



Financial Reporting Standards for Private Companies: Survey Results

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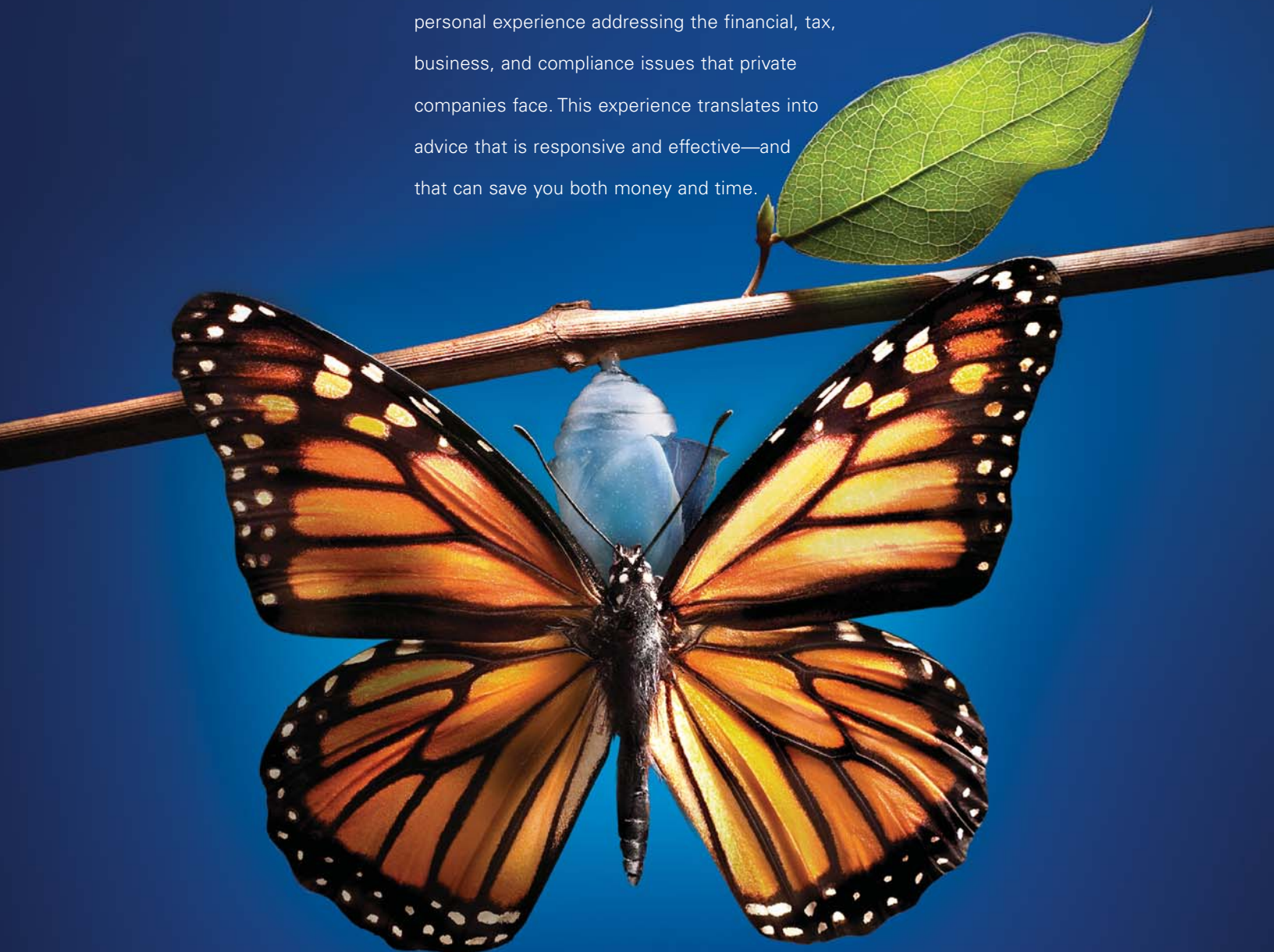


Table of contents

Introduction 2

About the research 3

Survey responses from executives representing privately held companies that issue general-purpose financial statements 4

- Profile of respondents
- What's important in your financial statements?
- The importance of producing financial statements comparable to other companies
- Differential reporting
- Historical cost or fair value—or both?
- Should company size count in the application of accounting standards?
- Canadian control over accounting standards

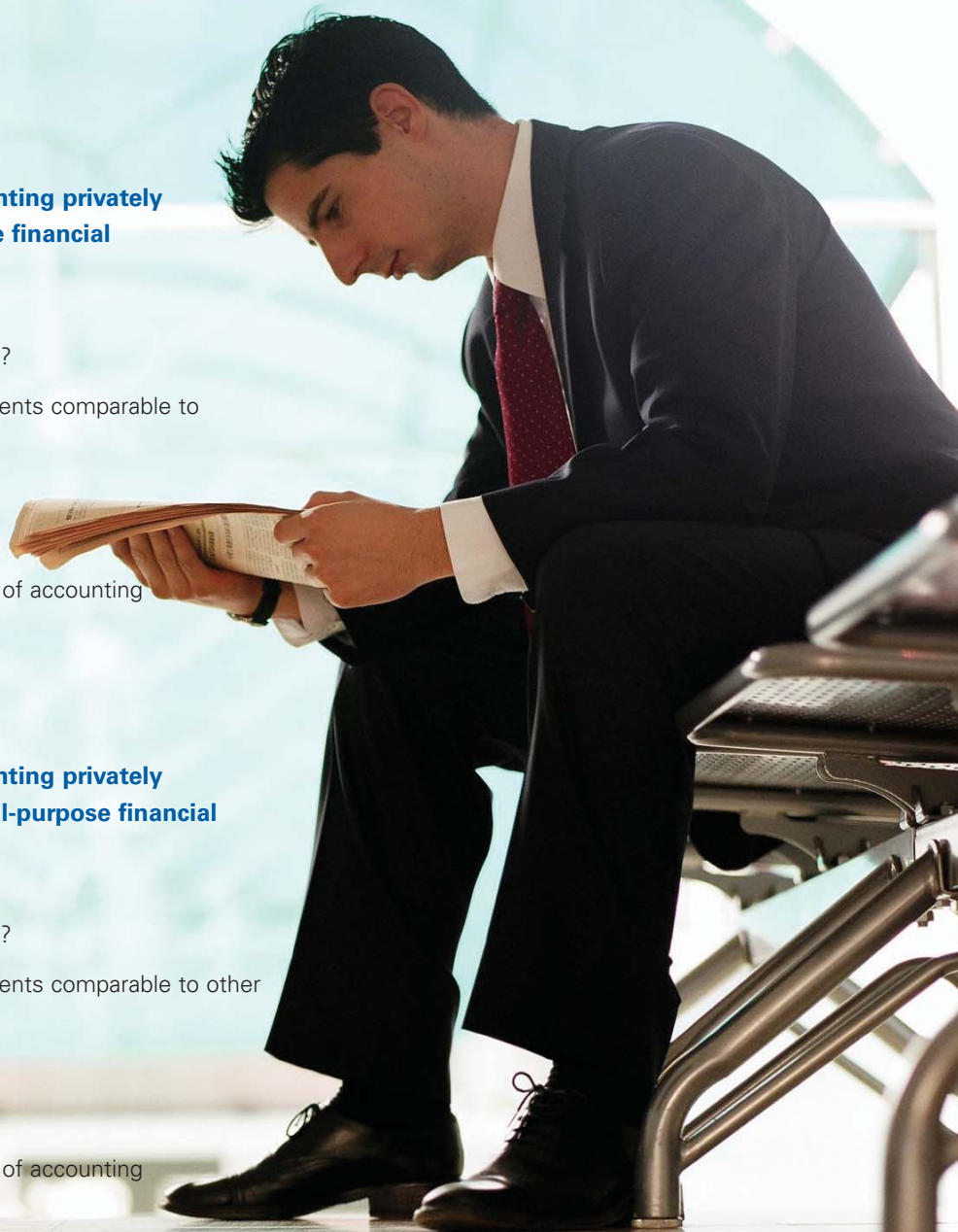
Survey responses from executives representing privately held companies that do not require general-purpose financial statements 8

- Profile of respondents
- What's important in your financial statements?
- The importance of producing financial statements comparable to other companies
- Differential reporting
- Historical cost or fair value—or both?
- Should company size count in the application of accounting standards?
- Canadian control over accounting standards

In conclusion 11

Appendix 12

KPMG's Submission to the Accounting Standards Board



Introduction

The Canadian Accounting Standards Board (AcSB) is in the process of adopting International Financial Reporting Standards (IFRS) as the accounting standards for Canadian public companies. Full convergence is expected in 2011. However, the Board recognizes that private businesses could benefit from different accounting standards; IFRS might not be useful or cost effective for this important sector of the economy.

Earlier this year, the AcSB asked for comments from financial statement preparers and users on three options for companies that issue general-purpose financial statements (i.e., statements suitable for broad distribution to a range of external investors or creditors):

- **A top-down approach based on IFRS for public companies**, but with certain exemptions or differential reporting options.
- **Adoption of the planned international standard designed for small and medium-sized entities** (SMEs). This is a simplified, self-contained standard for private companies, using IFRS but providing some exemptions or modifications for SMEs.
- **A unique “made-in-Canada” set of standards**. The AcSB would develop and maintain a set of private-company accounting standards.

We welcomed the opportunity to participate in this process, because we share our clients’ concern that Canada’s private business sector is burdened by “standards overload.”

As we prepared our response to the AcSB, KPMG Enterprise decided to ask Canadian private companies about the implications of these options for their business. We invited clients and other interested parties to respond to an online survey.

The survey results clearly indicated a market demand for a “fourth option” for the very large number of private companies that don’t need to issue general-purpose financial statements.

The survey results were invaluable in shaping our response to the AcSB, which was submitted on October 30, 2007.

In this publication we are pleased to share the results of the survey along with our formal response to the AcSB. We will continue to provide you with information on this important topic as the issue evolves over the coming months.

Meanwhile, we invite you to contact your KPMG Enterprise adviser if you have questions about KPMG’s response or about how the proposals might affect your business.

Yours sincerely,

Beth Wilson, FCA

Canadian Managing Partner, KPMG Enterprise™

November 2007



About the research

Whom did we survey?

The Canadian Accounting Standards Board (AcSB) recently issued an invitation to comment on the future of financial reporting by private enterprises in Canada. To prepare for our response to these new reporting standards, KPMG Enterprise™, the private-company practice of KPMG LLP, invited executives from private companies across Canada to participate in an online survey regarding the new proposed standards.

The online survey was distributed to KPMG's private-company clients across Canada in both official languages. We also sent the survey to KPMG people who are involved in private-company financial reporting.

Between September 12 and September 23, 2007, we received 156 responses.

Reflecting the views of owner-managed enterprises

The three options presented by the AcSB are meant for private companies issuing general-purpose financial statements. The results of the KPMG survey clearly identified a market demand for a separate solution for private companies that do not require general-purpose financial statements.

Two-thirds of survey respondents indicate that they do not represent private companies that publish general-purpose financial statements. They represent owner-managed enterprises that require only limited-use financial statements—companies where the users are informed internal users, such as family-member investors, or informed external users, such as the entity's banker.

The executives who identified themselves as representing this category of private company were given the option of not completing the survey. However, over one-third of these respondents proceeded to provide us with their views. We found them useful, particularly because the Canadian Institute of Chartered Accountants (CICA) has now announced it is proposing a Framework for Owner-Managed Enterprises (FOME). (To put this into perspective, there are 2.2 million private companies in Canada and over 80 per cent are owner-managed, with limited users of financial statements.)



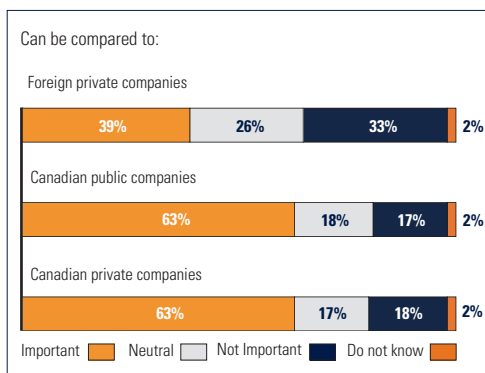
What do executives representing owner-managed enterprises want or need in their financial reporting?

The fundamental accounting principles underlying all the financial reporting options should be the same. There should be common definitions for assets, liabilities, equity, revenues, and expenses, and basic criteria for revenue recognition.

Survey responses from executives representing privately held companies that issue general-purpose financial statements



How important is it to you that your company's financial statements can be used to compare your company's performance to other companies?



Profile of respondents

One-third of the respondents are CFOs or vice presidents, Finance. One-quarter say their company is a wholly owned private company. Just under half of the companies have fewer than 100 employees; 22 per cent have more than 1,000. Half the companies have revenues greater than \$50 million. The majority (72 per cent) are located in Ontario.

One-quarter of respondents report that they operate in the Financial Services sector, with 24 per cent in the Consumer and Industrial sectors.

Not surprisingly, the executives who responded are familiar with current and planned changes in financial reporting. Most are aware of the AcSB's proposed changes, and familiar with the alternatives being proposed. One-third had read KPMG's discussion paper *Financial Reporting by Private Companies—Evaluating the Options*. Almost all indicated that accounting standards are important to them and their company.

What's important in your financial statements?

Respondents rank the income statement and the balance sheet—even the notes—as more important than the statement of cash flows.

Respondents were given a list of 19 financial statement measures and asked to rank them. Most (93 per cent) rank revenues as the most important. Following are consolidation of subsidiaries (65 per cent), information on related-party transactions (63 per cent), and income taxes payable (61 per cent).

Most respondents (65 per cent) from private companies that issue general-purpose financial statements state that it is important to them that their company financial statements could be used in a future public offering.

The importance of producing financial statements comparable to other companies

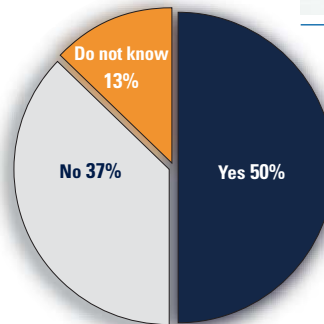
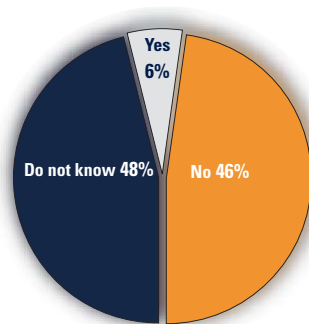
Two-thirds of the respondents from private companies that issue general-purpose financial statements indicate that it is important that their financial statements can be compared to Canadian private companies and Canadian public companies. Some 40 per cent believe comparability with foreign private companies is important.



Differential reporting

In our survey, most respondents (60 per cent) indicate that Canada should continue to have differential reporting options. Half believe that their company should be able to select specific options under differential reporting as opposed to adopting an all-or-nothing package. Half believe that the requirement for unanimous shareholder consent is a problem.

Do you believe [Canadian private companies] need to have additional options under differential reporting?

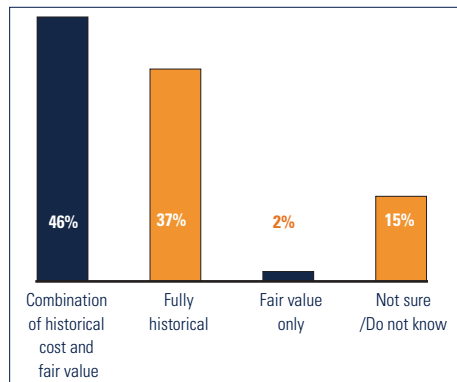


Do you believe the requirement for unanimous shareholder consent is a problem for differential reporting?

Historical cost or fair value—or both?

Just under half of respondents believe users of private-company financial statements prefer a combination of historical cost and fair value information. Slightly more than one-third believe that users prefer fully historical value.

Do you believe users of private-company financial statements prefer the historical cost model of accounting or a fair value model?



A KPMG internal respondent says:

“We are moving into a more global economy. We need comparable standards to what is being adopted internationally. Otherwise Canadian private-company accounting standards will not be relevant to international investors, banks and suppliers who will try to rely on and understand the financials.”



"It is the inconsistent standards that cause the confusion. For example, I answered in favour of full historical balance sheet values. Although this may not reflect the current values, at least the reader can rely on historical cost as a basis on every statement and make their own adjustments based on appraised or other valuation methods. There has to be an apples to apples baseline for any reliance on financial reports."

Should company size count in the application of accounting standards?

The relation of company size to required accounting standards is an issue on which executive opinion is split.

Some 35 per cent believe standards should be optional based on the size of the company. A number of reasons are given:

- "Materiality."
- "Some are too onerous for small companies, such as financial instruments."
- "For smaller companies, the amount of work to meet current disclosure standards represents a significant commitment of resources (time, money, people) that are not cost-effective and add no real benefit."
- "Size (measured under a combination of assets and sales) and the sophistication of the shareholders/users of the financial statements."

On the other hand, another 35 per cent do not believe accounting standards should be based on the size of the company—for a number of reasons:

- “One GAAP for all please.”
- “As a banker and potential creditor, we would like to see full disclosure made mandatory.”
- “No, depending on the uses of the statements. For investment potential, securing of debt instruments, etc., they need to be held to the same standard and comparability.”
- “I feel strongly that all financial statements, private and public, small and large, should be consistent so as to provide comparability across all business segments.”

Canadian control over accounting standards

Only 7 per cent believe there are unique Canadian circumstances that call for a made-in-Canada set of accounting standards for private companies. However, about 50 per cent are concerned or somewhat concerned about the lack of Canadian control when Canada adopts IFRS.



Survey responses from executives representing privately held companies that do not require general-purpose financial statements



Profile of respondents

The profile of the respondents differed from that of the executives associated with private companies issuing general-purpose financial statements. Most of the respondents in this sample are the CFO or vice president, Finance (21 per cent), the controller (21 per cent), or the CEO/president/owner (18 per cent). Sixty per cent indicate that the company was wholly owned. Just over half have fewer than 50 employees. One-third have revenues less than \$5 million and fewer than half are located in Ontario. Most operate in the Consumer and Industrial sectors, with 19 per cent in Financial Services.

Like the respondents in the general-purpose financial reporting category, most (88 per cent) are familiar with the private-sector reporting alternatives being proposed by the AcSB.

What's important in your financial statements?

Respondents rate all four financial statements—income statement, balance sheet, notes, statement of cash flows—as important to their company, with the income statement as most important.

The importance of producing financial statements comparable to other companies

Just under half (45 per cent) of the respondents indicate that it is important to their company that their financial statements can be compared to other Canadian private companies. They do not feel it is important to compare their financial statements with those of either Canadian public companies or foreign private companies.

Differential reporting

Eighty per cent of respondents believe that Canada should continue to have differential reporting options (compared to two-thirds in the general-purpose reporting group).

“Generally speaking, the lenders to private companies focus more on the balance sheet and the reporting options need to recognize this. The audit approach needs modification and GAAP needs to recognize the differences.”

Respondents identify a number of areas where differential reporting could be expanded:

- “Treatment of demand bank loans that are being paid off on a scheduled long term basis. They should be shown as long term (excluding current 12 months) with a note to the financial statement about the demand loan status.”
- “Revenue recognition, amortization as long as it is properly disclosed in the financial statements.”
- “Disclosure of fair value of financial instruments held to maturity; joint venture note; pension note.”
- “Leases, more options under financial instruments, less disclosure under most specific accounting areas, pension accounting.”

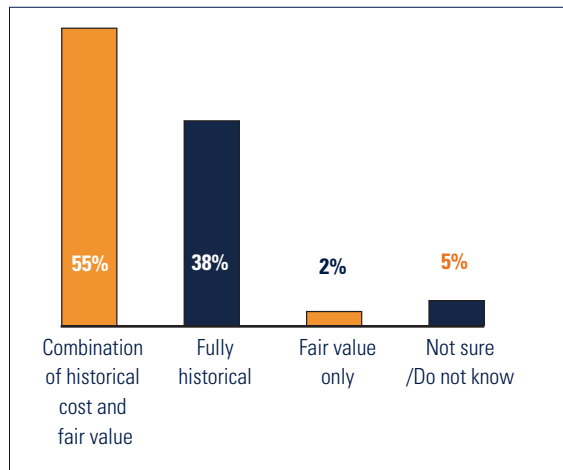
Half of the respondents do not believe the current requirement for unanimous shareholder consent is a problem in differential reporting.



Historical cost or fair value—or both?

Over half of the respondents in this group believe users of financial statements prefer a combination of historical cost and fair value. Another third believe that users prefer fully historical value.

Do you believe users of private-company financial statements prefer the historical cost model for accounting or a fair value model?





Should company size count in the application of accounting standards?

Half of respondents (53 per cent) indicate that accounting standards or disclosures should be optional based on the size of the company. (This compares to 35 per cent in the general-purpose statement group.)

The reasons given focus not so much on size as on the users of the financial statements:

- “A simple but minimum standard would be more cost efficient to the small private company where the only users are the owner, the tax agency and/or the bank.”
- “Small holding companies or where readers are limited to CRAB and the shareholders.”
- “Small companies would expend far in excess of value for accounting standards that render the financial statements virtually meaningless to ownership and oftentimes useless even for tax purposes.”
- “It depends on the standard and/or the disclosure. Certain accounting standards and disclosures may be a requirement regardless of the size of the company due to their importance relative to the significance they have on the financial statements. Others which have minimal impact may not need the same level of visibility. In the context of moving to common international standards, it will be important to minimize these options in the future so that there is comparability where this is of value in interpreting correctly the true financial performance and position of a company by informed parties.”
- “Certain disclosure may hurt competitive advantages to smaller entities.”

Fifteen per cent do not believe accounting standards should be based on company size:

- “All private companies should be treated the same, regardless of size. The users of financial statement are still a limited group, and it is the users’ needs that are the focus. Also, it may be difficult to determine what the appropriate “size” cutoff would be.”
- “The size test may not be a good indicator of the reporting needs of the users. Flexibility on reporting would be better served by a risk assessment profile or risk test.”
- “Nature of the business and transactions should dictate the choice of accounting policy, not size.”

Canadian control over accounting standards

Only 5 per cent believe there are unique Canadian circumstances that would necessitate a made-in-Canada set of accounting standards for private companies.

In conclusion

One respondent among the group that do not require general-purpose financial statements says:

“Balance between several important goals is what is required, namely:

- the move to a common international standard
- the need to minimize the burden for private company compliance
- to provide the flexibility to industry groupings to ensure that the standard makes sense for the type of business where financial performance is being reported
- in providing differential reporting options that are clearly disclosed and make sense and
- producing statements that are understandable to the proper audience needing financial understanding of the business.”

“How these competing goals are met across industry groupings, company sizes and different countries is the challenge. Clearly prioritizing these competing priorities relative to each other and making judgments on achieving the balance issue by issue is the required exercise.”

We thank those who took the time to complete the survey, contributing to our thinking on the issues of private-sector financial reporting, and to our submission to the AcSB.

The notion of establishing a separate accounting framework for limited-use financial statements is a significant shift in Canadian thinking—one that many believe is long overdue. In the coming weeks, the CICA expects to publish proposals on an accounting Framework for Owner-Managed Enterprises (FOME) focused on the financial reporting needs of private companies that do not want or need general-purpose financial statements. Another aspect of this proposal may be a reconsideration by the Auditing and Assurance Standards Board of its standards to enable a public practitioner to provide an audit report or review engagement report on financial information prepared in accordance with the FOME. Currently, public practitioners are often limited to providing a “notice to reader” on financial information for this segment as the financial information is prepared neither entirely in accordance with GAAP nor in accordance with another recognized framework.

The Appendix to this publication contains a copy of our submission to the AcSB.

We’ll keep you informed.



Appendix

KPMG's Submission to the Accounting Standards Board



KPMG LLP
Suite 3300 Commerce Court
West
199 Bay Street
Toronto ON M5L 1B2

Telephone (416) 777-8500
Fax (416) 777-8818
www.kpmg.ca

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

Via e-mail to: ed.accounting@cica.ca

October 30, 2007

Dear Mr. Martin:

Re: Financial Reporting by Private Enterprises – Invitation to Comment

Background

We are pleased to have this opportunity to respond to the Invitation to Comment (the ITC) issued by the Accounting Standards Board (AcSB or the Board) regarding the future of financial reporting by private enterprises in Canada. We concur with the Board's assessment that this significant sector of the Canadian economy has special needs that are not necessarily well met by either existing Canadian accounting standards or International Financial Reporting Standards (IFRS), which will be adopted by Canadian public companies as of a target date set at 2011. We commend the Board for its research and for facilitating round tables across Canada this summer to generate discussion and debate at this critical juncture in the evolution of Canadian financial reporting.

KPMG believes that financial reporting should deliver value to all businesses, including privately-held enterprises. We share our clients' concerns that Canada's private business sector is burdened by certain accounting standards that add little, if any, value to their financial reporting. Examples of this "standards overload" include accounting for post employment benefits and financial instruments. Differential reporting options have not been available on a sufficiently timely or comprehensive basis to address this concern for private businesses and now need to be re-evaluated as Canadian GAAP for publicly accountable enterprises moves to IFRS.



To help to ensure that KPMG's response to the ITC reflects the views of Canada's private business entrepreneurs, we published two papers outlining the matters addressed in the Invitation to Comment and the companion Discussion Paper. We also hosted on-line surveys for our clients and other interested parties and for our KPMG Enterprise™ practitioners to generate input to the deliberations.

Limited-use financial statements

The most significant finding of our analysis, which parallels the findings of the Board, is that a very large number of private businesses have no need for general purpose financial statements suitable for broad distribution to external users. What this business segment clearly needs, and wants, is a standardized basis of preparation for financial statements that are suitable for internal and informed external users, such as the entity's banker. Users of such "limited-use financial statements" are not solely reliant on financial reporting for their information needs as they are able to obtain information from management to the extent that it is not provided by the financial statements.

In the absence of a reporting framework for limited-use financial statements, many private businesses have opted to have their financial statements prepared on the Notice to Reader basis, effectively a preparer-choice model. Financial reporting without a widely-accepted underlying framework is not a satisfactory solution to standards overload as it is neither well understood nor applied consistently amongst businesses. It is also not susceptible to audit or review so the external user is without assurance as to the integrity of the financial reporting.

We therefore applaud the CICA's recent announcement of its intention to develop a simplified accounting framework for Canada's private businesses which only require limited-use financial statements (the CICA's proposed Framework for Owner-Managed Enterprises or "FOME"). We trust that the Auditing and Assurance Standards Board will quickly move to address the application of assurance standards to financial statements prepared using FOME. Our response to the AcSB Invitation to Comment presumes that the CICA's FOME initiative will move forward as announced.

We strongly encourage the CICA to use IFRS as the basis for this simplified accounting framework (FOME). Private enterprises in Canada are growth-oriented and need financial reporting that facilitates comparison with larger companies that will be using IFRS. Also, use of an IFRS-based model enables an easier future transition from private company to public company status.



General purpose financial statements

Establishing a distinct financial reporting framework for private companies which do not require general purpose financial statements will address the financial reporting needs of a significant majority of Canada's private businesses. Our research shows that the remainder of this sector which does require general purpose financial statements values financial reporting standards comparable to those applicable to Canadian public companies. Many of these private companies expect their financial statements to be used in a future public offering of shares or to raise debt financing. Accordingly, any financial reporting framework developed for them must be closely linked to the framework used by Canadian public companies to achieve comparability and to facilitate access to the capital markets. We therefore believe that the development of a unique Canadian financial reporting framework (option 3) is not justified.

We carefully considered the option of adopting the proposed IASB standard, IFRS for SMEs (option 2). Initially it was very appealing, as it would provide a link between financial reporting of private and public companies in Canada. Further, it would be based on a set of standards developed and maintained internationally, thereby requiring minimal development and maintenance costs incurred by Canadians. However, we believe that, in Canada, the users for whom the IFRS for SMEs standard is being developed are substantially the same group to which the CICA has committed to developing the new financial reporting framework (FOME).

KPMG International and KPMG Canada are generally supportive of the IASB's SME initiative. However, KPMG Canada believes further modifications of the proposals would be required to meet the needs of private businesses in Canada which require general purpose financial statements. For example:

- many lenders to Canada's SME sector accept financial reporting on a non-consolidated basis which the SME proposal does not allow
- the SME proposals as drafted would require certain items to be measured at fair value at each balance sheet date, whereas under full IFRS the items would be measured at amortized cost (e.g. an interest-free loan from a related party with no stated repayment terms), and
- the SME proposals provide that investments in equity securities (portfolio investments) would be measured at fair value at each balance sheet date which is inconsistent with allowing SMEs to measure investments in associates and joint ventures at cost. We believe this option should be extended to allow the cost basis of measurement for portfolio interests in the equity securities of private businesses.

Overall, we believe that the proposed SME standard is not sufficiently aligned with the needs of private businesses in Canada which prepare general purpose financial statements to justify its adoption as the accounting model for these enterprises.



We therefore ultimately concluded that option 1, a top-down approach based on GAAP for publicly accountable enterprises (effectively IFRS), to be the best model for private enterprises in Canada which require general purpose financial statements. This model will be familiar to preparers, users and practitioners in Canada once IFRS is fully implemented for publicly accountable enterprises. It will facilitate the preparation of financial reporting on a consistent and comparable basis for all companies requiring general purpose financial statements. As stated in the Invitation to Comment, this option involves modifying GAAP for publicly accountable enterprises (IFRS) by deleting some requirements or embedding different treatments in the standards, similar to Canada's current "differential reporting" model.

We believe that there are only limited differential reporting accommodations needed for private enterprises which prepare general purpose financial statements. It is our belief that the vast majority of the private enterprises, which have historically availed themselves of the existing differential reporting options under Canadian GAAP, will adopt FOME. The remaining private companies that prepare general purpose financial statements should therefore require fewer differential reporting accommodations than are currently provided.

Further, as the Board notes in its research summary, external users of financial statements highly value comparability when analyzing financial statements and often are not supportive of the existing differential reporting options that might otherwise be selected by the preparers of financial statements. To address this concern, we recommend that any differential reporting accommodations be required to be implemented on an "all or nothing" basis and not as a "mix or match" choice. We believe that the objective of comparability of general purpose financial statements is seriously impaired by the current ability to prepare general purpose financial statements on a menu-basis under differential reporting.

We observed that those respondents to our survey who require general purpose financial statements did not identify differential reporting accommodations beyond those currently available. Our consultations suggest that the ability to prepare financial statements on a non-consolidated basis is an accommodation that should be retained. Similarly, maintaining the ability to use the cost method to account for investments in entities subject to significant influence and joint ventures is appropriate.

Which additional differential reporting accommodations to make available should be the subject of further study by the AcSB. This study should include consultations with those private enterprises which cannot adopt FOME. If the FOME proposals are adopted, the differential reporting accommodations available for private enterprises preparing general purpose financial statements should not exceed the accommodations that are provided in FOME.



Summary

We believe that IFRS should be used as the basis for financial reporting for all Canadian businesses requiring general purpose financial statements (option 1). Accommodations under differential reporting should be limited and should be applied on an “all or nothing basis”. In our view, this approach best achieves the objectives of an accounting model for general purpose financial statements, notably:

- with the exception of those using differential reporting, all Canadian companies preparing general purpose financial statements will follow the same generally accepted accounting framework
- there will only be one alternative basis of preparation under differential reporting, not the significant number of permutations and combinations that the current “mix and match” model permits
- the transition of private companies to public company status will be made easier, and
- the financial reporting framework will be readily understood outside of Canada.

KPMG believes the standards overload issue is best dealt with by limiting the number of financial reporting frameworks for profit-oriented companies: one for general-purpose financial statements (with differential reporting permitted if certain criteria are met) and the other for limited-use financial statements.

Thank you for the opportunity to present our views. We would be pleased to provide further clarification or to respond to any questions.

Yours truly,

A handwritten signature in black ink that reads 'KPMG LLP'. The signature is written in a cursive, slightly slanted style. Below the signature is a horizontal line that starts under the 'K' and ends under the 'P'.

Chartered Accountants



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