

IFRS Section: Focus on Private Companies

In the October 2007 issue of *Financial Executive*, Paul Pacter reviewed IASB's project to develop an International Financial Reporting Standard tailored especially for small, nonpublicly accountable — or private — companies, which were then known as "small and mid-sized entities or SMEs." Pacter is director of Standards for Private Entities at the International Financial Accounting Standards Board in London.

At that time, the board had issued an Exposure Draft for comment and field tests of the ED were underway around the world by real, private companies.

Now, one year later, the 162 comment letters have been analyzed, and 116 field tests have been completed. IASB has begun redeliberating the proposals in the ED, with a view to issuing a final standard in first quarter 2009.

What's next and what can private companies expect based on the decisions the board has made?

For this issue's IFRS section, we asked Pacter to bring readers up to date, then discuss what's next and what private companies can expect based on the decisions the board has made.

— IFRS Section co-developers Cheryl de Mesa Graziano and Ellen M. Heffes

SIMPLIFYING IFRS FOR PRIVATE ENTITIES

BY PAUL PACTER

Comment Letters

The main nontechnical issues raised in the comment letters related to making the final standard a stand-alone document; retaining accounting policy options; anticipating future changes to full IFRS; the need for further disclosure

simplifications; changing the title of the document; considering which entities should be eligible to use the standard; and use of fair value.

Additionally, most comment letters raised technical issues related to specific sections in the ED.

Topics that received the most comments — generally in favor of further simplifications — included: consolidation; amortization of goodwill and other indefinite life intangibles; component depreciation and annual review of residual values; financial instruments; requirements for statements of cash flows and changes in equity; measurements for impairments and finance leases; share-based payment; employee benefits; and income taxes.

Field Tests

At the 2008 board meeting, staff presented an overview of the issues identified as a result of the field tests of the ED. Overall, participants encountered few significant problems in applying the ED, and they generally said they found it to be understandable and appropriate. The single most problematic area was determination of fair value where market prices or active markets are not available.

The second most significant area causing problems was the nature, volume and complexity of disclosures.

Working Group

IASB has a working group of more than 40 experts on financial reporting by private entities (including several U.S. financial executives), which met on April 10-11. The group prepared two comprehensive reports for the board: one with recommendations relating to scope, recognition, measurement and presentation;

and the other relating to disclosures.

Board Redeliberations

In May, the board began redeliberating the proposals in the ED. Redeliberations continued in June, July and September, and the board addressed the few remaining issues in October and November.

Here are some selected issues and the board's tentative decisions:

Title of the standard. It should be changed to "IFRS for Private Entities," with "private entities" defined the same as "small and medium-sized entities" (SMEs) in the ED.

Stand-alone standard. Requirements currently available by cross-reference to full IFRS will be either addressed in the final standard or eliminated.

Accounting policy options. In general, all options in full IFRS should be available to private entities. The body of the standard should include the simpler option. The more complex options should be in a separate appendix.

Small listed entities. They should not be included in the intended scope of the standard.

Entities that receive funds in a fiduciary capacity. If holding funds in a fiduciary capacity is a sideline to an entity's principal business (for example, a utility company or travel agency that takes deposits), the entity should be permitted to use the standard if it otherwise qualifies.

Restatements. An "undue cost or effort" principle should not be added wherever the standard requires restatement. The exemption for 'impracticability' is sufficient.

Fair value measurement. Clearly describe in simple language what the basis for measurement is rather than use the generic term "fair value."

Subsidiary of an IFRS entity. If a subsidiary of an entity using full IFRS wishes to use the recognition and measurement principles in full IFRS, it must also provide the disclosures required by full IFRS.

Financial statement presentation. The standard should incorporate the 2007 revisions to IAS 1, *Presentation of Financial Statements*. This would mean, among other things, that private entities would present a statement of comprehensive income.

Consolidated financial statements. These should be required for all private entities that are parent entities.

Combined financial statements. The description of combined financial statements should be retained in the "IFRS for Private Entities," with some additional guidance added.

Accounting policy hierarchy. The final standard should be clear that management may, but is not required to, consider the requirements and guidance in full

ive interest rate (EIR) method.

■ Not to permit a "shortcut method" for hedge accounting.

■ Not to allow debt instruments to be hedging instruments.

■ To add guidance on the types of risks eligible for hedge accounting and on factoring.

The board will confirm at a future meeting whether private entities may follow IAS 39/IFRS 7 in full in lieu of following Section 11.

Inventories. The board rejected last-in, first-out (LIFO) as an inventory costing method.

Associates and jointly controlled entities. The cost model, equity method and fair value through profit or loss model should be accounting policy options, as proposed in the ED, with one exception: the cost model would not be permitted for an investment that has a published price quotation.

Investment property. Both the cost model and the fair value through profit or loss model should be options.

Property, plant and equipment. Both the cost and revaluation models should be options. The cost of an item of PPE should be allocated to its significant parts, with each part depreciated separately (component depreciation) only when the parts have significantly different patterns of benefit consumption.

A private entity should reassess residual value, useful life and depreciation method for an asset only if there is an indication of change since the last reporting date.

Intangible assets including goodwill. The board considered, but rejected, an amortization approach for indefinite life intangibles including goodwill. Both the expense model and the capitalization model should be options for development costs.

Business combinations. Intangible assets and contingent liabilities acquired in a business combination should be separately recognized if their fair value can be measured reliably (an "undue cost or effort" exemption should not be added).

Leases. Leases should be classified as either operating or financing, according to their substance. The board did not support accounting for all leases as operating leases.

Equity. An entity that issues a compound financial instrument should classify its components separately as financial liabilities, financial assets or equity instruments (sometimes known as split accounting). The staff will present a recommendation for the distinction between debt and equity at a future board meeting.

Revenue. The percentage of completion method should be applied when recognizing revenue from services and construction contracts, as proposed in the ED. Further examples will be added.

Government grants. All grants will be measured at the fair value of the asset (received or receivable). The option in the ED to apply IAS 20, Accounting for Government Grants and Disclosure of Government Assistance for certain grants will be removed.

Borrowing costs. Both the expense model and the capitalization model should be options.

Share-based payment. The staff is researching alternatives for measuring equity-settled SBPs by private entities and will present a recommendation at a future board meeting.

Impairment of nonfinancial assets. Perform an impairment test only if there is an indication that an asset may be impaired, as proposed in the ED. However, the approach for determining the impairment loss once an impairment is indicated should be similar to IAS 36, *Impairment of Assets* and, hence, should include the concepts of "recoverable amount," "value in use" and "cash-generating units."

Post-employment benefits. The board continues to study whether all actuarial gains and losses and past service cost should be recognized immediately in profit or loss and, in what circumstances, private entities might be allowed to measure the defined benefit obligation at a current liquidation amount.

Income taxes. The board rejected a taxes payable with disclosure approach for deferred tax. However, it identified two possible ways to simplify deferred tax recognition and measurement that take into account the needs of users of private entity financial statements and cost-benefit considerations. Staff will present recommendations at a future meeting.

Board deliberations will continue until all issues have been resolved — probably this month. Board members will review and comment on the drafts with the goal of balloting on a financial standard early next year.

IFRS in deciding on accounting policies.

Financial instruments. The board decided:

■ To reorganize Section 11 on financial instruments to make it easier both to identify which instruments are within the scope and to apply the section if a private entity has only very simple financial instruments.

■ Not to add "available for sale" as a category.

■ Not to allow straight-line amortization of premiums and discounts as an elective accounting policy alternative to the effec-

Discontinued operations and assets held for sale. Discontinued operations should be segregated, including in data covering prior periods. There should be no "held for sale" classification for nonfinancial assets. Instead, the decision to sell an asset should be added as an impairment indicator.

Disclosures. The ED had proposed roughly 400 required disclosures — a substantial reduction from the requirements of full IFRS. In September, the board agreed to many further disclosure simplifications based on comment letters and field testing.

Remaining Steps

Board redeliberations will continue until all issues have been resolved, probably through this month. Thereafter, the staff will prepare a revised draft standard that reflects all of the board's decisions in redeliberations. Board members will review and comment on those drafts with a goal of balloting on a final standard early in 2009. A vote of at least nine members of the board is required to approve a standard.

The final standard would not have a specified effective date but, rather, would be effective whenever a jurisdiction chooses to adopt it. The IASC Foundation is developing comprehensive training materials that it expects to make available, without charge.

Could Standard Be Used in the U.S.?

In May, the governing Council of the American Institute of Certified Public Accountants voted to designate IASB as a recognized accounting standard setter (in addition to FASB), thereby providing the AICPA's members with the option to use IFRS without any need to reconcile to U.S. GAAP figures. This designation applies to all IFRS, including the planned IFRS for Private Entities.

Thus, an auditor could give a "fair presentation" opinion on financial statements prepared using the IFRS for Private Entities.

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FAIR VALUE: SEC, FASB ISSUE CLARIFICATION; MORE TO COME

One of the hotly contested topics in discussing the current market turmoil has been whether fair value or "mark-to-market" accounting — particularly as set forth in FASB Statement No. 157, *Fair Value Measurements*, contributed to downwardly spiraling valuations and the resultant tightening of credit.

Although both the Financial Accounting Standards Board and the International Accounting Standards Board have had working groups developing guidance on fair value in inactive markets, calls for further guidance were stepped up in the fall. Groups including the American Bankers Association and Financial Services Roundtable asked the U.S. Securities and Exchange Commission to step in and issue further guidance.

On Sept. 30, the eve of passage of the Emergency Economic Stabilization Act of 2008 (EESA), SEC and FASB issued a joint clarification on measuring fair value in inactive markets. The guidance can be found on the SEC Web site under "Press Releases." Written in question-and-answer format, the guidance addresses the following questions:

- 1) Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?
- 2) How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?
- 3) Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?
- 4) Can transactions in an inactive market affect fair value measurements?
- 5) What factors should be considered in determining whether an investment is other-than-temporarily impaired?

SEC 'Dear CFO' Letters Recommend Disclosures

The SEC-FASB Sept. 30 joint clarification on fair value reiterated the need for clear and transparent disclosures and refer-

enced letters issued by the SEC Division of Corporation Finance to a large number of issuers in March and September — referred to informally by the SEC and others as its "Dear CFO letters."

The guidance noted the letters "provide[s] real-time guidance for issuers to consider in enhancing the transparency of fair value measurements to investors."

The letters are in the Division of Corporation Finance section of the SEC's Web site at www.sec.gov.

FASB Issues Guidance on Fair Value

On Oct. 10, FASB issued guidance on fair value in inactive markets in the form of a FASB staff position FSP FAS 157-3.

Details on the FSP can be found on FEI's Web site; check the Topic Library section, "Financial Accounting Standards Board" category.

Separately, FEI's Committee on Corporate Reporting was among the more than 100 constituents that filed comment letters on FASB's proposal. CCR's letter is available on FEI's Web site in the Advocacy section by clicking "Comment Letters."

SEC Launches Fair Value Study

Also in October, the SEC announced it has commenced a congressionally mandated study of fair value (mark-to-market) accounting required under Section 133 of EESA.

The study will focus on, among other things, the accounting standards as they relate to: effects on a financial institution's balance sheet; impacts on bank failures this year; the advisability and feasibility of modifications; and more.

Deputy Chief Accountant Jim Kroeker is leading the staff study, which is being conducted in consultation with the U.S. Treasury Department and the Board of Governors of the Federal Reserve System. The SEC noted it plans to hold roundtables to seek input from issuers, investors, auditors and others as it works on this study, which is due to be delivered to Congress on Jan. 2, 2009.

On Oct. 8, FEI issued a statement commending the recent actions of Congress relating to EESA, including the study of these accounting standards.

— Edith Orenstein, director, Technical Policy Analysis, FEI