

# Accounting Standards for Private Companies: An Update

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## Private-Business Owners: The Patient Wait for New Standards?

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There's a fair amount of buzz in the accounting world these days—if accounting and buzz can be connected—about accounting standards for owner-managed private companies. These companies, their owners, and their advisers have been kept in limbo for some time, using current accounting practices but left wondering what the future will bring.

### The Recent News

In Spring 2008, the Canadian Accounting Standards Board (AcSB) issued a very large Omnibus Exposure Draft of future accounting standards for Canadian publicly accountable companies. The standards are based on the International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board (IASB). Canadian public companies will use IFRS accounting standards for fiscal years beginning January 2011.

IFRS are robust, principles-based accounting standards, currently adopted by about 100 countries around the world, particularly those of the European Union and the Pacific Rim. India, China, Brazil, and Israel are now looking to adopt IFRS. The United States will recognize IFRS for cross-listed companies and is reviewing the usefulness of the standards for its own use.

When it comes to Canada, this is the way for us to go. Canada's economy is small, open, and integrated with international business in many ways.

## The Latest News

### What about Canada's private enterprises?

There are about 80,000 public companies in Canada; some very large, many small. There are about 2.2 million private businesses, and about 85 percent of these are small. They are also very important drivers of the Canadian economy and employment.

At its April 23, 2008, meeting, the AcSB commenced discussion of the principles to be used in developing generally accepted accounting principles (GAAP) for Canada's private businesses. The Board tentatively decided that

- The existing *CICA Handbook* will be used as a starting point for the new standards.
- The underlying conceptual framework will be the same for private and public companies.
- Disclosure requirements will be substantially reduced.

The Board will address issues in the existing *Handbook*, such as accounting for income taxes and employee future benefits, that have caused significant concern to private business. The Board has approved the formation of a new Advisory Committee to aid in this project.

## Accounting Standards for Private Businesses—The Choices

KPMG Enterprise is fully supportive of the AcSB's initiative. We believe that:

- Canadian private companies need simplified GAAP. This significant sector of the Canadian economy has special needs that are not well met by existing Canadian GAAP. Standards overload is a real issue for this sector and existing differential reporting options have not proven sufficient.
- The model should be based on existing Canadian GAAP for private business, evolving toward a model based on IFRS (or IFRS for Small and Medium-Sized Entities (SMEs)), only after IFRS has been adopted by Canada's public companies, and the degree of global acceptance of IFRS for SMEs has been assessed.

## Accounting Standards for Smaller Private Businesses – A Growing Gap?

Some would argue that smaller private businesses really don't need GAAP, which are directed to a wide and disparate number of users. The financial statements of a private company may be of interest to only a very limited number of people—say, the owners and their banker.

A number of accountants who act as advisers to private business would agree; they believe the cost-benefit simply doesn't justify preparing financial statements according to current Canadian GAAP. The *CICA Handbook* has become very complex. Therefore, the accountant (who may be an external financial adviser) will undertake a compilation engagement and issue the financial statements with a "Notice to Reader." "Notice to Reader" financial statements prepared on a basis other than GAAP have become the low-cost alternative to audited or reviewed GAAP financial statements. This means there have been no substantive steps to check the statements for errors or omissions.

As public companies in Canada move to IFRS, smaller companies must not be cut off from the mainstream while Canada develops private-company GAAP. Entrepreneurs often want to borrow, go public, buy, sell, or enter into agreements with other companies, both public and private. It is critical that there continues to be a cost-effective option for private businesses that require GAAP financial statements.

### **Keeping up with Global Trends**

KPMG believes that private-sector GAAP should ultimately be linked to IFRS. Otherwise, Canadian investors, business people, and their advisers will be dealing with yet another version of GAAP, (we already have publicly accountable, differential, not-for-profit, and government sets of accounting standards).

For now, the model for private companies could be based on existing Canadian GAAP, and evolve towards a model based on IFRS for SMEs, after IFRS have been adopted by Canada's public companies in 2011, and Canadian businesses and advisers have had an opportunity to assess the global acceptance and usefulness of that new model. Realistically, the transition likely will not take place in the next five years. That's a fairly long timeframe for many businesses, but thinking ahead can mean not getting left behind.

Owners of private businesses should be aware that the accounting world is changing. Should Canada ultimately adopt IFRS for SMEs, there will be changes in presentation and perception. For example:

- IFRS are fair value-oriented (mark-to-market), with less reliance on historical cost. This could definitely change the balance sheets of private companies if, for example, investment properties, currently valued at historical cost, are valued at market. In many cases, this would result in substantial changes in the reported shareholders' equity position.
- Because of the focus on fair value, assets—whose value has been impaired but has recovered—will need to be written back up. This will add volatility to earnings.

There are many other examples of IFRS–Canadian GAAP differences that could also affect bonus plan calculations and bank covenants, such as accruing for losses under onerous contracts.

## What's Next?

At KPMG Enterprise, we will support and closely monitor the AcSB's project. We do believe that the AcSB should work quickly towards a GAAP model for private business that

- Does not impose significant change on preparers and users of financial reporting until IFRS is well ingrained in the Canadian business community
- Allows Canada to see whether IFRS for SMEs gain wide acceptance as an appropriate application of IFRS to the private-business sector
- Provides a simplified GAAP model that will facilitate the current financial reporting needs of Canada's private businesses that require GAAP financial statements
- Provides a more attractive reporting option than the current "Notice to Reader" default model for private businesses that have ceased preparing GAAP financial statements because of the prohibitive cost.

We will keep you informed as developments regarding accounting standards for private companies in Canada progress.

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