSSE), now in its fifth edition, along with what the United States learned from its Private Company Financial Reporting Committee. Australia, New Zealand and other countries are also examining private enterprise financial reporting.
- 79 Issues that could be covered under this approach, include, but are not restricted to, the following:
- greater use of historical cost measurements, rather than fair value;
 - amortization of goodwill and other intangible assets with an indefinite useful life;
 - related party transactions disclosures and measurements from a private enterprise user needs perspective;
 - future income taxes on a basis other than full allocation or taxes payable (for example, partial allocation); and
 - simplification of the requirements for financial instruments.
- 80 The appropriate accounting for such issues will need in-depth consideration. The outcome is at present not determinable. The issues are raised to stimulate the identification of fresh ideas, to assist the AcSB in making a realistic assessment of the legitimate differences that might be accommodated in an independent, Canadian stand-alone approach for private enterprise. As previously noted, this approach would not encompass a new conceptual framework developed specifically for private enterprises.

Pros and cons

- 81 Supporters of this approach maintain that:
- It would offer a completely fresh look at which accounting standards are appropriate for private enterprises.
 - It would focus on accounting and reporting issues from a Canadian perspective.
-

- It could place greater emphasis on principle-based standards and reliance on professional judgment, with less reliance on detailed rules.

82 Others consider this approach inappropriate, for the following reasons:

- In view of the IASB's significant effort in developing its proposed IFRS-SME, it could be construed as unnecessarily reinventing the wheel.
- There are only a few areas warranting differences from standards for publicly accountable enterprises, therefore, a strong linkage to those standards (i.e., IFRS) is needed.
- It could be a lengthy and costly exercise. Ongoing maintenance would be a Canadian responsibility, and that maintenance could also be relatively costly and time consuming.
- Over time, significant differences from both IFRS and the proposed IFRS-SME could evolve. Implications included in the discussion of the other options include lack of comparability and the ongoing need for education and training in two different sets of standards.

APPENDIX A

BACKGROUND AND HISTORY OF THE BIG GAAP/LITTLE GAAP ISSUE

- A1 The question of whether there should be separate GAAP for small businesses was first considered in 1980. The accounting community had some concern over how certain accounting standards, such as those on deferred income taxes, leases, related party transactions and consolidated financial statements, should apply to small business. A *CA Magazine* article published in June 1980 identified the cost of producing financial statements and the complexity of accounting standards as the main issues giving rise to this concern. The article, however, raised several problems regarding a two-tier GAAP:
- The problem of defining what constitutes a small business.
 - Why just two sets of GAAP (“large” and “small”) and not three or more?
 - The transition of a business from small to large.
 - The lack of comparability between large and small businesses.
 - Should differences be limited to disclosure requirements or should they “extend into the actual construction of the numbers” in the financial statements?
 - Segregating the accounting profession between “big GAAP” and “little GAAP” firms (which, in the opinion of the author of the article “would have dire consequences on smaller firms, especially with respect to university recruiting”¹⁹).
- A2 Various initiatives in the 1980s considered whether it was possible to resolve this issue. In December 1980, the CICA Special Committee on Standard Setting concluded that “no separate body of accounting principles for small or closely held companies (“small GAAP”) should be developed. However, the practice of exempting such enterprises from certain disclosure requirements – although not measurement requirements – should be continued and perhaps extended.”²⁰
- A3 The CICA Board of Governors saw the need for further consideration of the concerns and, in 1982, established a task force to report on whether financial reporting requirements should distinguish between large enterprises and small, closely held enterprises. In August 1982, the task force recommended that “a review of the Handbook be undertaken with the objectives of reducing detailed regulation and encouraging simplification and, in particular, to focus on the problems, as applied to the small and closely held enterprises, of deferred income taxes, lease capitalization, related party transactions and consolidations and equity accounting.” It also

¹⁹ Michael J. Ashby, “Does Canada need two GAAPs?,” *CA Magazine* (June 1980), pp 28-31.

²⁰ CICA Special Committee on Standard-Setting, *Report to CICA Board of Governors*, Recommendation 8: “Big-GAAP–Little GAAP” (Toronto: CICA, December 19, 1980), p. 31.

recommended that “caution be exercised in the future to avoid over-regulation and unnecessary complexity and that the impact of future pronouncements on small and closely held enterprises be separately considered.”²¹

- A4 The recommendations of the task force were passed along to the Accounting Standards Committee (the predecessor of the AcSB). In January 1983, the committee “initiated a project to identify the issues or problems concerning financial reporting by small business and recommend potential solutions to them.” It concluded that:

“there is little support in Canada for the development of a separate set of measurement or recognition standards for small businesses, but that differential disclosure requirements may be appropriate.”

It confirmed conclusions reached by the Task Force on Disclosure Differences that Canada did not suffer from a “standards overload” situation and that, on the whole, the Accounting Recommendations in the Handbook were not excessively complex or detailed. It also concluded that “the failure by some accountants to exercise professional judgment may be a cause of concern about the burden of financial reporting requirements on small businesses and of criticisms of certain Accounting Recommendations.”²²

- A5 The Institute of Chartered Accountants of British Columbia also set up a task force to consider this issue. It submitted its report in July 1981, concluding that “there is no realistic feasibility of a two GAAP system. The disadvantages associated with such a system ... so clearly outweigh any advantages as to make a continued search in that direction impractical.”²³
- A6 The FASB released an Invitation to Comment in November 1981.²⁴ As part of its efforts, the FASB commissioned a team of academics to conduct a study on financial reporting by private enterprises, with the resulting report being published in 1983.²⁵ The FASB concluded that separate accounting standards for private enterprises were not justified.
- A7 Activities in this area remained relatively quiet until the late 1990s, although concerns were still being expressed. In 1998, some individuals and organizations commenting on the report issued by the CICA Task Force on Standard Setting²⁶ pointed out that the increasing

²¹ CICA Task Force on Disclosure Differences, *Report to the Board of Governors* (Toronto: CICA, August 31, 1982), p. 5.

²² CICA Accounting Standards Committee, *Financial Reporting by Small Businesses* (Toronto: CICA, May 1984).

²³ The Institute of Chartered Accountants of British Columbia Task Force on Big GAAP/Little GAAP, *Report to Council* (Vancouver: ICABC, July 1981), p. 4.

²⁴ Financial Accounting Standards Board, *Financial Reporting by Private and Small Public Companies; Is there need for a change?*, Invitation to Comment (Stamford Connecticut: FASB, November 20, 1981).

²⁵ A. Rashad Abdel-khalik, *Financial Reporting by Companies: Analysis and Diagnosis* (Stamford Connecticut: FASB, 1983).

²⁶ CICA, May 1998.

complexity of standards could unduly add to the financial reporting burden of small business enterprises and urged that the issue be examined without delay. The AcSB commissioned a research report to examine the issue once again. The research report “Financial Reporting by Small Business Enterprises” was published in 1999.

A8 In its report, the study group said that:

“It is important for SBEs to prepare their financial statements in accordance with standardized accounting rules. ... the problems tied to the application of GAAP to SBEs do not affect all accounting rules, but, rather, are limited to a certain number of specific aspects of those standards. It would, therefore, be logical to retain all standards currently applicable to SBEs that are relevant and useful within one set of standards, that is, GAAP. This approach has many advantages: the credibility of GAAP financial statements is maintained and the confusion that could be created by two sets of standards is avoided. Many SBE financial statement users have a limited understanding of accounting rules and could have trouble distinguishing one set of GAAP from another.

“The Study Group believes, however, that the problems caused by a certain number of accounting rules need to be solved. This could be achieved by developing differential accounting rules within GAAP, for example, by exempting SBEs from the application of accounting rules that do not meet their needs.”²⁷

A9 One of the recommendations of the study group was that:

“A differential reporting principle should be established within GAAP. According to this principle, accounting rules governing SBEs would be permitted to differ from accounting rules applicable to public enterprises when such rules do not meet the financial reporting needs of SBEs or when the cost of applying the rules would outweigh their potential benefits for these enterprises. Normally these differences would apply only to disclosure and presentation rules. It is not impossible, however, that some future recognition or measurement rules will not meet the needs of SBEs or the cost/benefit effectiveness test. The advisability of establishing differential recognition or measurement standards will have to be examined in each particular case.”²⁸

A10 Following AcSB discussion and debate and extensive due process, Section 1300, *Differential Reporting*, was issued in January 2002. It permits a non-publicly accountable enterprise to adopt the differential reporting options set out in an accounting standard, accounting guideline or abstract of issues discussed by the Emerging Issues Committee as long as it has the unanimous consent of its owners.²⁹ The AcSB has a standing committee, the Differential

²⁷ *Financial Reporting by Small Business Enterprises*, Research Report (Toronto: CICA, 1999), Chapter 5, paragraphs 27 and 28.

²⁸ *Ibid*, chapter 6, paragraph 10.

²⁹ *Paragraph 1300.06*.

Reporting Advisory Committee (DRAC), that provides input to the standard-setting process for financial reporting by private enterprises. Committee members represent a cross-section of parties interested in private enterprise financial reporting. They include public accountants from small and mid-sized practices serving small and mid-sized enterprises, financial statement preparers from mid-sized enterprises, bank lending officers whose customers are primarily private enterprises and other financial statement users.

- A11 The 1990s also saw developments in other countries. For example, the FASB issued Statement of Financial Accounting Standards No. 126, “Exemption from Certain Disclosures about Financial Instruments for Certain Nonpublic Entities,” in December 1996. In November 1997, the UK Accounting Standards Board issued the first edition of its *Financial Reporting Standard for Smaller Entities* (FRSSE).³⁰ The most recent edition of this publication was issued in January 2007.
- A12 In July 2000, the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) identified a number of obstacles that small and medium-sized enterprises were facing in applying accounting standards issued by various standard-setting bodies, both national and international. It published two pertinent guidance documents in 2004.³¹ The IASB started developing an International Financial Reporting Standard for SMEs in 2003 and issued an exposure draft in February 2007.
- A13 The American Institute of Certified Public Accountants (AICPA) set up a task force in early 2004 to conduct research on how general purpose GAAP financial statements met the needs of private enterprise constituents and the costs of providing such statements versus the benefits. A number of surveys were undertaken. One of the conclusions was that “fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met.”³² On June 8, 2006, the FASB and the AICPA jointly issued an Invitation to Comment, “Enhancing the Financial Accounting and Reporting Standard Setting Process for Private Companies.” In December 2006, they established the Committee on Private Company Financial Reporting “to further improve the FASB’s current standard-setting process so that the needs of private companies are considered.”³³
- A14 The Hong Kong Institute of Certified Public Accountants issued a “Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard” in August 2005;

³⁰ For additional information on developments in the US and UK, as well as Australia and New Zealand, refer to *Financial Reporting by Small Business Enterprises, op. cit.*, Chapter 2, paragraphs 9 to 22.

³¹ *Accounting and Financial Reporting Guidelines for Small and Medium-Sized Enterprises (SMEGA): Level 2 Guidance and Level 3 Guidance* (New York and Geneva: UNCTAD, 2004). The “Level 3 Guidance” is directed at micro-enterprises.

³² *Private Company Task Force Report* (New York: AICPA, February 28, 2005), p. 6.

³³ “Judith H. O’Dell to Chair Committee on Private Company Financial Reporting,” press release (Norwalk, CT: AICPA and FASB, December 7, 2006).

the Eastern, Central and Southern African Federation of Accountants released “ECSAFA Guidance on Financial Reporting for Small and Medium Sized Entities.”

- A15 In May 2004, the AcSB issued the “Invitation to Comment – Accounting Standards in Canada: Future Directions.” Included in the document was a section on “differential reporting” and an invitation to interested parties to provide their views on various aspects of differential reporting, together with their reasons.³⁴ In its draft strategic plan, issued in March 2005, the AcSB acknowledged that “one size does not *necessarily* fit all” [emphasis added] and indicated that it would “pursue separate strategies for the major categories of reporting entities (public companies, private businesses and not-for-profit organizations).”³⁵ The AcSB also set out its strategy for private enterprises in this document. As part of its response, a task force of the Institute of Chartered Accountants of Alberta submitted a suggested accounting standards approach for private enterprises.³⁶ The AcSB commenced its work on the strategy in October 2005.³⁷
- A16 The number and complexity of accounting requirements have increased significantly over the years and this has exacerbated concerns from some constituents. In 1980, the CICA Handbook – Accounting was 312 pages (comprising accounting standards and guidelines). By 2007, it had grown to 1,420 pages (comprising accounting standards, guidelines and interpretations issued by the Emerging Issues Committee). Private enterprises get some relief from Section 1300, *Differential Reporting*, and a few related paragraphs in other Handbook sections. Many representations to the AcSB in recent years have argued, however, that Canadian GAAP does not meet the needs of private enterprises and the users of their financial statements in a cost-effective manner.

³⁴ *Accounting Standards in Canada: Future Directions* (Toronto: Accounting Standards Board, May 2004), paragraphs 83-96.

³⁵ *Accounting Standards in Canada: Future Directions — Draft Strategic Plan* (Toronto: Accounting Standards Board, March 2005), paragraphs 7-14.

³⁶ See Task Force Letter (Edmonton: Institute of Chartered Accountants of Alberta, July 12, 2005); www.icaa.ab.ca/taskforce/letters.shtml.

³⁷ *Ibid*, paragraph 52.

APPENDIX B

THE EXPERIENCE WITH DIFFERENTIAL REPORTING

- B1 Differential reporting has been a part of Canadian GAAP since 2002. The differential reporting model uses the cost-benefit constraint in the conceptual framework to justify differences in accounting treatments. The differential reporting options currently available are as follows:
- *Subsidiaries*, paragraphs 1590.26-.31, which allows use of the cost or equity method of accounting for subsidiaries, which otherwise would be consolidated. This option extends to consolidation of “Variable Interest Entities.”
 - *Investments*, paragraphs 3051.32-.34, which allows use of the cost method to account for investments that would be otherwise accounted for by the equity method.
 - *Interests in Joint Ventures*, paragraphs 3055.47-.51, which allows use of either the cost or equity method to account for interests in joint ventures that would otherwise be proportionately consolidated.
 - *Goodwill and Other Intangible Assets*, paragraphs 3062.55-.62, which allows impairment testing to be done on an “events and circumstances” basis
 - *Share Capital*, paragraph 3240.24, which allows enterprises to disclose information only about shares that have been issued.
 - *Income Taxes*, paragraphs 3465.09(1) and 3465.105-.106, which allows use of the taxes payable method of accounting for income taxes.
 - *Financial Instruments — Recognition and Measurement*, paragraph 3855.86, which allows the election to measure available-for-sale financial assets at cost when they would otherwise be measured at fair value.
 - *Financial Instruments — Disclosure and Presentation*, paragraphs 3861.87-.91, which allows (i) presentation of preferred shares issued in certain tax planning arrangements as equity and (ii) disclosure of fair value information only when readily obtainable.
- B2 The AcSB established the Differential Reporting Advisory Committee (DRAC) to review both existing GAAP and proposed changes to GAAP and to recommend differential reporting options. To ensure maximum consistency in decisions, the DRAC and AcSB apply the following evaluation process to the assessment of costs and benefits. Benefits to the users are assessed in relation to three of the four fundamental characteristics of financial information set out in “” Section 1000, *Financial Statement Concepts*, namely, understandability, relevance and reliability. Comparability is not used as a criterion because it fundamentally conflicts with providing accounting alternatives. When the characteristics of relevance, reliability, comparability and understandability create a conflict, a trade-off needs to be found that enables the objective of financial statements, decision usefulness, to be met. The assessment of benefits is made in relation to two groups of users of financial statements of private enterprises: the non-managing owners and the creditors. The costs of complying with individual accounting requirements are broken down into the following

categories: preparation costs, communication costs (when appropriate), specialized expertise costs and related audit or review costs. Costs and user benefits are weighted on a three-point scale, low, moderate, and high. The following situations indicate a potential need for a differential reporting option:

- low benefits and low, moderate or high costs of compliance call for a differential treatment;
- moderate benefits and moderate or high costs of compliance call for a differential treatment;
- high benefits and high costs of compliance at most lead to simplified treatment producing not significantly different results.

- B3 Surveys, academic research and extensive AcSB consultations with stakeholders indicate that differential reporting is in wide use. Nonetheless, there has been some criticism of both the differential model and the specific options available. The following is a summary of experiences with differential reporting.
- B4 For an enterprise to qualify for differential reporting, it must be non-publicly accountable and also obtain unanimous consent from all of its owners. Unanimous consent is not an annual requirement; it stays in force until the options or owners change
- B5 Many note that unanimous consent is onerous, since it requires significant effort to locate owners and explain differential reporting to them. Also, in certain instances, this consent seems only a formality since the owners often do not care whether differential reporting is used. Further, management can set other policy matters without consent from all owners, and it is argued that the use of differential reporting or the election of differential options should be no different.
- B6 Unanimous consent is intended to protect minority shareholders. Minority shareholders, particularly those not related to the owners or not part of a company's senior management, typically cannot demand (and receive) additional information above and beyond the financial statements. Minority shareholders have a right to financial statements – unanimous consent ensures that those financial statements incorporate only the differential reporting options they have expressly approved.
- B7 As indicated in Appendix E, minority shareholders who rely on GAAP financial statements as their primary source of information appear to be relatively uncommon. The most frequent users of private enterprise financial statements are typically lenders. Some lenders believe that, in addition to owners, their consent should be obtained before an enterprise uses differential reporting.

Size test

- B8 Differential reporting applies to all qualifying private enterprises, regardless of size. This is based on the theory that the difference between public companies and private enterprises is public accountability; size does not matter.

- B9 Not having a size test, the DRAC and, ultimately, the AcSB must consider a wide range of enterprises in assessing costs and benefits for the differential reporting cost-benefit decision model. The cost-benefit assessment tends to vary with the size of the enterprise. Inclusion of large private enterprises in the cost-benefit assessment may have led to fewer differential reporting options than if a size test had been in place.
- B10 Recent staff discussions with financial statement users concerning what constitutes “small and medium sized” has elicited widely varying views on quantitative thresholds. Some lending institutions consider small enterprises to be those that borrow less than \$100,000; others believe that those borrowing less than \$2,000,000 are small enterprises.

Cost-benefit decision model

- B11 As noted above, not having a size test leads to potential problems in applying the differential reporting cost-benefit decision model since costs and benefits can vary significantly with the size of the enterprise.
- B12 Quantifying benefits can be particularly difficult. Individual users have different views on what is beneficial information, and these views are not consistent within user groups or specific case facts.
- B13 Another often expressed concern is that many view GAAP as focusing on the needs of equity investors as the primary external users of the financial statements. This may add to the frustration with differential reporting since many private enterprises do not have minority shareholders.

Flexibility of choice

- B14 Differential options are just that – options. Qualifying enterprises are free to choose individual options, presumably based on their own specific needs and cost-benefit constraints. This flexibility is likely a reason why differential reporting is used to the extent it is. Without such choices, enterprises would have to adopt an all-or-nothing approach to differential reporting. For example, under an all-or-nothing approach, an enterprise that wished to follow only the taxes payable option would also be prohibited from consolidating subsidiaries.
- B15 Some users dislike the optional feature of differential reporting, largely due to the adverse consequences this has on comparability. When differential reporting was established, it was understood that comparability was not a critical factor to private enterprise financial statement users.³⁸

Accompanying disclosure

³⁸ See CICA Handbook – Accounting Section 1300, “Differential Reporting; Background Information and Basis for Conclusions,” (Toronto: CICA, 2002), paragraph 37.

- B16 Several differential options require additional disclosures in lieu of a recognition and measurement requirement. Financial statement preparers and public accountants have generally not supported these added disclosures. They argue that they require as much work as not electing the differential reporting options. This comment is most often made about the future income taxes option. The AcSB believes, however, that the information required in the additional disclosure should be readily available from preparation of the corporate tax return.
- B17 It is often difficult to argue for differential reporting options, since different users find different information useful, depending on the user's circumstances, the fact pattern and the individual enterprise. Adding this further disclosure is often the only way that the cost-benefit decision model will allow for a different treatment. In the case of the future income taxes option, many users believe that the additional disclosures required are critical, and would object to an enterprise electing the taxes payable method and not providing this information

APPENDIX C

THE SAME CONCEPTUAL FRAMEWORK

- C1 The purpose of this appendix is to consider the application of the conceptual framework in the context of private enterprises of all sizes.
- C2 In view of the decision of the AcSB to adopt International Financial Reporting Standards (IFRS), the review is based on the IASB's Framework for the Preparation and Presentation of Financial Statements as set out in IFRS. Comparisons with the Canadian framework (Section 1000, *Financial Statement Concepts*) are provided in the footnotes.
- C3 The primary objective of a conceptual framework is to set forth fundamentals on which financial accounting and reporting standards will be based. A conceptual framework establishes the concepts that guide standards-setters in developing standards of financial accounting and reporting. Knowledge of these fundamentals helps all those who are interested in financial accounting standards to better understand the content and limitations of information provided by financial accounting and reporting, thereby furthering their ability to use that information effectively and enhancing confidence in financial accounting and reporting. A framework can also provide guidance in resolving new or emerging problems in the absence of, or gaps in, the applicable authoritative pronouncements.³⁹
- C4 The objective of the IASB's "Framework for the Preparation and Presentation of Financial Statements" is to "set out the concepts that underlie the preparation and presentation of financial statements for external users" and, in achieving this, *inter alia*, to "assist users of financial statements in interpreting the information contained in financial statements prepared in accordance with International [Financial Reporting] Standards" and "to assist preparers of financial statements in applying International [Financial Reporting] Standards and in dealing with topics that have yet to form the subject of an International [Financial Reporting] Standard."⁴⁰ In December 1988, the CICA Accounting Standards Committee (AcSC⁴¹) issued Section 1000, *Financial Statement Concepts*, which has essentially the same objective and is considered to be consistent in all material respects with the IASB framework.
- C5 Both the IASB and the AcSC intended their frameworks to apply to all enterprises that issue general purpose financial statements, irrespective of their nature or size. Some people think, however, that the framework is biased toward publicly listed enterprises. This could be due to

³⁹ Based on information taken from pages i and ii of Statement of Accounting Concepts, No.1, *Objectives of Financial Reporting by Business Enterprises* (Stamford Connecticut: Financial Accounting Standards Board, November 1978).

⁴⁰ IASB Framework, Introduction, Purpose and Status, paragraph 1 (f) and (d). The framework was issued by the IASB's predecessor in 1989 and adopted by the IASB in 2001.

⁴¹ AcSC was AcSB's predecessor until October 1991.

the fact that the boards that developed the frameworks comprised individuals whose main professional responsibilities were weighted toward public companies.

- C6 There has been some evolution in accounting and the application of the concepts since both the IASB and Canadian frameworks were originally issued in the late 1980s. For example, fair values are now more prominent as a measurement basis and the so-called matching principle cannot be used to justify the recognition of an item as an asset where it does not meet the definition of asset or the criteria for recognition as such.⁴² A joint IASB and FASB project, which the AcSB is actively monitoring, is improving and converging the conceptual frameworks of both those organizations.
- C7 Further, various GAAP hierarchies explain how the concepts contained in the conceptual framework should be applied when the primary sources of GAAP do not deal with particular accounting and reporting issues.⁴³
- C8 The AcSB has concluded that both frameworks cover basic tenets applicable to all enterprises, irrespective of their nature and size, while at the same time giving sufficient flexibility to accommodate the nature and particular circumstances of all both public and private enterprises.

Users of general purpose financial statements

- C9 The IASB Framework notes that general purpose financial statements are directed to the common information needs of a wide range of users,⁴⁴ many of whom have to rely on financial statements as their major source of financial information. It indicates that such

⁴² This is stated in the IASB Framework, Recognition of Expenses, paragraph 95. *Financial Statement Concepts*, paragraph 1000.51, (which the AcSB, subject to comments received, is proposing to delete) is not as emphatic in this regard.

⁴³ For example, see *Generally Accepted Accounting Principles*, paragraph 1100.04(b), together with paragraph 1100.02(c), for a definition of “primary sources involved.” “Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities” (New York: IASB, February 2007), paragraphs 10.3, sets out the sources that should be considered in descending order, namely, first, “the requirements and guidance in the [draft] standard dealing with similar and related issues,” and, second, “the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles set out in [the Section on] *Concepts and Pervasive Principles*.”

⁴⁴ IASB Framework, paragraph 9, refers to investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public. *Financial Statement Concepts*, paragraph 1000.09, refers to investors (debt and equity investors and their advisers), creditors and others who do not have internal access to entity information. For financial institutions, depositors and policyholders are also specifically mentioned. The July 2006 IASB Discussion Paper, “Preliminary Views on an improved conceptual framework for financial reporting” paragraphs OB2 and OB6, has a far more extensive list, referring to equity investors and creditors and their advisers (which are the most prominent external groups), suppliers, employees, customers, governments and their agencies and regulatory bodies, and members of the public.

statements should be focused on the needs of external users, not on the needs of internal users, such as the owners, owner-managers, management and directors, since they are presumed to have the power to obtain the information they need from sources inside the company.

- C10 The conceptual framework notes that, “while all of the information needs cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.”⁴⁵ The observation in the last sentence is true for public enterprises but is not relevant for private enterprises.
- C11 Some have asserted that a potentially significant difference between public companies and private enterprises is that equity investors are the primary external user group for public companies while, for private enterprises, equity investors generally are internal users who own or manage the company. Lenders are the most frequently encountered external users. It has been suggested that, since general purpose financial statements are produced primarily for external users, the focus of private enterprise financial statements should be on the lenders, and changes to the framework may be warranted to recognize this fact. Such suggestions include developing a set of standards that are special purpose in nature, designed for external creditors alone.

Objectives of financial statements

- C12 The conceptual framework states that the objective of financial statements is to provide information useful to a wide range of external users in making economic decisions. It notes that such economic decisions include assessing the stewardship of management, the accountability of management for the resources entrusted to it and deciding whether to reappoint or replace management.⁴⁶ The research to identify the users of private enterprise’s financial statements and their needs, as set out in Appendix E, supports the AcSB’s conclusion that this objective applies to all enterprises, irrespective of public accountability.

Constraints on relevant and reliable information

Benefit versus cost

- C13 The conceptual framework notes that the benefits derived from information should exceed the costs of providing it. It also notes that the evaluation of benefits and costs is a judgmental process, and that the costs are not necessarily incurred by the users who enjoy the benefits.⁴⁷

⁴⁵ IASB Framework, paragraph 10. *Financial Statement Concepts*, paragraph 1000.11 notes, however, that “the objective of financial statements for profit-oriented enterprises focuses primarily on information needs of investors **and** creditors.” A similar statement is made in the July 2006 IASB Discussion Paper, paragraph OB12.

⁴⁶ IASB Framework, paragraphs 12 and 14 (cf. *Financial Statement Concepts*, paragraph 1000.15).

⁴⁷ IASB Framework, paragraph 44 (cf. *Financial Statement Concepts*, paragraph 1000.16).

Although the cost-benefit constraint applies to reporting by all enterprises, some feel that it affects private enterprises differently than publicly accountable enterprises. The concern relates more to the costs than the benefits. It is generally acknowledged that the work effort and costs of complying with certain accounting standards is proportionately more burdensome, and may be somewhat overwhelming, for private enterprises, particularly smaller ones. Further, there are likely fewer users to reap the benefits of the information produced than is the case for public companies.

- C14 The AcSB's experience with differential reporting demonstrates that applying the cost-benefit constraint to the particular circumstances of private enterprises can result in certain accounting requirements being different for private enterprises than for public companies.

Timeliness

- C15 A further constraint noted in the conceptual framework is that general purpose financial statements must be produced on a timely basis; otherwise, their relevance might be impaired. On the other hand, providing information on a timely basis may result in it being reported before all aspects of a certain transaction or other event is known, thus impairing reliability.⁴⁸ Some maintain that this is more of a concern for private enterprises than for publicly accountable enterprises in that they often have fewer resources, both human and financial, to produce the information. The more detailed and complex the standards, the greater the effort and resources needed to produce financial statements on a timely basis. Others note that the regulatory requirements to produce financial statements within a certain timeframe do not apply to private enterprises and, therefore, there is less pressure on this sector.
- C16 Timeliness issues can normally be addressed by increasing accounting resources – which is a cost issue. The issue of cost-benefit was discussed above, where it was noted that costs of complying with certain accounting standards is proportionately more burdensome for private enterprises. The AcSB also notes that the transactions entered into by private enterprises are often less complex than those entered into by public companies. This should generally make it easier to issue financial statements on a timely basis.

Qualitative characteristics

Understandability

- C17 The conceptual framework notes that “users are assumed to have a reasonable knowledge of business and economic activities and accounting ...” It also states that “information about complex matters ... should not be excluded merely on the grounds that it may be too difficult for certain users to understand.”⁴⁹
- C18 Users of private enterprise financial statements, including lenders, may not have the same degree of sophistication with respect to accounting issues as those of publicly accountable

⁴⁸ IASB Framework, paragraph 43 (cf. *Financial Statement Concepts*, paragraph 1000.20(b)).

⁴⁹ IASB Framework, paragraph 25 (cf. *Financial Statement Concepts*, paragraph 1000.19).

enterprises. In addition, they do not generally have access to interpretations provided by financial analysts, but have to rely for any explanatory assistance on the preparers of the financial statements (and possibly their advisers), who will often not have as much of an expertise in accounting or financial reporting as those who prepare and analyze public company financial statements.

- C19 The AcSB notes that complex accounting standards are often necessary to achieve a fair presentation of the underlying complex transactions and events that businesses confront. It is the nature and complexity of those transactions and events, not the nature or size of the enterprise *per se*, which is the determining factor.
- C20 The AcSB believes that the concept that financial statements should be understandable applies to all financial statements and that nothing in the framework precludes the development of a GAAP for private enterprises that would be understandable by users with a reasonable knowledge of business and economic activities and accounting for private enterprises.

Comparability

- C21 The conceptual framework notes that “users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance.”⁵⁰ There appears to be general agreement that this applies equally to all enterprises, irrespective of their nature and size.
- C22 The conceptual framework also notes that the ability to “compare the financial statements of different entities” is important “to evaluate their relative financial position, performance and changes in financial position.”⁵¹ Some maintain that this may be of lesser importance to investors in private enterprises due to the lack of marketability of shares. AcSB staff research has, however, shown that financial statement users make comparisons in a variety of ways (see Appendix E). Some have expressed a concern that the optional mix-and-match feature included in differential reporting hampers their ability to compare enterprises, particularly those in the same industry. It is also a significant issue raised by some users against having separate accounting standards for private enterprises.
- C23 It is noted, however, that “the need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards,” and that it needs to be considered in the context of relevance and reliability.⁵²

Relevance

- C24 The conceptual framework indicates that:

⁵⁰ IASB Framework, paragraph 39 (cf. *Financial Statement Concepts*, paragraph 1000.22).

⁵¹ *Ibid.*

⁵² IASB Framework, paragraph 41.

“to be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.”⁵³

- C25 Relevance has both confirmatory and predictive aspects, which are interrelated. Information is relevant if it enables a user to take advantage of opportunities or to react to adverse situations.
- C26 In the opinion of the AcSB, relevance applies equally to private enterprises as to public enterprises. The key issue is whether the decision-making needs of users of private enterprise financial statements are the same as, or different from, those of users of public enterprise financial statements.
- C27 Some question whether all of the information currently required by accounting standards is necessarily relevant for external users of financial statements of private enterprises. This is a question of the application of the conceptual framework and not of whether the conceptual framework applies to private enterprises.

Reliability

- C28 To be included in general purpose financial statements, the conceptual framework indicates that information must be reliable – it must be free of material error and faithfully represent what it purports to represent or could reasonably be expected to represent.
- C29 Faithful representation, substance over form, neutrality, completeness and (in so far as it does not affect neutrality) prudence, are all sub-characteristics of reliability. The difficulty is more in the application of these sub-characteristics than in the sub-characteristics themselves, and that applies to all enterprises, irrespective of their nature and size.⁵⁴

Definitions of assets, liabilities, income and expenses

- C30 These definitions in the conceptual framework are based on current and future economic benefits that may flow to and from an entity in various ways.⁵⁵ The research on user needs supports the AcSB view that these definitions apply equally to public and private enterprises. Users agreed virtually unanimously that having different definitions of assets, liabilities, revenue and expenses is unwarranted and would be unworkable.

Recognition

- C31 The conceptual framework establishes general criteria for recognizing assets and liabilities (namely, the probability that any future economic benefit associated with an item will flow to

⁵³ IASB Framework, paragraph 26 (cf. *Financial Statement Concepts*, paragraph 1000.20).

⁵⁴ IASB Framework, paragraphs 31-38 (cf. *Financial Statement Concepts*, paragraphs 1000.21).

⁵⁵ IASB Framework, paragraphs 53-64 and 74-80 (cf. *Financial Statement Concepts*, paragraphs 1000.29-.34 and 1000.37-.38).

or from the entity, and the item has a cost or value that can be measured with reliability).⁵⁶ Those criteria apply equally to private and publicly accountable enterprises. This does not preclude recognition differences in developing a set of standards for private enterprises. Differential reporting currently includes recognition differences based on cost-benefit considerations.

Measurement

- C32 The conceptual framework describes measurement as “the process of determining the monetary amounts at which the elements of financial statements are recognized and carried in the balance sheet.”⁵⁷ It sets out a number of different measurement bases that are employed “to different degrees and in varying combinations” in the financial statements, and notes “historical cost” as the one most commonly adopted.
- C33 Measurement is an issue on which there has been some considerable change since the various conceptual frameworks were issued in the 1980s. For example, accounting standards for financial instruments now require greater use of fair value measurements. This issue is of some concern to both preparers and users of private enterprise financial statements. It is, however, an application issue rather than a framework issue, since the conceptual framework does not prescribe which measurement basis to adopt.
- C34 The AcSB believes that no changes are required in the framework regarding measurement bases for private enterprises. The AcSB does acknowledge, however, that the evaluation of the cost-benefit constraint for measurement bases could differ for private enterprises.

Conclusion

- C35 Based on its review, the AcSB has concluded that the conceptual framework is relevant to financial reporting by all Canadian enterprises, both public and private. Differences in the application of the concepts in the conceptual framework might, however, be justified. Accordingly, the AcSB has concluded that a common conceptual framework should apply to all business enterprises, irrespective of their nature and size.

⁵⁶ IASB Framework, paragraphs 82-88 (cf. *Financial Statement Concepts*, paragraphs 1000.41-.52).

⁵⁷ IASB Framework, paragraph 99 (cf. *Financial Statement Concepts*, paragraph 1000.53, which states that “measurement is the process of determining the amount at which an item is recognized in the financial statements”).

APPENDIX D

NEEDS OF FINANCIAL STATEMENT USERS

— IDENTIFICATION OF USERS

Survey of owners/CFOs of private businesses

- D1 In November and December 2005, owners and/or CFOs of private enterprises were surveyed to determine whom they regarded to be the users and significant users of their financial statements. The provincial institutes/ordre of chartered accountants were each asked to distribute the questionnaire to 30 owners and/or CFOs of private business. In addition, several individual members or former members of CICA committees or other groups were approached to either complete the questionnaire, if they were with a private business, or send the questionnaire to 10 of their clients, if they were practitioners. The Financial Executives International Canada also agreed to invite its members in private business to respond.

Total responses and enterprise location

- D2 202 responses were received. Of the 129 companies that provided their location, 44 were based in Ontario, 28 in Alberta, 23 in British Columbia, 12 in Québec and 22 from the remaining provinces.

Size of enterprise

- D3 29 of the responses were from enterprises with less than 20 employees, 57 with 20 to 100 employees and 113 with more than 100 employees. 12 of the enterprises had revenues of less than \$1 million, 30 from \$1 to \$5 million, 44 from \$5 to \$20 million, 32 from \$20 to \$50 million, 31 from \$50 to \$100 million, and 52 of more than \$100 million.

Users of GAAP financial statements

- D4 According to the survey, owner-managers are the main user (181 enterprises), closely followed by major Canadian banks (178 enterprises) and the taxation authorities (165 enterprises). Non-management owners/minority shareholders were identified as users by 106 enterprises. The number of users ranged from 1 to 14 per enterprise, with the average being 6 users.

Significant users

- D5 For the purpose of the survey, “significant user” was defined as follows:

“those users to whom you [as the company owner or CFO] feel an obligation to provide your company’s financial statements because of the importance of their decision-making needs.”

- D6 With respect to significant users, the following were the ones most often mentioned:
- Canadian banks (131 enterprises)

- shareholders and owners (115 enterprises)
- other lenders (54 enterprises)
- owner-managers (33 enterprises)
- taxation authorities (30 enterprises)
- board, executive, management, senior employees (21 enterprises)
- governments and regulators (16 enterprises)
- guarantors (15 enterprises)
- suppliers (13 enterprises)
- customers (11 enterprises)
- lessors (11 enterprises)
- insurers (10 enterprises)
- venture capital providers (9 enterprises)

D7 33 enterprises specifically identified non-management owners/minority shareholders as significant users. They are also likely included, however, in the shareholders and owners group which, as noted above, 115 enterprises identified as users.

D8 As might be expected, individual significant users are often company specific. For example, landlords, the payroll service, major automotive enterprises, legal/tax advisors and the community at large were all mentioned as significant users by certain enterprises.

D9 The number of significant users identified ranged from 0 to 8 per company, with the average being between 2 and 3. Five enterprises indicated that all of their identified users were significant users, whereas five enterprises did not identify any of their users as significant.

D10 The survey results basically confirm the conclusions of a literature review, that there are two main groups of users of private enterprise financial statements – bankers and other lenders, and owners and management.

**STAFF REPORT
SUMMARY OF DISCUSSIONS HELD WITH
PRIVATE ENTERPRISE FINANCIAL STATEMENT
USERS**

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SUMMARY

General

- E1 Discussions with various constituents of private companies' generally accepted accounting principles (GAAP) financial statements indicated that creditors (that is bankers and other lenders) are the primary external users of such financial statements. Independent investors (that is, those who do not have access to the internal information produced by a private company's management) as a group are far less prevalent than is the case for public companies.
- E2 There is no specific demand by external users (both creditors and independent investors) for a separate set of accounting standards for private companies. In general, however, they do not necessarily accept all of the information that is presented in the GAAP financial statements. They adjust some of those amounts to meet their specific needs. Further, there are frequently other amounts and information presented in the GAAP financial statements that are superfluous to their particular needs (goodwill, other intangibles and future income taxes, for example, were mentioned by several external users). This will vary, depending on the external user. External users are also generally aware of the problems being faced by private companies in the preparation of financial statements in accordance with current accounting standards, from both a cost and a complexity perspective. Many (although not all) external users support differential reporting, as set out in Section 1300, *Differential Reporting*, of the CICA Handbook – Accounting (although, within this group, some expressed concern over some of the differential reporting options that are permitted). Based on these factors, many external users might be sympathetic to a separate or modified set of accounting standards for private companies.
- E3 The importance assigned to private company GAAP financial statements by internal users (owners, owner-managers, company management and employees) varies. The main concern expressed by such users is the increasing cost of, and time spent in, producing such statements. Some of the information now required to be included was considered redundant with respect to their particular circumstances, a position that they maintain is supported by their external users, particularly their bankers. In many cases, they are also experiencing difficulty in explaining the information to their external users. As preparers, the message they are trying to convey regarding the financial position and operating results of their company is therefore being “clouded” by the required adoption of certain accounting standards.

Owners, owner-managers and company management

- E4 Owners, owner-managers and company management do not regard themselves as key users of GAAP financial statements. Their primary interest in the preparation of GAAP financial statements is to meet the requirements of external parties, particularly the bankers and other lenders. GAAP financial statements, however, do often form the basis for the structure of their internal financial statements, and are usually a key requirement in obtaining future loans or capital investment and in any merger or acquisition discussions.

Minority shareholders

- E5 Minority shareholders often have a relationship with a company in which they have invested which classifies them as *quasi* internal users (they may be relatives of the owners or employees of the company). In these circumstances, they often have access to internal information, when requested, and are not regarded as a key user of GAAP financial statements.
- E6 Private equity and venture capital companies are also often a minority shareholder of their private company clients. They are covered separately in this appendix (see paragraphs E107 to E125). Individuals who are private-equity-type minority shareholders (so-called “angel” investors) generally regard GAAP financial statements as crucial in meeting their information needs. They seemed to be neutral regarding the need for a separate set of accounting standards for private companies. Current GAAP requirements seem to adequately meet their particular needs.
- E7 Independent non-institutional minority shareholders have been difficult to identify. The lack of a public market for shares of private companies could be regarded as a deterrent to holding a minority interest in a private company, although some of the deficiencies can be offset through an agreement that specifically sets out the rights and obligations of the minority shareholder. The few representatives to whom project staff has spoken seem to regard GAAP financial statements as important, since they may be the only financial information that they receive. They either did not support or were neutral about the need for a separate set of accounting standards for private companies.

Bankers and credit unions

- E8 Bankers and other lenders, such as credit unions, were identified as the key external user of private company GAAP financial statements, but they adjust financial statement amounts to meet their own particular needs, rather than placing direct reliance on such information. There is no demand from them for a separate or modified set of accounting standards for private companies. They are, however, often sympathetic to their clients’ concerns regarding the increasing complexity of accounting standards and the increasing cost of producing audited financial statements. There is a wide range of lending transactions. At low lending levels, and perhaps low risk levels, a separate set of standards may not be an issue mainly because GAAP financial statements are not critical to lending decisions. This is evident in the current marketplace from the large number of private entities preparing non-GAAP financial statements, which are being accepted by users. At higher risk levels or dollar thresholds, however, there may be issues with respect to comparability with public entities as well as the ability and desire to work with and understand two separate sets of standards. According to some of the representatives from this group, differential reporting is already creating some problems in this respect.

Leasing companies

- E9 For leasing companies providing essentially a lending function, the position is similar to that for banks. Canadian Finance & Leasing Association (CFLA) representatives, however, maintained that leasing companies are probably more reliant on GAAP financial statements than a bank or credit union, which has access to other types of

financial information, such as bank balances, client history, etc., on a frequent basis. A survey undertaken by the CFLA of some of its members to ascertain the importance of current GAAP information in meeting their financial information needs confirmed views expressed by CLFA representatives that, while there is a strong desire for consistency between GAAP for public and private companies, there are a number of instances where issues of cost/benefit could merit different standards for private entities. Representatives also felt that financial reporting is becoming very complicated, to the point where it is often difficult to understand what is going on.

Private equity companies

- E10 Unlike banks, private equity companies are often both equity investors and lenders. They also have a different time horizon, undertake a far greater investigation of the financial statements for due diligence purposes and, overall, appear to be a much more sophisticated user of financial statements. Their perspective regarding a modified or separate set of accounting standards, however, is, in many respects, similar to that of banks.

Bonding agencies, surety and guarantee companies

- E11 This group is a key user of the GAAP financial statements of construction companies, most of which are private. Representatives from this group, while having little exposure to GAAP financial statements of public companies, did not see any real need for accounting standards being different for private companies, although, in their opinion, some of those standards, particularly those relating to revenue recognition, need significant improvement, at least in so far as they relate to construction companies. They did not find GAAP financial statements particularly complex and did not experience difficulty in understanding them.

Insurance companies

- E12 Since those insurance companies approached by the Insurance Bureau of Canada expressed little interest in participating in this project, it seems that this issue is of little interest to them.

OWNERS/OWNER-MANAGERS/CFOS AND PRACTITIONERS

General

- E13 In discussions with these, and other, groups, it was often difficult to separate “accounting” and “assurance”. It appears that many view these two disciplines as one, and this possibly tends to propagate the “standards overload” mantra. Overall, GAAP financial statements do not play a large part in assisting a business owner or CFO in running a business, largely due to internal financial statements being much more flexible, detailed and timely. They do, however, play a confirmatory role, can form the basis for the overall structure of the internal statements, and are often used in future planning.
- E14 Overall, most representatives of these groups supported the current definition of non-publicly accountable enterprises, as found in Section 1300, *Differential Reporting*, that

demarcates on the basis of public and private, rather than making an arbitrary determination as to what is “small”, “medium” or “large”. It was noted at some discussions that the current “line in the sand” (public v. private) does make it difficult to make concessions in financial reporting for private companies, simply because the reporting must satisfy the needs of a wide range of entities.

Reaction to GAAP financial statements

- E15 Some practitioners felt that many of their private company clients (especially small business owners) do not really understand GAAP financial statements; they are generally too complex for them.
- E16 Most small businesses appear to run their operations based on cash flows, cash in the bank, receivables, sales, etc, or even by intuition (for example, a cheque book approach). Several practitioners indicated that the needs of many of their private company clients are being met through compiled financial statements (often non-GAAP).
- E17 Some private company representatives indicated that GAAP financial statements are used as closure — they are the “final report card”. One owner indicated that GAAP financial statements are of significant value in making global or entity-wide decisions with respect to his business. Another owner (where there is no internal reporting) noted that the GAAP financial statements provide an indication of the financial progress of the company, the extent to which expansion is possible, and the information needed for existing and potential creditors.
- E18 Some practitioners noted that annual financial statements, whether GAAP or non-GAAP, are important for those small business clients that do not have any internal reporting procedures; in fact, they may be the only financial statements that they receive. They meet with such clients to explain the results and any potential consequences (such as non-compliance with loan covenants). Another practitioner felt that compilation reports, which are not necessarily prepared in accordance with GAAP (for example, notes are often not included) are adequately meeting the needs of many of their small business clients. In their opinion, a new category for “exempt companies” is not really needed.
- E19 One private company representative stated that, in his opinion, “there must be some ground that the small business can stand on that results in useful, cost-effective GAAP type financial statements. ... We must, as a profession, stop trying to put all pegs (square, round, oblong, etc.) in the same round hole (as we have defined it). ... Differences must be accommodated, in the interest of cost effectiveness, without sacrificing full disclosure based on circumstances. ... We must be able to apply rules/guidelines, etc. to the situation, not make the situation fit the currently defined set of rules.”

How GAAP financial statements help you operate and manage your business

E20 Private company representatives indicated that GAAP financial statements are of very limited value in assisting private companies in managing their business. Generally, such statements are not finalized until 90 days after year end. Some private company representatives noted that they are confirmatory, and, together with the report (audit or review engagement) by an independent accountant, give comfort regarding the amounts and information generated by management. One private company representative noted, however, that GAAP contains information beyond direct operating costs (such as advertising, insurance and taxes) that is important, but not essential, to them in running the day-to-day operations of the business. Bonuses are often based on, and not paid until after the issue of, the GAAP financial statements. Another private company representative indicated that GAAP financial statements provide valuable information to owners and shareholders regarding the financial health of the business.

Are internal financial statements prepared for management purposes?

E21 Most private company representatives indicated that their companies prepare monthly or quarterly internal financial statements which generally go into greater depth than the GAAP financial statements. For example, they set out detailed line operations by branches and divisions, and provide operational information not required by GAAP financial statements. In many cases, however, the structure of the internal statements is based on GAAP and adjusted, as and when appropriate, following the review of the annual GAAP financial statements. Budgets, and comparisons of budgets with actuals, are also important tools internally. Internal reporting varies from company to company, since each entity and its related decisions are different.

Other reasons why GAAP financial statements are significant

E22 The following reasons were mentioned:

- Bank loans and other financing arrangements were mentioned by most private company representatives as the key reason (and, in some cases, the only reason) for preparing GAAP financial statements. Some felt that their bankers generally do not understand GAAP, whereas others felt that their bankers did have at least a basic understanding of GAAP and that their GAAP financial statements provided them with extremely useful information.
- Many private company representatives indicated that information required for tax purposes was a key reason for preparing GAAP financial statements. Others noted, however, that internal financial statements are usually adequate for tax purposes. Also, tax authorities are not a user of GAAP financial statements in the sense that owners and lenders are; they do not make investment or credit-granting decisions. Project staff reviewed CRA regulations and confirmed that GAAP financial statements are not required for purposes of filing a tax return.
- One private company representative noted that there may be more value attached to GAAP financial statements when the ownership changes. Several private company representatives noted that they often choose to prepare GAAP financial statements

in anticipation of possibly selling, taking the company public, or obtaining outside investment in the business at some future date.

- Other users specifically mentioned were: suppliers (but, in the instance mentioned, to date, the supplier has never asked questions on the financial statements submitted); venture capitalists; and a bonding company. Some private company representatives also noted that, typically, private companies are somewhat reluctant to make their financial statements (GAAP or non-GAAP) generally available; there has to be a good reason before they will even provide them to external parties, such as trade creditors or customers.

Noteworthy components of GAAP financial statements

Cash flow statements

- E23 The cash flow statement was generally regarded as important since it provides a concise summary of what has taken place during the year. Some felt, however, that the information provided is too aggregated; more detail is needed (for example, related party information; sales/purchases of capital assets should not be netted). One owner found it the least useful component statement for this reason.

Income statement

- E24 Some private company representatives noted that net income and indices and ratios based on GAAP measures are becoming less comprehensible to many users (particularly the less sophisticated users) due to complexity of accounting standards.

Notes to the financial statements

- E25 Some private company representatives felt the notes were important. One private company representative stated that it is the part of the financial statements of most interest to him, since it explains and expands on the amounts shown in the statements themselves. Others felt they were too detailed and, often, confusing and, on occasion, disclose information that is not in the best interests of the company (such as competitive information).

Noteworthy line items in GAAP financial statements

- E26 Some private company representatives noted that line items used in computing ratios and covenants are of particular interest.

Do your minority shareholders rely on GAAP financial statements?

- E27 Several private company representatives noted that minority shareholders generally have access to the (monthly or quarterly) internal statements and do not need or use GAAP financial statements to meet their financial information needs. In the private company, and particularly the small business, scenario, there is often a family or other close relationship among the shareholders/owners of the company.
- E28 From discussions with representatives of the private companies themselves and other users, however, it would appear that, other than private equity investors (both entities and individuals), external minority shareholders of private companies (that is, non-

related owners and those who are not employees of the private company) may be relatively infrequent; however, this does not mean that they are not important. Further, private companies tend to be closely held by their owners so as to maintain complete control of the business. Purchases of other private companies are mainly 100% purchases. “Family or other close relationships” do not necessarily equate to having access to additional financial information beyond the financial statements.

Which GAAP financial statement items are important?

Revenue

- E29 Concern was expressed that the revenue recognition standards are complex and take an enormous amount of time to understand and digest. One CFO interviewed questioned the requirement to amortize lease revenue over the term of the lease. She indicated that lease revenues are structured to take inflation into account, with lower rentals in the early years and increased revenues in the later years. At the moment, it is not material, but should it become material, a qualified audit report will be issued. Project staff understands that, generally speaking, private companies have the ability to depart from GAAP. Their financial statement users as a whole often accept qualified reports.

Goodwill

- E30 Generally, private company representatives consider the impairment test approach to be too complex. They prefer amortization, or even immediate write off. They did, however, acknowledge that goodwill and other intangibles do have value and are assets.

Other Intangibles

- E31 One CFO interviewed expressed concern regarding fair valuing intangibles in connection with lease properties. For example, when acquiring a rental property, such as a mall, that is fully leased, a value has to be assigned to the fact that the mall is fully leased. She noted, however, that no guidance has been issued on how to do this. This issue arises from EIC-140, “Accounting for Operating Leases Acquired in Either an Asset Acquisition or a Business Combination.” Fair value allocation guidance that would apply to any business combination or asset acquisition would also apply to EIC-140.

Financial instruments

- E32 Risk disclosures related to financial instruments were deemed to be of limited value by some private company representatives. One owner stated that credit risk and interest rate risk were irrelevant to him.

Long-term investments and liabilities at fair value

- E33 In the small business context, fair values were generally considered irrelevant by most private company representatives. One owner even felt that stating (measuring) long-term investments and liabilities at fair value could result in wrong business decisions (he indicated that, for example, extending the company’s credit based on fair values could have very unfortunate consequences). When compared to covenants written with historical cost as a measurement base, it can also, in their opinion, adversely affect debt-equity and other asset ratios.

E34 When pressed for more information as to the usefulness of “fair value”, participants agreed that short-term items such as current liabilities should be re-measured at fair value, and current or long-term assets such as marketable securities should be held at fair value. Several participants acknowledged that external users might find fair value information useful.

Hedge accounting

E35 Some degree of frustration was expressed over hedge accounting requirements (this comment was made in the context of the restrictions on using hedge accounting as laid out in accounting standards relating to hedging).

Measurement uncertainty

E36 Concern was expressed by some private company representatives that the measurement uncertainty note is too general to be of much use.

Classification of demand loans as current

E37 A number of private company representatives expressed concern over EIC-122, “Balance Sheet Classification of Callable Debt Obligations and Debt Obligations Expected to be Refinanced.” This concern was endorsed by a significant number of the practitioners with whom project staff met. Both groups felt that substance over form should govern how such loans are classified. If, based on past experience and other factors, such as positive current and forecasted future cash flows, it is highly unlikely that a demand loan that has been around for some time will be called in during the following fiscal year, it should be classified as long term, with possible note disclosure, rather than as current. Some representatives mentioned that the banks themselves, for the purpose of their analysis, adjust such demand loans to long term. A few participants noted that they agreed with EIC-122 and that it was simply a matter of understanding the logic behind the EIC Abstract.

Debt-equity classification

E38 This was specifically raised as a concern by at least one private company representative who indicated that the requirement to classify preferred shares as liabilities and the related dividends as interest was a particular frustration. The company’s banker reclassifies them as equity. This representative indicated that the differential reporting option does not apply in the case of her company.

Stock-based compensation

E39 At least one private company representative expressed concern over the measurement of stock-based compensation. He felt that this item was difficult to comprehend and was of questionable logic. He found it impossible to explain the amount arrived at to other users.

Reaction to differential reporting

E40 The reaction to differential reporting was somewhat mixed, but generally private company representatives were supportive. Some practitioners, however, suggested that, at present, it is too rules based. At least one participant expressed some concern that the application is optional; if the differential reporting options are considered appropriate,

everybody should apply them. Some suggested that the external users (that is, the bankers) should also be asked to consent to their use.

Reaction to the possibility of separate accounting standards

E41 Reaction was generally favourable. It will very much depend, however, on the actual requirements of such accounting standards.

Other

E42 Other concerns raised were as follows:

- Several private company representatives would support the introduction of accounting standards for compiled (“notice to reader”) financial statements, to enable readers to have some confidence in, and better understand, such statements.
- Some private company representatives expressed frustration at the difficulty of keeping up with new accounting standards due to their complexity and frequency of change. It was noted that attending Institute professional development sessions can be frustrating, since instructors are often unable to explain the logic behind new standards.
- Some practitioners felt that accounting standards should be written in a more straightforward fashion.
- At one meeting, a strong dislike was expressed for any potential proposal to formalize a tax basis of accounting or other comprehensive basis of accounting (OCBOA). It was felt that, for many small businesses, current reporting needs are being adequately met by compiled financial statements. Several constituents felt that there is little need for, or value in, developing another basis of accounting.
- Two private company representatives noted that they do not agree that banks or creditors can get whatever information they want simply by asking. Both stated that they strongly push back on requests for information, especially if bankers get too demanding. They also stated that they have changed lending institutions due to such requests. The trend is towards more competition in providing credit; knowledgeable business people are using this to negotiate more favourable terms and conditions.
- A few practitioners noted that they did not support a separate set of standards. They felt that current standards are equally applicable to private and public companies. They could not think of any current requirements that are excessive for private companies or irrelevant to financial statement users. These practitioners noted that, for the vast majority of private entities, accounting standards are not an issue, simply because the transactions that are entered into by most entities (95% was mentioned) are straightforward and do not attract complicated accounting.

Summary

E43 From the discussions that have taken place, it is evident that GAAP financial statements are not used in monitoring the day-to-day operations of private companies. They often have a confirmatory role in indicating that internal statements (or when not prepared, the owner-managers’ intuition) correctly portray the performance and financial position

of the business. They are used, in many cases, for future planning and as a basis for forecasting.

- E44 Significant concerns, however, were expressed about their cost and complexity; however, it is uncertain what exactly is meant by “complexity” — some believe EIC-122 is complex. Many private company representatives indicated that they themselves find the GAAP financial statements confusing, and have difficulty explaining them to their external users without assistance from their independent accountants or their business advisers. They also indicated that their bankers often find them confusing. Other representatives noted that they do not find current standards overly complex or difficult to understand

NON-INSTITUTIONAL MINORITY SHAREHOLDERS

- E45 As noted in paragraphs E27 and E28, it would appear that minority shareholders, who do not have family or employee relationships and are not private equity investors, may be relatively infrequent in the private company realm. This is difficult to confirm since information on private company share ownership does not appear to be collected. Staff has made enquiries with Statistics Canada on the matter; unfortunately it does not have such data.
- E46 At the private company level (especially for small and medium-sized private companies), many minority shareholders seem to have family or employee relationships. They are involved in the company for other than investment reasons. According to owners and CFOs contacted, they have access to the internal statements and other internal information. In a number of cases, owners or CFOs indicated that their minority shareholders are not even interested in receiving the GAAP financial statements.
- E47 One minority shareholder who was interviewed is also a commercial lawyer with in excess of 30 years’ experience. This individual noted that not many minority shareholders are non-employees or non-related; however, lately he has seen an increase in employee share participation, largely in the context of transitioning ownership between generations. He questioned whether such employees, as well as non-arm’s length individuals, always have access to whatever information is desired, noting that whenever there is a “falling out” or disagreement between parties, relationships quickly deteriorate.
- E48 Discussions took place with five independent (that is, non-related) minority shareholders who were not private equity investors “arm’s length, non-institutional.”
- E49 Representatives of this group noted that, beyond the right to receive financial statements, arm’s length, non-institutional minority shareholders generally have few rights. Since there is no active market for private entities, the opportunity to sell their shares is often very limited. When they are sold, the value assigned is often less than it is for identical shares held by the majority shareholder(s). GAAP financial statements are sometimes the only financial information they receive from the company; they generally cannot access additional information, such as aged receivables listings or

inventory ledger details. Shareholder agreements are often entered into to create a market for minority shareholders. These agreements generally state that, on the occurrence of a specific event, the entity will repurchase the shares of the minority shareholder. Such shareholder agreements usually set the price of the repurchase in reference to the financial statements (for example, a “multiple of earnings” approach).

- E50 The experience of representatives of this group on the value of the GAAP financial statements varied. One representative noted that the GAAP financial statements enable him to assess whether his interests are being fairly and adequately taken into consideration by company’s management. The financial statements allow him to follow through by asking questions at the company’s annual general meeting (AGM). Another representative stated that he sees a large number of issues with respect to oppression of minority shareholders, for example, management remuneration and bonuses being paid without justification, management spending issues, and related party transactions, to name a few. Another representative felt that the GAAP financial statements do not set out what the company is worth, which he considers to be essential information for minority shareholders. Yet another felt that important disclosures tend to be omitted, particularly when the company is experiencing difficulties.
- E51 Some non-institutional, arm’s length minority shareholders seem to focus on cash flows, forecasts and strength of management in assessing and monitoring their investments. Others tend to focus more on the strength of an entity’s balance sheet and trends in the income statement, as well as focusing on management performance.
- E52 A private equity minority shareholder who is an investor in private high-tech companies indicated that, for some of his investments, he has been the only minority shareholder in the firm; for others, he was part of a group of investors. He specifically emphasized the importance of financial statements for a minority shareholder. He indicated that, as an outsider, he does not know what is going on in the business on a daily basis. Most of the time he learns of emerging problems or detrimental impacts of special contracts signed by management when it is too late to stop the transactions. He recounted a recent experience where the managers, in their willingness to sell their product, included many no-charge clauses, such as free after-sale service, training, as well as performance and other types of guarantees, in the contract signed with the client. The financial consequences of these no-charge clauses were disastrous and almost forced the entity into bankruptcy.
- E53 One individual noted that the cost of obtaining audited financial statements has increased dramatically over the past number of years. When they ask management and auditors for the reasons for cost increases, changes in assurance standards and inflationary pressures are noted; changes in accounting standards are not cited as a source of cost increases.
- E54 Representatives of this group either did not support or were neutral regarding a separate set of accounting standards for private companies. Reaction to differential reporting was somewhat mixed.

CANADIAN BANKERS AND CREDIT UNIONS

General

- E55 Overall, the representatives of these groups expressed very diverse views with respect to financial reporting needs, with, oftentimes, needs being inconsistent between geographic region and within lending institutions.
- E56 Throughout discussions, group representatives (particularly lenders) frequently referred to “small businesses.” They were not clear as to what is a “small business” but, when asked, often referred to revenue thresholds or lending thresholds. It would appear that major financial institutions draw arbitrary size lines in determining which business group (small business, commercial, mid-market, etc.) deals with a particular client.
- E57 Some representatives noted that a “general purpose” set of standards such as GAAP exists to serve a wide variety of users and user needs. They note that, due to the wide variety of user needs within the private company sector, they believe that it will likely not be possible or feasible to develop a special purpose set of financial statements for any one specific group of users.
- E58 The Accounting Standards Specialist Group of the Canadian Bankers Association, which comprises representatives from the head offices of the major Canadian banks, indicated that it is strongly opposed to both a separate set of accounting standards for private companies and differential reporting.

Relationship with private companies

- E59 Lenders are primarily interested in assessing an entity’s cash flows so as to determine the ability to service debt. They are also interested in assessing risk, working capital and leverage.
- E60 There are generally two types of loans: those based on operations and those based on assets. Current and potential cash flows are generally the key factor for operating loans, whereas the value of the asset is key for asset-based loans. Over the life of both types of loans, cash flows are important in assessing the ability to repay the loan. They are therefore a key control (monitoring) feature.

Are GAAP financial statements always required?

- E61 Most representatives of banks and credit unions indicated that GAAP financial statements are very important to them. They are not required in all circumstances, but, even when not required, they are a valuable source of information when they can be provided. For loans at the lower level (generally varying from up to \$100,000 to up to \$250,000, with one institution noting a maximum threshold of \$500,000), lending can often be undertaken using only personal credit scores and personal guarantees. The representative of one financial institution indicated that they are considering moving their threshold for GAAP financial statements to \$2 million. A claim for recourse on personal assets of the owner-manager (for example, the residence) is an example of a personal guarantee. Some institutions noted that personal guarantees are not used in a “trade off” fashion; they are used to bolster the argument for credit. There is some

degree of flexibility with respect to dollar thresholds discussed, for example, where there is an entity with an excellent reputation and history and the banker deems there to be little risk, non-GAAP financial statements will still be accepted when the lending level would otherwise dictate that GAAP financial statements are necessary. The flexibility of the institution's lending policies and discretion available to account managers was deemed to be fairly limited. At the very low end of the spectrum (under \$50,000 to \$250,000 depending on the institution), credit scoring is used. Even in these circumstances, however, financial statements (GAAP or non-GAAP) are a valuable source of input.

- E62 The required assurance level expressed on financial statements depends on a number of factors, including the size of the loan, the size of the business, past experience, knowledge of the client company and its management. Some representatives, however, indicated that these factors may not be as crucial for asset-based lending; asset-based lenders are more interested in the underlying value of the assets they are lending against and look to these assets as security and therefore are less reliant on financial statements.
- E63 For loans at a lower level (see the thresholds mentioned above), compiled financial statements are often accepted. There appears to be an assumption on the part of at least some bankers that such financial statements are GAAP based. Further, the "notice to reader" communication is not necessarily signed by a public accountant; one representative referred to instances where an internal accountant signed such a notice. From \$200,000 to \$2 to \$5 million, GAAP financial statements supported by a review engagement report are usually required. Over this threshold, audited financial statements are usually required, although circumstances may dictate that they be provided at a lower level.
- E64 Representatives at one of the sessions noted that today's competitive environment is forcing the banking community to accept lower levels of assurance, simply because others are accepting them. Several representatives noted that, if their client is growing, they advise them to prepare their financial statements in accordance with GAAP and have them reviewed or audited.
- E65 Some representatives indicated that, from their viewpoint, financial statements are more important regarding private companies than they are regarding public companies. In the public company arena, there is a great deal of additional public information that can be analyzed and assessed.
- E66 At one session comprising primarily branch managers, however, it was stated that the banks are moving away from relying on the financial statements as the primary tool.
- E67 At a couple of sessions with individual bank representatives, it was noted that reliance is inappropriately being placed by external users, particularly bankers, on the name and reputation of the accounting firm regarding the credibility of financial statements, particularly compiled financial statements, a practice that is highly questionable.. "Having a good reputation" does not necessarily mean being a "large" accounting firm. Instead, it is a question of the personal reputation of the firm's partners in the community, regardless of the size of the firm.

Use made of GAAP financial statements by the banks

- E68 Virtually all the banks at certain lending levels are using models to generate risk ratings. These risk ratings are used to support the decision to lend or not lend, and if the decision is to lend, establish guidance regarding pricing of the loan. Inputs to the model include relevant non-financial information, as well as information included in the financial statements manipulated, where necessary, to meet their particular needs. As a result of using models, data integrity is important. Consequently, the level of independent assurance provided (audit, review, notice to reader) will have an impact on the risk assessment. Some representatives specifically stated that the level of assurance has a direct impact on the pricing of the loan. Regarding data quality and integrity, a number of representatives indicated a strong dislike for compiled financial statements, since they are often non-GAAP and in many cases are “free form.” In many (possibly most) cases, they do not contain a cash flow statement and note disclosures; where they are provided, they are often inadequate and incomplete. Some representatives indicated that they may, on occasion, require specified assurance procedures to be undertaken on certain key financial items (for example, inventories and accounts receivable).
- E69 At least one of the major banks represented approves small business loans centrally. They are not approved at the branch level, rather the information is forwarded to head office for analysis and approval. It was noted at another meeting, however, that some judgment is left to account managers regarding lending level and risk assessments; in such situations, client and loan history, relationships with the company and management, and other qualitative factors are particularly important considerations.
- E70 At the meeting with representatives of the Canadian Bankers Association, it was noted that a “standard small business scoring model” is being developed, and this will likely have a significant influence in the future.
- E71 Project staff was also informed that Moody’s Investor Services provides a number of models and analytic tools that are often one of the sources used by Canadian banks in generating risk ratings.

Do GAAP financial statements provide necessary information?

- E72 Generally, representatives did not express any major concerns about the extent of information provided. They indicated that nothing in the financial statements is considered irrelevant. There were concerns that it is sometimes too general, and that more specific information should be provided.

What information is particularly important?

- E73 One representative felt that financial statements are more important in the private entity environment than in the public entity environment. This was supported by the fact that there is so much information presented in the public entity environment that is not prepared by private companies or, if it is prepared, it is not made available to private company financial statement users (Management Discussion and Analysis (MD&A), Annual Information Form (AIF), etc.).

- E74 Cash flow information is regarded as particularly important. Notes to the financial statements are regarded as key inputs to developing and maintaining an understanding of an entity's financial statements.
- E75 With respect to particular items, potential future liabilities and contingent liabilities were specifically mentioned, with disclosure of lawsuits and potential lawsuits being particularly important.

Is comparability important?

- E76 Comparability is considered important. With respect to inter-period comparability, it was suggested at one session that comparative information for three periods would be valuable. Inter-entity comparability among private companies is also deemed important. Representatives indicated that their data bases permit them to compare their private company clients by various sources, such as revenues and industry. Moody's and Risk Management Association/Robert Morris Associates data bases are often used to help analyze and assess risk.
- E77 Some representatives noted that they compare private entities to public entities. This point was echoed at several locations, but was particularly strong in Alberta and British Columbia. It was noted by some, however, that this might not be a critical barrier to developing a separate set of standards for private entities, depending on the degree of difference. Other representatives indicated that comparison of private and public entities is not a key factor for them.
- E78 Some representatives felt that the various options permitted under accounting standards (for example, inventories, one of the main items on which they focus), as well as differential reporting options, make comparisons difficult. Bankers look for trends, but are having difficulty identifying trends due to inconsistent financial statements.

Is additional information readily provided by clients and potential clients?

- E79 Many representatives noted that the assumption that the banks can get whatever additional information they need is not always true. Competitive pressures often force them to rely on the financial statements or other financial information with which they are provided. Once the loan is approved, the loan agreement will itemize the information that must be provided. For small companies and small loans, they may have to prompt the client company that the promised financial statements are yet to be provided. It was noted that such prompting does not always result in receipt of statements. Some representatives noted that they are somewhat limited in their ability to request or demand information, as such demands open up the door for the client to walk away.

Usefulness of the information required by Canadian accounting standards

What component statements are of value to you?

- E80 All component statements are regarded as important. The cash flow statement is particularly important, although a concern was raised about netting certain information. For example, for inter-company advances, some representatives noted that detailed separation is important, since they are interested in expected repayments. Concern was also expressed by some representatives that new and refinanced debt are not separately or fully disclosed.

Are GAAP financial statements becoming too difficult for you to understand?

- E81 Representatives did not express significant concerns in this regard. They have resources in their various organizations to be able to deal with this issue should it arise. Some representatives did note that simple information is preferred. If it becomes too complex, they may have to unravel and re-assess the complexities, increasing their costs. A banker who submitted a written response, however, indicated that the issue of concern to him is that, since there are various ways to present financial statements, all within GAAP, results may look quite different depending on presentation. He feels this detracts from the value of the statements and forces lenders to complete additional due diligence to avoid misinterpretation or ambiguity.

Is the information provided in GAAP financial statements too general?

- E82 This was an issue of some concern. Some representatives would like to have more information on certain line items in the income statement, for example, interest charges should be broken down by source; remuneration should be split between management bonuses, management salaries and other wages. They indicated that they often “normalize” earnings before interest, taxes, depreciation and amortization (EBITDA) and that anything that can help in this regard would be beneficial.

Is there any irrelevant or superfluous information?

- E83 There was general agreement that virtually nothing is irrelevant or superfluous, although there is certain information that is eliminated in making risk analyses. (That decision, however, should be left up to them). Rather, they would like to see more detailed information put in the notes, and more note disclosure in general.
- E84 This may seem contradictory (“nothing is irrelevant, but some things we ignore”). One representative, however, noted that the range of uses and what is useful varies within an institution by type of loan, risk, size of loan, etc. Banks recognize that they are but one specific user group, and are not troubled by making adjustments.

Is there any additional information that you would like to see?

- E85 A number of representatives indicated that they would like to see related companies presented on a consolidated or combined basis. They are often more interested in the group performance than that of the individual entity. They mentioned that they can usually get the information they require about an individual entity through the client’s

internal financial statements. A number of representatives also indicated that covenant violations should be disclosed in greater detail than might currently be required. Providing more detailed explanations on the nature of the business and legal status of the company, more detailed income statements and expanding the disclosure of related party transactions were also mentioned.

Is recognition by way of note disclosure more important than measurement?

- E86 In most cases, measurement is essential. Where there is controversy regarding different bases of measurement for particular items, however, note disclosure of what measurement basis has been used and readily available information about any alternative basis(es) is generally deemed to be appropriate.

Usefulness of financial statement line items as required by Canadian accounting standards

Leases

- E87 This was not an issue raised by representatives without some prompting. Generally, capitalizing such leases and presenting the corresponding debt was deemed the preferred approach (the approach supported in the 1999 CICA Research Report, FINANCIAL REPORTING BY SMALL BUSINESS ENTERPRISES), since to do otherwise would impact the debt-to-equity ratio calculation. They also noted that when it complies with the definition of a capital lease, capitalization reflects the economic substance of the lease.

Goodwill

- E88 Goodwill is generally eliminated by the banks in making their risk assessment. It was noted, however, that, in certain circumstances, it cannot be completely ignored, since it can be an issue with respect to succession planning.
- E89 One representative felt that there is value in testing goodwill and intangibles for impairment, due to the impairment test providing information about the entity as a whole. This representative felt that the banking community at large appears slow to catch on to the value of doing so.

Other intangibles

- E90 Intangibles in general are generally eliminated by the banks in making their risk assessment, although it is recognized that certain intangibles, such as patents and copyrights, may have economic value.

Financial instruments

- E91 Representatives seemed to be generally unfazed by the financial instruments accounting standards; this is likely due, however, to the banking industry not yet being fully aware of the new financial instruments suite of disclosures. It was noted at several meetings that lenders and other users often react to changes in accounting standards when they see the effect of the change, which is, of course, well after the actual standard has changed. Several representatives noted that the high-low preferred shares issue was now understood by the banking industry.

Long-term liabilities at fair value

- E92 Fair value information is often viewed with some scepticism. Representatives indicated that they can do their own valuation when needed. Usually, they are not trying to value the company, but are trying to determine whether cash flows and operating results demonstrate their client's potential to pay the interest and repay the principal. Representatives generally were agreeable to the notion of holding certain current assets at fair value (for example, marketable securities) and, subsequent to some discussion, also recognized that testing for impairment used fair value information. Representatives also recognized that it was important to hold current liabilities at fair value. Issues of realization came up when the issue of holding property, plant & equipment at fair value was raised by representatives. With respect to long-term investments and long-term liabilities, there seemed to be general agreement that disclosure of readily available market values should be provided. Fair value changes can also impact the income statement, and, for their purpose, they would have to be reversed.

Future income taxes

- E93 Many representatives indicated that future income taxes would usually be eliminated by the banks in making their risk assessment, since they are not relevant as far as current and future cash flows are concerned and, in many cases, are deemed to be immaterial. Some bankers noted that, in disregarding future income taxes, they assume that the balance will not reverse. If there is evidence that they may turn around in the foreseeable future, the relevant portion may be included. Others, however, viewed them as a potential future or contingent liability which could not be ignored. A representative at one of the group meetings indicated that he would never eliminate future income taxes; in fact, he would require the provision of this information from his private entity clients, since they could represent a significant liability that could impact future cash flows.

Debt and equity

- E94 Some confusion is often experienced regarding the distinction between debt and equity, For example, accounting standards call for preference shares to be classified as liabilities due to potential redemption, whereas, historically, they have been regarded as a significant part of the equity of many private companies, particularly, small businesses.
- E95 Some representatives did not see any conceptual difference between debt and equity provided by the owners, particularly those of a small or medium-sized business; they were both contributions of capital by the owners.
- E96 More detailed disclosure of inter-company debt is also considered by some representatives to be needed.

Discontinued operations

- E97 "Discontinued operations" was not raised as an issue of any major concern. (The 1999 CICA Research Report had noted that some bank representatives viewed this information as relevant, since it enables them to assess the viability of the remaining

activities. Others viewed it as seldom relevant in the case of Small Business Enterprises.)

Measurement uncertainty

- E98 Concern was expressed by some representatives that the measurement uncertainty note is too general to be of much use.

Related party transactions

- E99 This information is considered very important. Many felt that related party transaction disclosures should be significantly expanded.

Classification of demand loans as current

- E100 Most representatives seemed to support the rationale behind EIC-122. They would like to have additional note disclosure provided regarding the current and long-term portions. Some representatives, however, did express some concern with this abstract. They felt that the classification should be based on substance rather than form, and indicated that they made adjustments for demand loans that are in substance term loans. Such adjustments are needed to determine whether covenants are being met. They believe that substance should be based on management intent. In their opinion, this is simply reflecting reality where the bank is not expecting the loan to be repaid in the following fiscal year. Some bank representatives noted that they would not withdraw or waive the right to call the obligation, which is essentially the basis for classification as demand.

Reaction to differential reporting

- E101 The reaction to differential reporting was somewhat mixed. Some representatives indicated that, with adoption being optional, it can affect both inter-period and inter-entity comparability. It was also noted that, from a user perspective, choice often makes analysis difficult. It can also create additional work in analyzing the information. Some representatives indicated that, when considered necessary, they undo differential reporting so as to attempt to bring the numbers “back to GAAP.” One representative stated that adoption of differential reporting has an impact on the risk assessment, with those adopting so-called “full GAAP” being more positively assessed than those adopting differential reporting. Representatives noted that, due to concerns of comparability, there may be a limit with respect to the number of differential reporting options, depending on the nature of differential options (for example, measurement and recognition options should be finite).

Reaction to the possibility of separate accounting standards

- E102 At least some representatives specifically indicated that a simpler set of GAAP for private companies, particularly small businesses, would not create an overwhelming concern for them. As is currently the situation, they do their own analysis; more note disclosure, however, would be useful.
- E103 At one meeting with individual bankers, the two people interviewed indicated that they would prefer to have a specific handbook for small and medium-sized entities (SMEs), a simple one including more detailed application rules (for example interpretation rules)

to make sure that all the required information is provided and the standards are applied properly, even in cases where no auditor's report is issued. Others noted, however, that it would be too onerous to develop, maintain and work with a separate accounting standards' system for private companies.

E104 Some representatives noted that the Basel II framework may cause banks to be less accepting of a separate set of standards for private companies. Several banks note that the essence of Basel II requires a financial institution to allocate different levels of equity to back loans based on the probability of default as assessed on a periodic basis by the institution. The model to determine the probability of default is generated by the institution and cross-referenced to the default history in order to give the model validity. There is no standard model; however most financial institutions have a general analysis of liquidity, leverage and cash flow. Models require a level of consistency in financial statements to aid in generating reliable predictions. Models are generated for each major industry classification. Given the number of industries in Canada, the different levels of assurance reports (resulting in different levels of assurance as well as GAAP and non-GAAP financial statements), these representatives believe that the addition of separate private company standards would cause many financial institutions to run out of customers before they can get a statistically valid probability of default. In short, adding a set of standards that is significantly different could result in models becoming too granular to properly work.

Other

E105 Other views expressed included the following:

- At one of the sessions, several representatives expressed concern over a lack of consistency in application of GAAP across practitioners. They also noted that they are seeing diversity in practice, which is likely due to some accountants not properly reading contracts and lending documents.
- Some representatives indicated that most departures from GAAP are not a problem, provided they are clearly set out (which does not necessarily mean quantification) in the financial statements, together with an explanation for the departure.
- In one of the sessions, some interest was expressed in having a fourth level of assurance, something between "notice to reader" and "review," which would allow the practitioner to act unfettered by the independence standards.

Summary

E106 Overall, representatives expressed diverse and, on occasion, inconsistent views with respect to financial reporting needs. In deciding which business group within a bank deals with a particular line (small business, commercial, mid-market, etc.), the size of the loan, and risk, rather than the size of the business seems to be the primary determinant.

VENTURE CAPITAL AND PRIVATE EQUITY COMPANIES

Relationship with private companies

E107 In this industry, the objectives and strategies of companies tend to vary quite significantly, as do the types of their investments. Some venture capital and private equity companies fulfill an “angel” function, assisting their clients by providing funding to them to develop their ideas to the stage that they become commercially viable. Some fulfill a financing function by providing subordinated debt supplementing the financing their clients have received through loans from their bankers. Others undertake a “builder” function by providing the necessary financing and technical expertise to enable their private company clients to reach a stage where they can become a public company, be desirable candidates for mergers or acquisitions, or continue to operate as successful and profitable entities. Venture capital and private equity firms often participate as both equity and debt investors.

E108 Venture capital and private equity company representatives indicated that they generally take a longer term more macro approach and are interested in an entity’s longer term prospects for growth. The average length of time of their investment in a company is five years (or in the three- to eight- year range). Exits are primarily through mergers and acquisitions and re-financings. Initial Public Offerings (IPOs) exist, but are much less prevalent as an exit strategy.

Are GAAP financial statements always required?

E109 Venture capital and private equity companies generally are not as flexible as the banks when it comes to the level of assurance and application of GAAP. Virtually all representatives noted that, except at the start-up or development stage, they insist on audited financial statements. At the start up/early development stage of technology companies, they are usually not that focused on GAAP financial statements; instead, they are more focused on the underlying ideas/concepts of the business and the quality and expertise of the company’s management, and they perform their own very detailed investigations and due diligence. Representatives noted that this is largely due to the entity being invested in having little or no history; start-up entities are invested in based on ideas and concepts. For start-ups, whenever capital is committed to such an entity, from that point on, GAAP financial statements and audit level assurance become required.

Use made of GAAP financial statements by venture capital/private equity investors

E110 Representatives noted that they perform very detailed analyses of the financial statements. Prior to being involved with a potential client, detailed due diligence is undertaken. No stone seems to be left unturned by this group of investors. Analyses appear to be very much done on a case-by-case basis, with little use of database or template-based modeling. Case-specific models are developed which forecast results out five to seven years.

Do GAAP financial statements provide the necessary information?

E111 Similar to the bankers — no major concerns were expressed; nothing is considered irrelevant; the information is sometimes too general — specific information should be provided. More concern was expressed over information not provided than the information provided (see paragraphs E115 and E116).

What information is particularly important?

E112 All information is regarded as important, particularly that relating to current assets, current liabilities and cash flows.

Is comparability important?

E113 Comparability is considered important. Comparisons are frequently performed with public entities. Comparisons with other private companies are generally not practical, due to information constraints. At least one participant noted that they employ a database service to allow private entity comparability.

Is additional information readily provided by clients and potential clients?

E114 Both venture capital and private equity representatives indicated that they have little difficulty in obtaining additional information. The types of additional information vary; in virtually all cases, however, access to information is written into investment documents. One representative noted that, in the event of default in covenants, they can virtually do whatever they want —including replacing senior management. They monitor their clients' operations very closely and are virtually always either members or participating observers on their clients' boards of directors.

Canadian accounting standards: relevance of the required information

E115 Generally, representatives from this group found the information required by Canadian accounting standards to be very useful — but more as a starting point than the final result. They generally felt that, in their industry, the GAAP numbers need to be adjusted to meet their particular business needs. One representative indicated that, for her clients, an adjusted set of financial statements had to be prepared. At least one member expressed concern that options provided within GAAP (aside from differential reporting), and professional judgment, give management a fair amount of latitude to manipulate the financial statements (for example, inventory valuation, inventory obsolescence, impairments), accentuating the need for them to do their own analysis and their own due diligence work to enable them to adjust the information portrayed in the financial statements to meet their own particular needs. This was portrayed as “the real numbers” by one representative. He felt that there are certain requirements under GAAP that make no economic sense as far as his business is concerned. Concern was also expressed that it is relatively easy for management to exclude or fail to make reference to certain liabilities.

E116 Another representative felt that, at least for his business, EBITDA was a far more significant number than net income and that it should be portrayed as a subtotal in the income statement. This representative noted that the emphasis on EBITDA was due to the wide ranges of financing structures that are employed by private entities. At the same time, he acknowledged that different companies and accounting firms can come up with different EBITDA numbers for the same company, and that even if a standard way of deriving EBITDA is developed, further adjustments would still be needed to come up with a meaningful number in particular circumstances. Like “net income” itself, however, an EBITDA sub total number would provide a good starting point. Yet another representative stated that EBITDA is not a useful number since it omits valid information.

Canadian accounting standards: are you concerned about specific requirements?

E117 Generally, representatives from this industry seemed relatively comfortable with current accounting standards. They, for the most part, do not have an issue with the understandability of information provided by current accounting standards. It must be recognized, however, that a number of those with whom discussions were held had a legal background, rather than an accounting background. Also, as noted above, they take the information included in the GAAP financial statements, and adjust it for their particular needs. Some concerns, however, were raised by certain representatives.

Fair value measurement

E118 Several representatives noted that the move towards fair value measurement for financial instruments is a positive step. For many complex financial instruments, such as derivatives, the cost is nil and the significance on the balance sheet disappears. They believe that the best way to understand such instruments is through reflecting them in the financial statements at fair value.

The classification of debt and equity

E119 This was an issue of concern to some of the representatives from this group. Investments in their clients can take various forms, such as convertible debentures, preference shares, redeemable preference shares, common shares, *et al.* Some of such instruments, either wholly or in part, are classified as liabilities. They view many of such instruments as equity. It was also noted that bifurcation was somewhat confusing in both the allocation method and the results of doing so.

Consolidation

E120 One representative of this industry felt that consolidation of subsidiaries can result in confusion to the users of the financial statements, due to the different nature of operations of companies in the group. Separate financial statements are often more appropriate and understandable. Another indicated that their focus is on investment, and not control, and this is not altered by the fact that they may have in excess of 50% of the equity.

Future income taxes

E121 Some representatives found this number confusing and questioned whether it was a true liability. They felt that the focus should be on the amount projected to be payable in the foreseeable future (say, the next five years).

Goodwill and other intangibles

E122 One representative noted that one of their investees had to spend significant amounts of time and money in allocating a purchase price and establishing a value for goodwill and other intangibles. They did not believe that such an exercise was valuable, since goodwill and intangibles are often ignored in their analysis.

Reaction to the possibility of separate accounting standards

E123 Although representatives from this group generally stated that they were not in favour of a separate set of accounting standards for private companies, some concern was expressed that existing GAAP was “somewhat unnecessarily too sophisticated” for private companies and should be simplified. This complexity had both time and cost implications as far as both they and their private company clients were concerned. On the other hand, different standards could cause future problems for their clients. For example, if they go public or are merged with, or acquired by, a public company, they would be faced with having to convert to a different set of standards at that time; therefore, it might be best to follow public company standards from the outset. It was also noted that when an exit is made by sale to another entity, it would likely be the case that public entity GAAP would be needed.

E124 One representative noted that he would be open to changes, providing that differences made sense from a cost/benefit perspective. It would also be beneficial if migration between standards were easy to do, perhaps by setting out the differences in the notes.

Reaction to differential reporting

E125 Representatives from this group were generally supportive of differential reporting, including its optionality feature. One representative noted that they do not like the differential reporting option in Section 3240, *Share Capital*, due to wanting to have information on share capital that is authorized, but not issued, readily available. Another representative noted a dislike for differential reporting due to issues with comparability.

LEASING COMPANIES

E126 Next to banks and credit unions, leasing companies are the main source of borrowing by private companies. Pertinent issues raised in discussions with representatives of this group through the Canadian Finance and Leasing Association (CFLA) were as follows.

Relationship with private companies

E127 Leasing companies are involved in far more than just leasing transactions. They issue subordinated debt and are involved in structured finance. Leasing companies typically have a more infrequent relationship with an entity than, say, a bank.

Are GAAP financial statements always required?

E128 For mid (\$75,000 to \$500,000) and big ticket (over \$500,000) items, GAAP financial statements, with a review engagement or audit report, are required. For small ticket (under \$50,000 to \$75,000) items, credit scoring is extensively used and financial statements are not as important.

Use made by leasing companies of GAAP financial statements

E129 Although GAAP financial statements are only part of the credit file, for mid and big ticket items, they are critical — they are key in making most credit decisions. Leasing companies are probably more reliant on financial statements than a bank or credit union, as the latter has access to much more information (for example, bank balances, client history) on a frequent basis

What information is particularly important?

E130 Note disclosure is very important in understanding the business of a client or potential client, and is often the starting point of the analysis.

Is comparability important?

E131 Consistency is deemed extremely important. Many CFLA members deal with public as well as private companies and make comparisons between them. While there is a strong desire for consistency between public and private companies, they recognize that there may be instances where issues of cost/benefit merit different standards for private entities.

Is additional information readily provided by clients and potential clients?

E132 Generally speaking, the information needs of leasing companies are explicitly set out in the terms of the agreement.

Usefulness of the information required by Canadian accounting standards

E133 The following views were expressed regarding the usefulness of the financial statements:

- Representatives feel that financial reporting is getting very complicated, to the point where it is getting difficult to understand what is going on.
- More forthcoming disclosure on breaches of covenants would be helpful.
- More detailed information on management remuneration is needed; private companies often “bonus down” to the small business deduction limit allowed for tax purposes.
- EIC-122 was generally supported.
- Future income taxes were deemed to be somewhat confusing — it does not seem to be understood by many small businesses.

- Goodwill is routinely deleted by many (but not all) leasing company lenders in their risk analysis.
- Although pension plans are not frequently encountered in private companies, note disclosure can be excessive.
- Some concern was expressed over the practicality of fair valuing certain items. An historical cost approach for private companies should be explored further, with note disclosure of fair values where these are readily obtainable.
- Some concern was expressed over differential reporting. Its optionality creates problems of comparability between enterprises and sometimes forces leasing companies into doing a lot of “digging” into financial statements when a differential reporting option(s) is (are) adopted.

Surveys of users and preparers of private company information

E134 Pursuant to our discussions, the CFLA undertook a mini-survey of some of its members with a view to ascertaining the importance of current GAAP information in meeting their needs. Nine members responded. The survey was divided into two categories so as to identify information needs of “users” (heads of credit) and “providers” (CFOs) of private company information. Users were asked to identify information necessary for evaluating credit worthiness of potential or current customers, areas where current Canadian GAAP rules are either inadequate or excessive, and any areas where information, although relevant, is more costly to obtain than the perceived benefits. Providers were asked to identify information deemed necessary, and areas where information, although relevant, is more costly to obtain than the perceived benefits

E135 General observations drawn from the survey responses are as follows:

- For purposes of assessing creditworthiness of private companies, user needs tend to depend on the size of the entity requesting credit. Generally, the larger the deal size (greater than \$50,000), the greater the need for more information, such as audited financial statements. When the information is not available from the audited financial statements, however, users can generally obtain the information they require from the potential borrower.
- All the primary financial statements and the related notes are critical.
- Unconsolidated financial statements are typically viewed by “users” as critical for assessing credit worthiness. Consolidated information is also assessed as very important, particularly if there are inter-corporate guarantees.
- Views are somewhat mixed on the importance of accounting requirements relating to the following:
 - split accounting for compound financial instruments (bifurcation);
 - research and development costs; and
 - asset retirement obligations.
- Accounting requirements in the following areas are regarded as excessive:

- future income taxes;
- pensions;
- hedge accounting;
- derivatives and instruments that do not qualify for hedge accounting; and
- stock-based compensation.

BONDING COMPANIES

E136 Bonding agencies (guarantors) always rank behind the bank and other creditors. They provide standby credit should, in the case of a construction contract, the performance of the construction contract fail or if additional financing is required to complete a contract. Bonding is a fairly risky proposition as they are unsecured creditors who must be prepared to step in should a contract “go bad.” Other than construction equipment, the average construction contractor has little or no assets to speak of. The vast majority of bonding is done with private entities.

E137 Representatives staff spoke with noted that, overall, construction bonding is very much like bank financing and the credit analysis that banks perform; however, there is likely a heavier reliance on financial statements simply because guarantors are not privy to continual information about a client such as bank account information.

E138 Bonding is almost always done when transacting with the public sector (for example, a Ministry of Transportation). Bonding helps the public tender and bidding process function. Bonding is not generally a requirement in the private sector; it is, however, done occasionally.

E139 Entities that have revenues in excess of \$2 million have the potential to be bonded. Contracts under a certain dollar amount (\$250,000 was noted) are generally not bonded, due to the cost of bonding. The total number of entities that are bonded at any particular time is estimated at 15,000. GAAP financial statements (a review engagement at minimum) are required by bonding agencies.

Usefulness of GAAP financial statements

E140 GAAP financial statements are considered to be a very important tool for bonding companies. They know the industry and can expertly interpret financial information. They would like, however, to see more information on items such as the aging of receivables, how estimates are arrived at, the identification of the individual parties for inter-company loans and investments, and the method of revenue recognition. It was noted that, in the US, there is a much more detailed level of required supplementary information that is geared to bonding agencies.

Use made of GAAP financial statements

E141 Bonding agencies go through an assessment and analysis that is similar to that undertaken by banks, only they focus more on current assets and current liabilities. Bonding agencies require, among other things, financial statements for a minimum of

three years. Comparisons are made between entities; frequent use of benchmarking and ratio analysis is performed. The focus is often on working capital and cash flows.

E142 One representative indicated that he would prefer long-term monetary assets and liabilities to be measured at historical cost in the financial statements with note disclosure on the current and cumulative impact of using a fair value measurement basis.

Is additional information readily provided by clients and potential clients?

E143 There is often a problem in getting additional information from clients. Many do not prepare internal financial statements. That is one of the reasons why the GAAP financial statements are so important. In addition to the financial statements, bonding agencies look to the experience, integrity, and competency of the contractor. They like to have regular meetings with the contractor to monitor and discuss the contractor's progress.

Significant problems with existing GAAP

E144 Two areas were mentioned where significant problems are being experienced: revenue recognition and the differential reporting option relating to future income taxes.

E145 With respect to revenue recognition, more detailed definitions of the percentage of completion method and the completed contract method and guidance on how to apply these methods would be helpful. Each accounting firm seems to have its own way of dealing with these two methods. Some tend to just go along with the amounts provided by management. There are a select number of firms in any given centre who have a large clientele in the construction industry. For these firms, revenue recognition is generally done on a consistent basis. Firms that do not have frequent dealings with this industry have difficulties with construction revenue recognition. Accounting standards need to be more prescriptive in this area.

E146 With respect to future income taxes, many construction companies have adopted the differential reporting option of accounting for income taxes on the taxes payable method. The note disclosure that is required when this option is followed is often either absent or inadequate. Future income taxes can be a significant liability for construction companies, and its omission is inappropriate for such companies. Several representatives felt that future income taxes and understanding of them, are integral to understanding financial statements in the construction industry.

E147 Bonding agencies are happy to make whatever adjustments that they believe are necessary to the financial statements. They generally have to reclassify for the effects of EIC-122. Goodwill and intangibles are generally discounted.

Comparisons of private companies

E148 Comparisons are undertaken, but adjustments are made to make comparisons possible.

Private companies standards and differential reporting

E149 All representatives indicated that they did not see the need for different standards for private companies; the nature of the business is usually simpler than it is for public companies, so the more complex standards generally do not usually apply. Several representatives did not express any problems with differential reporting, largely because analysis is performed on a case-specific basis.

INSURANCE COMPANIES

E150 The Insurance Bureau of Canada (IBC) was contacted regarding the possibility of arranging a roundtable discussion with a group of their member companies. Apparently, however, there was no interest on the part of those companies in having a face-to-face meeting.

E151 One company did, however, respond to an issues document that was sent to the IBC and distributed to some of its member companies. Its response covered the following issues.

Where GAAP financial statements are required

E152 Requirements for GAAP financial statements are limited to the following situations:

- review of new broker stability (limited);
- review of broker financial stability when issuing broker loans;
- reviewed when entering into significant agreements (for example, critical supplier);
- limited use by underwriting and claims department (less than 1%);

Since they would rely on outside expertise in evaluating financials in the event of a “loss of income,” their understanding of differential reporting is not important; and the level of assurance would typically be audit or review, depending on the situation, with “notice to reader” being unacceptable.

Usefulness of GAAP

E153 With respect to the usefulness of GAAP, its response was as follows:

- All lines on the income statement and balance sheet are useful.
- The statement of cash flows is a useful statement (although challenging for those preparing it).
- Notes to the financial statements are currently sufficient and meet the needs of insurance companies. It was noted, however, that the notes to the financial statements have become far too complex and have only led to far more confusion from a reader’s standpoint rather than providing more useful information.
- GAAP financial statements are becoming increasingly difficult to understand.
- Requirements relating to fair value will only add to the complexity of financial statements and reduce the ability of the non-expert to understand them. It will likely lead to more volatility of results, less comparability and uncertainty of the use of

models, estimates and assumptions. There will be uncertainty and inconsistency around fair values as models, assumptions and estimates will be subject to manipulation and judgment. There could be increased manipulation of results through fair value adjustments (either up or down).

- The move to IFRSs and the elimination of the “matching principle” are of particular concern and have only led to more confusion from a reader’s standpoint rather than providing more useful information.
- For some items, disclosure could be an acceptable substitute for recognition. It is felt that “fair value” is a good example where disclosure would be preferable to recognition.

OTHER

Purchaser of private companies

E154 Project staff had a short conversation with the Executive Vice President and CFO of a public company that has purchased several private companies. She expressed concern over the quality of the financial statements of many of those companies, even when they have been audited. She maintains that the related party transaction disclosure is gobbledegook and disclosures are often grouped together to the degree that they lack useful information. She feels that, under existing GAAP, public company reporting is understandable, whereas private company reporting is frequently lacking in transparency and is not informative. She is concerned that a different set of standards for private companies would just make the situation worse.

Suppliers

E155 One private company director of finance who was interviewed indicated that his company’s main suppliers are key users of its GAAP financial statements (which are audited). He indicated that providing them with the GAAP financial statements helps the company to negotiate better terms and prices. To date, however, he has not received any questions or requests for any clarifications of what is said in the GAAP financial statements.