



# Financial Reporting Standards for Private Companies Part Two:

Views of Private Companies and the Users  
of Their Financial Statements

GAAP for Non-publicly Accounting Entities

KPMG ENTERPRISE



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# Introduction

The Accounting Standards Board (AcSB) has long recognized that a 2011 adoption of IFRS might not meet the needs of private businesses, and that members of this important sector of the Canadian economy are likely to benefit from following different, more simplified accounting standards.

Today, there are approximately 2.2 million private firms in Canada, more than 80 percent of which are owner-managed. The vast majority of private company financial statements are prepared for a limited number of users, such as family-member investors or informed external users like bankers and creditors.

KPMG Enterprise™ shares the concerns held by many Canadian private companies when it comes to the burden of “standards overload.” Consequently, we actively participated in research to determine how to best alleviate this problem and seek solutions to the benefit of all parties. Our participation included conducting a survey in September 2007 and subsequently publishing a report entitled *Financial Reporting for Private Companies*.

The AcSB announced in February 2008 they would discuss the merits of introducing a simplified form of generally accepted accounting principles (GAAP) to be available for all private enterprises.

Last spring, the AcSB established an Advisory Committee to assist with its agenda in the development of recommended private company standards. It also established the following principles for private company GAAP:

- The existing *CICA Handbook* requirements would constitute the starting point for financial reporting standards for private enterprises
- The same conceptual framework will apply to Canada's private and public companies
- Only *Handbook* issues that have been cause for concern to private enterprises (contentious issues) would be reconsidered
- Specific disclosure requirements would be examined with a view to substantially reducing requirements for private businesses.

Both the Advisory Committee and the AcSB have devoted significant time over the summer and fall to the initiative, and a number of significant proposals have been announced, most notably the proposal for a simplified model for accounting for financial instruments.

KPMG Enterprise is a strong supporter of this undertaking and has invested significant resources to support the AcSB and its Advisory Committee. As a part of this commitment, KPMG Enterprise followed up these developments with an updated survey, *Financial Reporting Standards for Private Companies: Part Two*, to solicit input from interested parties regarding the contentious issues. Over 600 responses were received, with nearly two-thirds of those coming from the private business community.

As we discuss in more detail in this report, respondents to the survey are, in general, very supportive of the initiative and proposals of the AcSB. Private businesses and the lenders and investors who use their financial statements are in agreement with the AcSB on most reporting issues.

We greatly appreciate the time people put into responding to the survey and, of equal importance, their thought provoking commentary. We will make the findings of this survey available to the AcSB for its deliberations and we will incorporate them when responding to the AcSB's *Exposure Draft* on the proposed standards for privately-held companies. The *Exposure Draft* is expected during the first quarter of 2009.

In the meantime, we are pleased to share the results of the survey in this publication, and we will continue to share information about financial reporting standards for privately-held enterprises as issues are discussed and resolved over the coming months.



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# Perspective and Insight



## Differential Reporting – Private Business and Supporters Stress Need for Different Standards

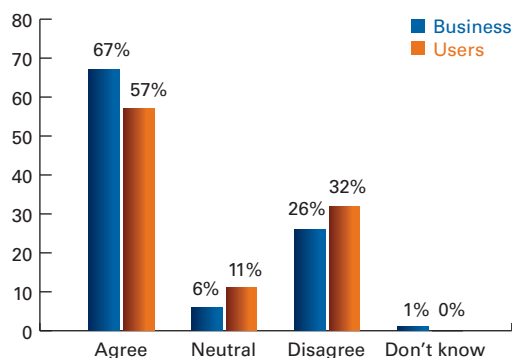
Since 2002, with the approval of their shareholders, Canadian private companies have been eligible to adopt certain accounting policies that public companies could not use. These options reflected a recognition by the AcSB that certain aspects of generally accepted accounting principles were either too complex for private companies or that the cost of application exceeded the benefits to the users of private company financial statements.

### Key differential reporting options include:

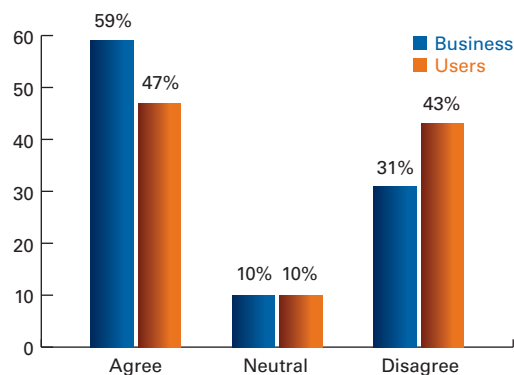
- The ability to account for intercorporate investments using the cost or equity model in lieu of preparing consolidated financial statements
- Requiring private companies to assess goodwill and intangible assets for impairment only when there is an event or circumstance that may indicate that the carrying value is not recoverable
- Allowing private companies to account for income taxes on the taxes-payable basis to avoid the complexities of tax allocation accounting.

KPMG Enterprise asked whether private companies should continue to enjoy access to differential reporting options. Respondents from private businesses and the users of their financial statements indicated support for the continuation of differential reporting, although the user community was less supportive of the ability to prepare non-consolidated financial statements.

**“Private companies currently have differential reporting options that allow them to opt out of certain accounting requirements. Do you agree that private companies should be able to choose amongst different accounting options?”**



**“Do you agree that private companies should have the option to prepare financial statements on a non-consolidated basis?”**

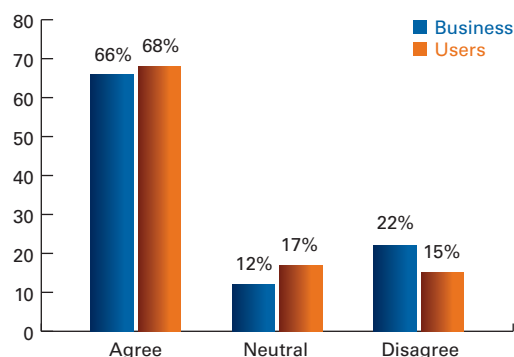


It is interesting that even though both private business and users support the continuation of differential reporting, both groups observed that differential reporting significantly impairs the comparability of financial statements, which is a key concept underlying generally accepted accounting principles.

“In the drive for public companies to adapt to Sarbanes-Oxley legislation and IFRS reporting standards, there have been many changes introduced to financial accounting that are not well understood or meaningful to the owner of a private company. Even external stakeholders such as lenders, suppliers, clients and insurers are often better served by financial statements and reports that are simpler and more transparent. More complexity adds cost and reduces value to the user community.”

Company/Business

**“Do you agree that the ability to choose amongst options for alternative accounting treatments significantly impairs the comparability of financial statements?”**



Both private business and users expressed support for the differential reporting option for reassessing goodwill and intangible assets only when events or circumstances indicate a potential impairment.

The related AcSB proposals align well with the survey’s findings. The AcSB is proposing to maintain the existing differential reporting options. An important enhancement is that unanimous shareholder approval will no longer be required; the selection of reporting options will be at management’s discretion.



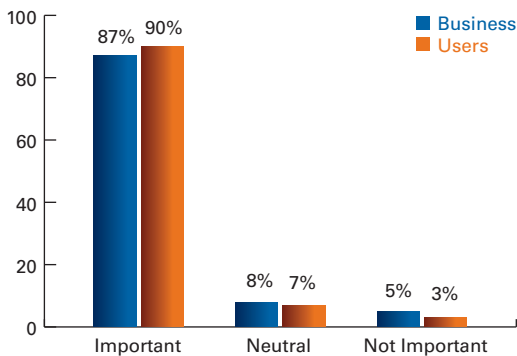
## Financial Instruments – An Endorsement of Fair Value Accounting, with Certain Restrictions

In 2006, as part of its strategy to align Canadian accounting standards with US standards, the AcSB introduced a comprehensive change in the standards for accounting for financial instruments. These standards were scheduled to become effective for fiscal years ending December 31, 2008, for Canadian private businesses with a calendar year-end.

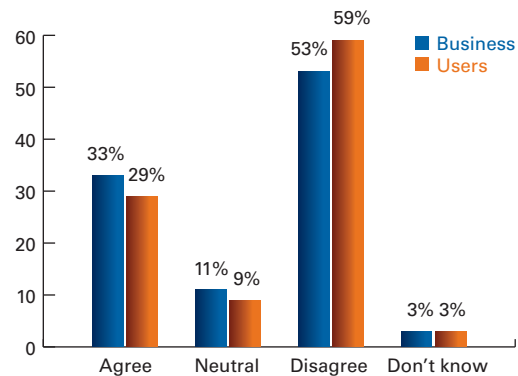
The new standards reflect a move away from historic cost accounting to fair value accounting for financial instruments and introduce the concept of comprehensive income to Canada. By virtue of the number of accounting options provided and other changes, such as the need to identify and separately value embedded derivatives, the new standards are very complex and difficult to apply.

Survey participants were, perhaps surprisingly, supportive of many of the underlying concepts of the new standards. They were virtually unanimous in their belief that the disclosure of fair value for portfolio investments was important. They strongly disagreed with the proposition that historic cost information was sufficient for their needs. They also showed strong support for the need to disclose fair value information about speculative investments and to disclose the fair value of derivatives and embedded derivatives in the financial statements, even when derivatives are part of a hedging program.

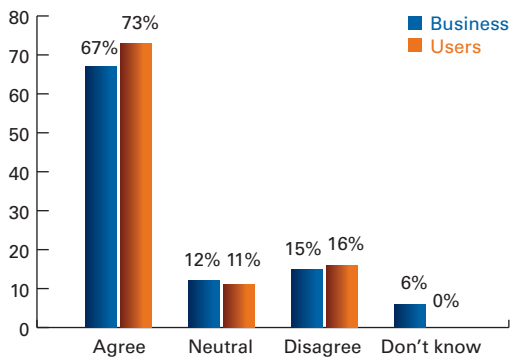
**“How important is it that the fair value of portfolio investments be disclosed in the financial statements?”**



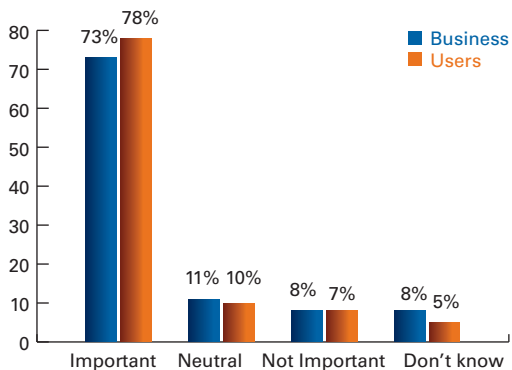
**“Please indicate your level of agreement with the following statement: Historic cost, less provisions for loss of value, provides sufficient information about portfolio investments.”**



**“Do you agree that speculative investments should be recorded at fair value?”**



**“How important is it that the users of private company financial statements be informed of the fair value of the derivatives and embedded derivatives within the company’s contracts?”**



The AcSB’s proposals appear to generally reflect the market’s needs. The AcSB has announced that it will develop a simplified financial instrument standard, wherein investments in equity instruments for which there are readily determinable fair values will be recorded at fair value. The proposed standard will also require that any free-standing (i.e., speculative) derivatives be recorded at fair value. However, the AcSB has moved further with its initiative to ensure that the standard is cost-effective for private business. The AcSB will sustain its previously announced decision to rescind the requirement to identify and separately value embedded derivatives. In addition, the AcSB is working to develop a simplified hedge accounting model that will focus on the disclosure of the significant terms and conditions of hedging arrangements; private businesses will not need to incur the cost to determine and record the fair value of financial instruments used in effective hedging relationships. For all other financial instruments, private business will continue to apply the familiar amortized cost model, which is not expected to require significant change from current practice.

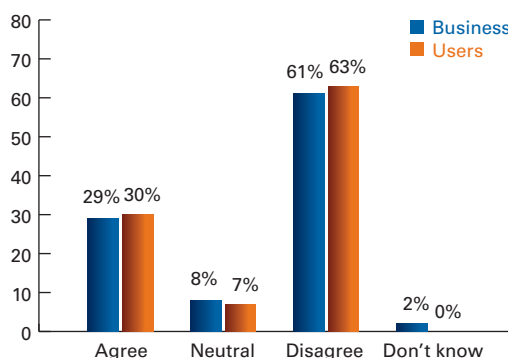


## Classification of Callable Debt – Disagreement with Standard Setters on Short-Term Classification

In 2001, the AcSB clarified its view that callable debt obligations and debt obligations maturing within 1 year from the balance sheet date should be classified as a current liability unless they have been refinanced on a long-term basis before the financial statements are issued. In the AcSB's view, neither the intention of the debtor to refinance the obligation nor the intention of the lender not to exercise the call option is sufficient to justify presentation as non-current.

The private business community continues to express significant disagreement with this position. It responded with a strong majority view that this presentation is inappropriate. The user community was less definitive in its view; it expressed generally as much support for the AcSB's position as disagreement therewith.

**“Do you believe that callable loans should be classified as current liabilities even though there are terms of repayment that extend beyond one year?”**



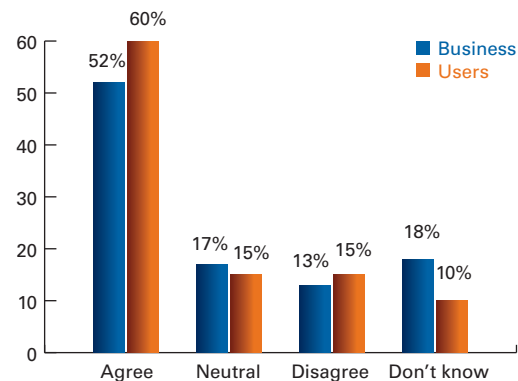
The AcSB has redeliberated this issue as part of the private enterprise GAAP initiative and has announced that it does not intend to modify its views on this matter, having concluded that the presentation of such debt as a current liability is consistent with the nature of the obligation and the basic conceptual model underlying GAAP. However, the AcSB has discussed providing guidance on the presentation of callable debt on the balance sheet in a way that would distinguish it from other current liabilities.

## Employee Future Benefits – Smaller Businesses Support “Expense as You Fund”

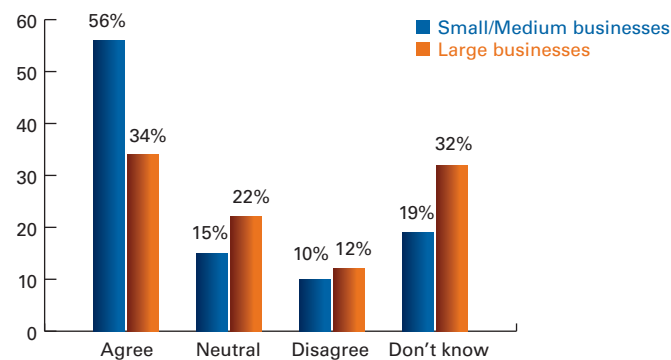
The AcSB and its Differential Reporting Advisory Committee have been aware of the concern about the cost of accounting for defined benefit pension plans. The current accounting model requires annual actuarial information about the accounting value of accrued benefit obligations and incorporates complex accounting requirements relating to the recognition of actuarial gains and losses, and adjustments arising from plan amendments. Comprehensive financial statement disclosures are also required. The AcSB identified the need for a review to identify opportunities for simplification for private business.

Many of Canada’s private businesses have one or more “top-hat” or “individual pension plans” (IPPs), which provide defined pension benefits for the owner-manager and/or his or her spouse or key employees. In responding to our survey, business expressed support for adopting an “expense as you fund” accounting model for such pension plans.

**“Do you agree that if the only member (beneficiary) of an Individual Pension Plan (IPP) is the owner-manager (or immediate family) of the business, the company should only be required to expense payments to the pension plan and provide disclosures based on the triennial actuarial review required by regulators?”**



However, the support from business for this alternate model came primarily from smaller businesses; larger private businesses did not share this view.



The AcSB concurred that a simplified approach would be acceptable only when the beneficiaries of the plan are the owner-manager of the business and/or their spouse. The AcSB’s proposal will allow such plans to be accounted for based on the triennial funding valuation (this approach is generally already being used for regulatory purposes). Rather than recognizing experience gains and losses, and other adjustments over prescribed periods, the gains and losses will be recognized when they occur. As a result, companies adopting this simplified model may experience more volatility in their earnings.

We believe that respondents to our survey will be supportive of the AcSB’s proposal.

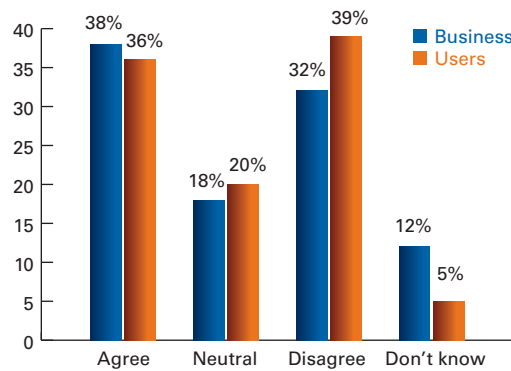


## Stock-Based Compensation – Divergent Views

Similar to their public counterparts, private companies often provide ownership opportunities to their employees as part of their compensation strategy. This is done, for example, by granting stock options that are designed to reward employees if the value of the company grows.

The current fair value accounting model for stock-based compensation is complex and often requires valuations. Obtaining the necessary information is costly. Our survey asked whether the current accounting model imposed an undue cost on business. Responses were mixed.

**“Do you agree that accounting for stock-based payments at fair value imposes an undue cost on private companies?”**



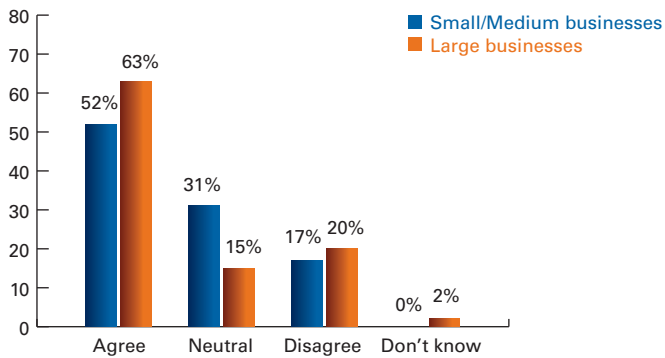
The AcSB considered whether an alternative, less complex, model might be appropriate. It considered the intrinsic value model, wherein compensation expense is recognized only when options are “in-the-money.” However, the AcSB concluded that the existing fair value model should be retained as it is the more effective and efficient model for providing appropriate recognition of stock-based compensation expense.

Respondents to our survey have divergent views on this issue as only a minority believed that the fair value model imposes an undue cost on private companies.

## Other Areas – General Support for Existing GAAP

Our survey sought respondents' views in a number of other areas, including accounting for leases and asset retirement obligations. Respondents were supportive of existing GAAP in these areas and, as such, will be supportive of the AcSB's proposal to retain existing standards. We noted that respondents from smaller companies found less value in existing lease accounting rules than did respondents from larger companies.

**“Do you agree that the distinction between operating and capital leases is useful to a reader of the financial statements of a private company?”**



“I think the accounting standards should take into consideration the users of the financial statements and their sophistication. Larger private companies probably have more complex issues and more sophisticated readers, and can comply with all accounting standards. Smaller private companies and their users are probably more focused on the cash generating ability of the business (or lack thereof).”

Lending Community

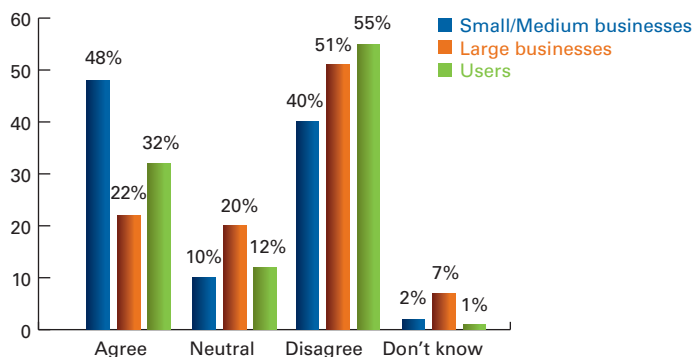
## Approach to Disclosures – Note Disclosure Continues to Be Important

One of the underlying premises of the AcSB’s private enterprises strategy was that users of private business financial statements are able to access whatever information they require to support their decisions, i.e., they can access information that is not in the financial statements. In contrast, for shareholders of a public company, the only financial information available is the company’s public filings, which include audited financial statements.

Based on this premise, the AcSB believes that disclosure requirements for private business can be substantially reduced from the current model. The AcSB has commented that disclosures for private companies should be based on the existing general standards of financial statement presentation and the requirement to disclosure accounting policies, with the onus being on preparers of private business financial statements to disclose whatever additional items would be of significance to their users.

Participants in our survey were not in agreement with the AcSB premise. A majority of both the private business respondents and the user community disagreed with the statement that they can access whatever additional information they require and are therefore not fully reliant on the information within the financial statements.

**“The users of the financial statements of a private company can access whatever additional information they require and are therefore not fully reliant on the information within the financial statements.”**

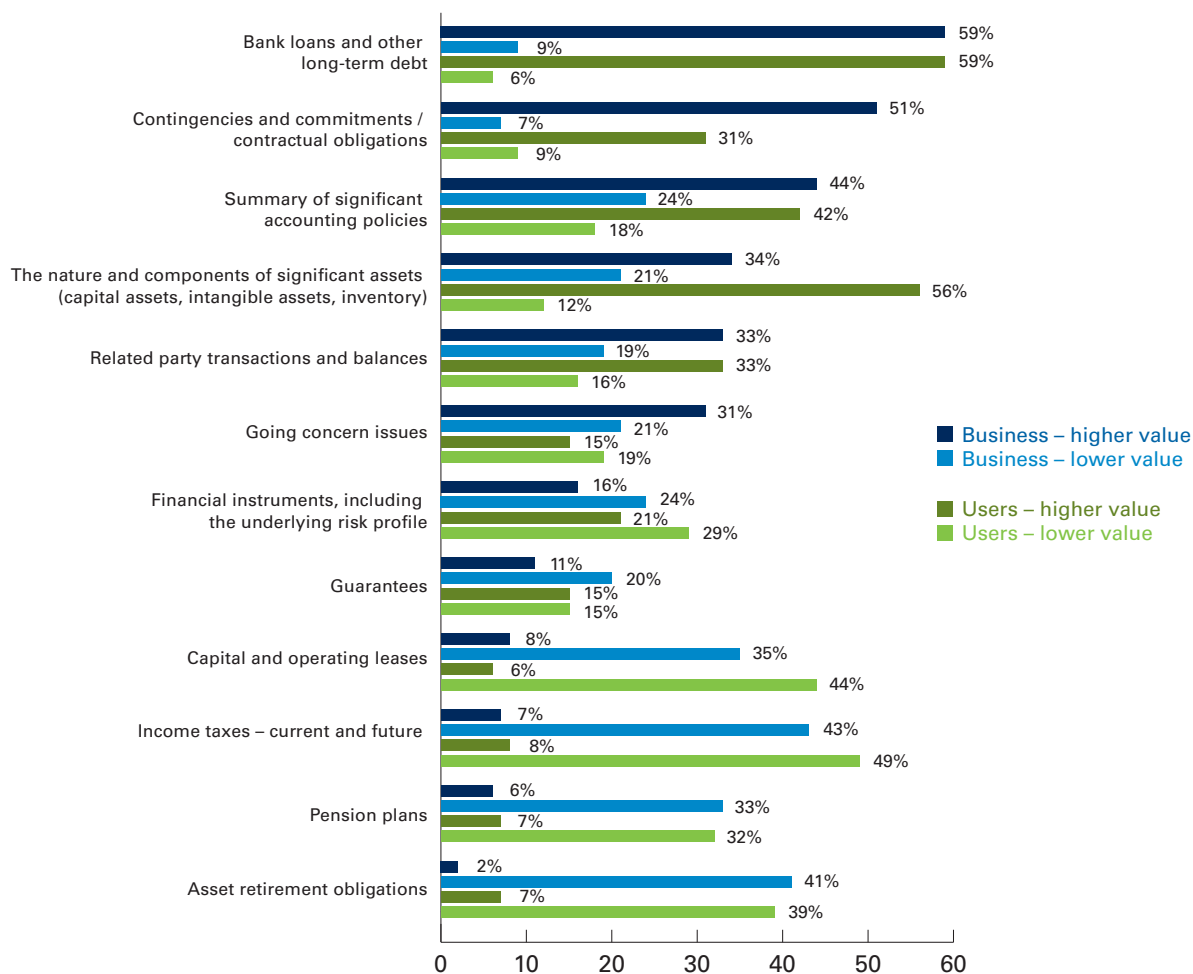


The Board has not yet published any specific proposals regarding disclosure. This issue warrants further attention as the project proceeds to ensure the needs of businesses and the users of their financial statements are met.

Survey respondents identified certain disclosures that they value more or less highly. More specifically, they were asked to identify:

- The top three areas of disclosure that provide the most value to private company financial statements
- The top three areas of disclosure that provide the least value to private company financial statements.

The survey results were as follows:



We generally observed a high degree of consistency in the responses of businesses and users. Perhaps surprising was the lack of value that both groups of respondents placed on disclosures relating to pension plans, leases, and income taxes as these are areas for which the AcSB has traditionally required comprehensive and extensive disclosures on the presumption they are reflective of significant underlying risks. We were also surprised to see the perceived lack of value of disclosures for guarantees and going concern as we had presumed users would value these disclosures in assessing the risk profile of the company. Less surprising was the lack of support for financial instrument disclosures, given the initiative to simplify the related accounting. Clearly there is strong support for many of the traditional financial statement disclosures, such as accounting policies, the underlying detail for asset categories, the terms and conditions of bank indebtedness and other long-term debt, and commitments and contingencies.

The AcSB had not identified a need to enhance or focus on cash flow related disclosures in the financial statements of private enterprises; however, a common theme in comments from survey respondents was the high importance they place on cash flow information. We expect that the AcSB will take this into consideration as it addresses financial statement disclosures, one of the latter components of its project.

KPMG Enterprise will ensure that the views of survey respondents with respect to disclosures are highlighted to the AcSB.

## In Conclusion



We thank those who took the time to complete our survey for your valuable contribution. Your responses will help KPMG Enterprise coordinate its efforts as the accounting profession identifies the most appropriate financial standards for private enterprises.

We will continue to keep you informed of further developments in this important area.

# About the Research

## Whom did we survey?

KPMG Enterprise invited executives from private companies across Canada, as well as users of their financial statements, including investors and the lending community, to participate in an updated online survey. We asked them to answer questions about important issues that are currently being debated with respect to developing the most appropriate financial reporting standards applicable to private enterprises.

This online survey was conducted in both official languages between June 2008 and August 2008. It also involved the participation of KPMG Enterprise professionals who specifically focus on financial reporting for Canadian private companies and are familiar with ongoing developments in this area.

## Profile of respondents

There were 607 responses to the KPMG Enterprise survey, of which approximately 64 percent (391) were private business financial statement preparers, 26 percent (156) were public accountants, and the remaining 10 percent (60) were either investors or members of the lending community.

Members of the business community who responded generally reflected larger entities, i.e., over 50 employees or sales in excess of \$5 million. Similarly, the responses from the lending/investing community were weighted toward those that invested/extended credit in excess of \$10 million. The limited responses from those in or serving the smaller company segment appear to provide further support to the AcSB's view that such smaller companies and their lenders do not require general purpose financial statements; therefore, those parties are not as engaged in the project to develop GAAP for Canada's private enterprises. This may also be reflected in the differing view of smaller businesses that the users of their financial statements have access to whatever information they require.



## About KPMG Enterprise

KPMG Enterprise is a network of professionals devoted exclusively to serving private companies in Canada. KPMG Enterprise business advisers care passionately about the success of their private company clients. As the primary point of contact, they strive to become the trusted adviser. They take time to understand the client's business and deliver value that is unique to that private company. The goal is to deliver services in a way that is manageable and affordable, which can ultimately help the private company client save time and money.

KPMG Enterprise business advisers can provide relevant and timely advice and ideas. Their mandate is to help private companies achieve their business objectives. They get to know the client's business so they can bring forward the best people and the right resources to serve the specific needs of the client.





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