Invitation to Comment

Financial Reporting by Private Enterprises

prepared by:
Accounting Standards Board

Comments are requested by October 31, 2007

AcSB

Accounting Standards Board
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CNC
Conseil des normes comptables

Accounting Standards Board

Financial Reporting by Private Enterprises
Invitation to Comment

Responding to this Invitation to Comment

The Accounting Standards Board (AcSB) has issued this Invitation to Comment to invite feedback on the future of financial reporting by private enterprises. In particular, it discusses how accounting standards might deal with the special needs of this sector. The AcSB is composed of people with backgrounds in business, public practice and academe who know how to prepare and use financial statements. All members serve as individuals, not as representatives of their employers or organizations.

Individuals and organizations are invited to send written comments to the AcSB on this important topic. Comments are most helpful if they clearly explain the issues they raise and suggest a specific course of action, supported by specific reasoning. All comments received will be available on-line in a public file within one week of receipt.

To be considered, comments must be received by October 31, 2007, addressed to:

Peter Martin
Director, Accounting Standards
Accounting Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2

For ease of handling, we prefer comments to be sent by e-mail (in Word format), to:
ed.accounting@cica.ca

INVITATION TO COMMENT

Introduction

This Invitation to Comment (ITC) asks crucial questions about the future of financial reporting by private enterprises. In particular, it raises issues affecting how accounting standards will deal with the special needs of such enterprises. The ITC is accompanied by a Discussion Paper that describes those issues in more detail and summarizes the findings of research the AcSB has conducted for this project. Readers should consider the issues identified, answer the questions raised below and explain the reasoning supporting their responses. Readers are also urged to participate in round-table meetings and other communication activities the AcSB and other groups organize throughout the comment period.

The AcSB expects to begin deliberating the issues raised in this ITC and the accompanying Discussion Paper in late 2007. Responses to this ITC and Discussion Paper are requested by October 31, 2007.

Purpose

This ITC explains why the AcSB concluded that there are three viable options for developing accounting standards for financial reporting by private enterprises. In reaching its conclusions, the AcSB addressed the following questions:

- Should GAAP for private enterprises apply to <u>all</u> private enterprises?
- Are the same fundamental accounting principles common to financial reporting by all enterprises?
- What degree of connection or linkage should there be to standards for financial reporting by publicly accountable enterprises (i.e., International Financial Reporting Standards)?
- Which approach to developing accounting standards for private enterprises will result in financial statements that satisfy users without imposing an undue burden on preparers?
- Should a non-GAAP standard, or guidance, be developed for entities without significant external users?

Each of these questions is examined briefly in this ITC and discussed more fully in the Discussion Paper. Readers should thoroughly review both before formulating their response to this ITC. The Discussion Paper's Appendix E presents the results of the AcSB's research into user needs. As the goal of GAAP financial reporting is to meet the needs of external users, respondents should keep those research results in mind when responding to this ITC. A response that explains clearly why a respondent does not agree with the AcSB's reasoning and offers persuasive alternative arguments is more likely to influence the deliberations of the AcSB.

The AcSB is also looking for input from minority shareholders of private enterprises who are not private equity or venture capital investors on how important GAAP financial statements are to them. Should they be a company's employees or relatives of the owners, they should indicate this, together with the nature of the relationship or their employment.

Scope

The focus of this ITC and accompanying Discussion Paper is on private, for-profit enterprises, regardless of size. The AcSB has rejected a size test that would exclude any private enterprises from applying the standards that will be developed for this sector.

The AcSB's strategy for publicly accountable enterprises calls for the adoption of International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), starting in 2011. The board has, however, accepted that one set of accounting standards does not necessarily fit all types of enterprises. It is now considering the special circumstances of organizations that are not publicly accountable to determine how best to satisfy their financial reporting needs.

This ITC does not deal with not-for-profit organizations. The AcSB is developing a separate strategy for this sector, and will consult with it to determine whether all such organizations should base their accounting on the standards for publicly accountable enterprises or on those to be developed for private enterprises. The AcSB is nevertheless interested in receiving comments from those involved with not-for-profit organizations on any issues in this ITC they deem relevant to them.

Readers interested in following the history of developments in this area, sometimes referred to as the "Big GAAP/Small GAAP" issue, are referred to Appendix A of the accompanying Discussion Paper.

General purpose financial statements are prepared in accordance with accounting standards so that investors, creditors and other users have access to the financial information they need for their decision making. The accounting standards the AcSB develops are, therefore, not aimed at management, people who can obtain the financial information they need when they need it, nor those who do not rely on the financial statements. Nothing, however, precludes any enterprise from preparing GAAP financial statements.

In summary, this ITC does not deal with:

- publicly accountable enterprises;
- not-for-profit organizations; or
- private enterprises that have only internal financial statement users or non-significant external users (see Discussion Paper paragraphs 13-23).

Pictorially, the scope can be depicted as follows, with the shaded area being the focus of this ITC.

<table>
<tr><td>PUBLICLY ACCOUNTABLE ENTERPRISES (NOT IN SCOPE)</td><td>PRIVATE ENTERPRISES WITH SIGNIFICANT EXTERNAL USERS (IN SCOPE)</td></tr>
<tr><td colspan="2">NOT FOR PROFIT ORGANIZATIONS (NOT IN SCOPE)</td></tr>
<tr><td colspan="2">PRIVATE ENTERPRISES WITHOUT SIGNIFICANT EXTERNAL USERS (NOT IN SCOPE)</td></tr>
</table>

Fundamental accounting principles

Accounting standard setters worldwide seek to develop internally consistent standards, based on sound fundamental accounting principles, addressing general purpose financial statement issues such as:

- What are the objectives of financial statements?
- Whom do the financial statements address?
- What are the elements in statements and how are the elements defined?
- What qualities should financial information have?
- When should financial statement elements be recognized?
- What should the measurement objective be?

Fundamental accounting principles apply to all entities. For example:

- An item that meets the definition of an asset is recognized as an asset regardless of the type of entity that has the item.
- Financial statements for all types of enterprise comprise a balance sheet, an income statement and a statement of cash flows.

Over time, standard setters have refined such fundamental accounting principles so that they are better able to ensure that their standards are internally consistent and provide a sound framework for promulgating future accounting standards. The frameworks developed by different standard setters are very similar and, currently, the IASB and the US Financial Accounting Standards Board have a joint project to develop a common conceptual framework.

Paragraphs 28-44 in the Discussion Paper address these issues.

Respondents are asked to comment on whether they agree that a common underpinning of fundamental accounting principles applies to all types of entities and, if not, to explain why not.

Linkage to standards for publicly accountable enterprises

As discussed above, the AcSB has decided that Canada's publicly accountable enterprises will begin using IFRS for their financial reporting. This means that Canadian GAAP will have to change where current standards and IFRSs differ.

But there are questions about how much connection or linkage might be needed between accounting standards for publicly accountable enterprises and those for private enterprises.

Those who support strong links between standards for publicly accountable enterprises and those for private enterprises argue that participants in the Canadian financial reporting system (users, preparers, auditors and educators) would benefit if differences in standards were restricted to those justified by sector-specific needs. They also note that only few areas would require different accounting treatments and, accordingly, a strong link would be most efficient. Supporters of this view then argue that users, preparers, auditors and educators would need to be familiar with essentially only one basis of accounting and, should they have any involvement with private enterprises, they would need to be familiar only with the specific differences related to private enterprise financial reporting. An added advantage of close linkage is that it minimizes costs incurred by a private enterprise should it adopt the standards for publicly accountable enterprises.

Others see no compelling reason for any close links between financial reporting by publicly accountable and private enterprises. Those primarily involved in private enterprise financial reporting do not quarrel with the decision to adopt IFRS for publicly accountable enterprises, which will promote easier capital flows within global capital markets. But they see little or no benefit to a link to global accounting standards because, in their view, private enterprises rarely want access to global capital markets. Moreover, they argue that recent standards deal with issues normally encountered by publicly accountable enterprises but rarely by private enterprises.

The linkage issue has a direct impact on the choice of a financial reporting option for private enterprises. Some comments on linkage are noted with respect to each of the alternative approaches described below**.** Paragraphs 53-57 of the Discussion Paper offer a more detailed review of the arguments for and against linkage.

Respondents are asked to comment on the need for linkage and the extent of its importance in developing accounting standards for private enterprises.

Approaches for further consideration

The AcSB has identified the three options described below as "contenders."

Respondents should say which of these options they believe will best satisfy the needs of both users and preparers of private enterprise financial statements, supported by their reasoning.

Option 1 — A top-down approach based on GAAP for publicly accountable enterprises

This option involves modifying GAAP for publicly accountable enterprises (IFRS) by deleting some requirements or embedding different treatments in the standards, much as done in Canada's current "differential reporting" model. This option may provide the strongest linkage to IFRS, depending on the number of differences adopted.

Readers are asked to assess this approach with an open mind, setting aside their opinion of the current Canadian differential reporting model and without focusing on any specific modifications to IFRS that might be required for private enterprises. With this approach, all aspects of the current differential model would be open for debate. Certainly, a differential approach based on IFRS could differ from the current differential reporting model quite significantly in its specific features. Respondents are asked to comment on whether the "mix and match" aspect of the current differential reporting model should be retained under this option, or replaced by an "all or nothing" basis of application.

Paragraphs 59-66 of the Discussion Paper discuss this option further, including the AcSB's assessment of its advantages and disadvantages.

Option 2 — Adoption of the IFRS-SME, with or without modification

The IASB has released a proposed standard for small and medium-sized enterprises (the IFRS-SME) to provide a simplified, self-contained set of accounting standards appropriate for smaller, non-listed companies. The proposed IFRS-SME is based on the full set of IFRS developed primarily for listed companies. (The IFRS-SME Exposure Draft and Basis for Conclusions can be found at www.iasb.org.)

Option 2 entails adopting the IFRS-SME, perhaps with some modification to meet the needs of Canadian private enterprises.

This option will provide some degree of linkage, depending on how much the final IFRS-SME differs from the full IFRS and the number of modifications necessary to "Canadianize" the IFRS-SME. The IFRS-SME is based on the IFRS and is expected to be updated periodically as IFRSs change, so it is likely that the IASB will maintain some degree of linkage between full IFRS and IFRS-SME.

A summary of the IFRS-SME and the AcSB's assessment of the advantages and disadvantages of this option are set out in paragraphs 67-75 of the Discussion Paper.

Option 3 — An independently developed set of standards

Under this option, the AcSB would develop a set of standards independent of the standards for publicly accountable enterprises. This could be a "fresh start" or use existing standards as a source. It would, however, be based on the conceptual framework (see paragraphs 28-44 of the discussion paper).

This option is less clearly delineated than the other two because, unlike them, it does not have clear points of reference. Respondents who favour this option are asked to be as specific as possible in identifying and describing the principal features they believe to be essential.

This option may, or may not, provide linkage to the standards for publicly accountable enterprises. It is possible that, if this option were adopted, the specific requirements may not differ extensively from those for publicly accountable enterprises. Then, again, they might.

The AcSB has concluded that a "frozen" set of standards is not workable. Option 3 will involve periodic improvements following adoption of the initial set of standards. Evolution may, or may not, be based on evolution in the IFRS applied by publicly accountable enterprises.

Paragraphs 76-82 of the Discussion Paper provide a more detailed discussion of this option, together with the Boards' assessment of its advantages and disadvantages.

Individual options and timing

None of the three options could be implemented immediately. While some options (particularly Option 1) would allow for faster implementation, all involve significant changes and would require a certain amount of time for a smooth transition. The resource and infrastructure implications of the three approaches differ in important respects. The following timing considerations would apply:

- If Option 1 were chosen, the AcSB could begin developing the new set of standards immediately but preparers and users might find it impracticable to apply them until publicly accountable enterprises had implemented the underlying IFRS.
- Timing of the second option will depend on when the IASB finalizes the IFRS-SME. This is currently expected to in the second half of 2008, but it could be later. The AcSB will then need time to identify and develop any necessary modifications to suit Canadian circumstances. Again, application of this alternative might be impracticable until publicly accountable enterprises have implemented the underlying IFRS.
- The third option could require a significant amount of time to implement. A complete "from-the-ground-up" approach would entail creating an entire new set of standards. Using as a starting point current Canadian GAAP, including the existing differential options, would, of course, take less time then a completely fresh start.

A set of standards for enterprises without significant external users

The Discussion Paper notes that GAAP is developed for entities that provide financial statements to external users who have no other sources of financial information about the entities. The AcSB's analysis indicates that a large number of private enterprises do not have any significant external users of their financial statements. The AcSB has also heard from some stakeholders that such entities might need a non-GAAP set of standards that would provide drastically simplified guidance.

Paragraphs 24-26 in the Discussion Paper discuss this issue further.

Respondents are asked to comment on the need for development of non-GAAP guidance, including an indication of who requires such guidance, its purpose and who should develop it.