An IFRS for private entities

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ABSTRACT **Increasingly, over the past quarter century, small- and medium-sized entities (SMEs) have expressed concern that the accounting standards they are required to follow are becoming more and more burdensome. Some of that burden is unavoidable. Traditional simple accounting principles just were not designed for the complex transactions that some small companies enter into – for instance, derivatives and hedging, foreign operations, business combinations, asset sales with 'strings attached', pension obligations, and revenue transactions with multiple deliverables. But, certainly, part of that burden has arisen because accounting standards designed for public capital markets are increasingly being 'pushed down' to entities without public accountability, either because their jurisdiction has replaced its national GAAP with International Financial Reporting Standards (IFRSs) or has been, little by little, converging its national GAAP with IFRSs. The International Accounting Standards Board (IASB),[1] which develops IFRSs, is working on a separate *IFRS for Private Entities*. As part of that project, in February 2007, the IASB published for comment an exposure draft (ED) of a proposed private entity standard titled *IFRS for Small and Medium-sized Entities*. During the 3 years, that the IASB worked to develop the proposal, the Board had been using the term SMEs to describe the entities that would be within the scope of the resulting standard. That term is widely used throughout the world, although less so in the United States. For reasons explained later in this article, in May 2008 the IASB decided to replace the term 'SMEs' with 'private entities'. The resulting standard will be titled the *IFRS for Private Entities*. This article uses the term private entities. The IASB's February 2007 ED is a simplified, self-contained set of accounting principles that are appropriate for smaller, non-listed companies. It is based on full IFRSs, which have been developed to meet the needs of listed companies in public capital markets, with modifications for a private entity environment as explained more fully later in this article. Comments were due by 30 November 2007. By removing choices for accounting treatment, eliminating topics that are not generally relevant to private entities, simplifying methods for recognition and measurement, and omitting many disclosures, the ED reduces the volume of accounting guidance applicable to private entities by more than 85 per cent when compared with the full set of IFRSs. As a result, the ED offers a workable, self-contained set of accounting standards that would allow investors for the first time to compare private entities' financial performance across international boundaries on a like for like basis.**

This article discusses:

- **the IASB's reasons for issuing an IFRS for private entities,**
- **the types of entities at which it is aimed,**

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- **what the IASB has proposed in the ED and why,**
- **what the IASB has not proposed, and why not,**
- **how the IASB reached the conclusions that it did,**
- **how the IASB plans to maintain the standard after it is issued,**
- **comment letter responses to and field testing of the ED,**
- **the IASB's re-deliberations through July 2008,**
- **the remaining steps leading to a final IFRS for Private Entities, and**
- **plans for training materials.**

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WHY GLOBAL FINANCIAL REPORTING STANDARDS FOR PRIVATE ENTITIES ARE NEEDED

High-quality global financial reporting standards enhance the comparability of financial information. They improve the efficiency of allocation and the pricing of capital. This benefits not only those who provide debt or equity capital but also those entities that seek capital, because it reduces their compliance costs and removes uncertainties that affect their cost of capital.

High-quality global standards facilitate cross-border trading and growth. They also remove the need for jurisdictions to find resources to develop their own standards, improve consistency in audit quality and facilitate education and training.

The benefits of global financial reporting standards are not limited to entities whose securities are traded in public capital markets. The world markets are integrated for private entities – even for many small ones. More and more private entities are looking to do business across borders, and obtain foreign capital for business reasons or to take advantage of better rates or other factors. Not only do private entities benefit from a common set of accounting standards, the users of their financial statements, particularly those in different jurisdiction, also benefit. High-quality global standards improve users' confidence in the financial information, enable them to make comparisons between private entities (accounting differences can completely obscure comparisons) and also assist their understanding of the financial information, as they only need to understand one set of standards. For example:

- *Lending decisions*. Financial institutions make loans to private entities, often across borders. In most jurisdictions, over half of all private entities, including the very small ones, have bank loans. Bankers rely on financial statements in making lending decisions, in establishing terms and interest rates and in monitoring loans.
- *Loan monitoring*. Once a loan is made, banks and other creditors need financial information to monitor the loan.
- *Credit decisions by overseas vendors.* Vendors want to evaluate the financial health of buyers before they sell goods or services on credit. This is especially true when the buyer is a relatively small entity or is based in another jurisdiction.
- *Credit rating*. Credit rating agencies try to develop ratings uniformly across borders. Similarly, banks and other institutions often develop ratings in the same way as credit rating agencies. Reported financial figures are crucial to the rating process.
- *Overseas customers*. Many private entities have overseas customers and those customers

want to use their supplier's financial statements to assess the prospects of a viable long-term business relationship.

- *Venture capitalists*. Venture capital firms provide funding to private entities across borders.
- *Development institutions*. Global, regional and national development institutions, both public and private sector, provide financial assistance to entities in developing countries around the world. They rely on financial statements to make financing decisions and to assess financial results.
- *Non-management owners*. Many private entities have outside investors who are not involved in the day-to-day management of the entity. The comparability resulting from global accounting standards is especially important when those outside investors are located in a different jurisdiction from the entity and when they also have interests in other private entities.
- *Consolidation with an International Financial Reporting Standard (IFRS) parent*. Many private entities are subsidiaries of parents that use full IFRSs or national equivalents of IFRSs (more and more so as the use of IFRSs spreads). Consolidation would be significantly simplified if those subsidiaries all were to use the proposed *IFRS for Private Entities* rather than their various local GAAPs because of (a) consistency among subsidiaries and (b) consistency of the recognition and measurement principles in the proposed *IFRS for Private Entities* with those in full IFRSs except for a limited number of identified, quantifiable, mandatory differences. Although subsidiaries could always opt to follow full IFRSs, to ensure that their accounting policies are identical to those of the parent, it would usually be more beneficial for subsidiaries to follow the proposed *IFRS for Private Entities*. That allows them to take advantage of the substantially reduced disclosure requirements under the *IFRS for Private Entities* in their individual financial statements.

An *IFRS for Private Entities* is likely to improve the quality of financial reporting by private entities in many jurisdictions because, often, the standards that private entities are currently following may not have been designed with decision-usefulness as the overriding objective. Nor do they deal clearly with the kinds of relatively complex transactions that many private entities enter into.

In many jurisdictions, the legal requirements for financial reporting by private entities:

- were written into laws many years ago (sometimes the result of political compromise),
- are limited in scope,
- are cash (rather than accrual) oriented,
- do not include many accounting recognition and measurement principles,
- are tax-driven rather than aimed at providing information for lending, credit and investing decisions, and
- require only one or two primary financial statements (for example the income statement and the balance sheet), often without supporting notes or with only very limited disclosures.

The proposed *IFRS for Private Entities* is designed for entities that produce general-purpose financial statements that are useful for economic decision-making by a broad range of resource providers and other users, such as non-manager owners, lenders, vendors and other creditors, customers and employees.

Another benefit will be to reduce the financial reporting burden on private entities in those jurisdictions where, at the moment, standards designed for reporting by participants in public capital markets have been pushed down to private entities. This will also help improve the quality of private entity reporting because the reality, in some jurisdictions is that the quality of implementation by private entities of accounting standards designed for public capital markets leaves something to be desired.

Another obvious benefit of an *IFRS for Private Entities* is the cost savings to national professional bodies that are now developing national private entity standards. Those bodies could refocus their attention on assisting members in quality implementation of the *IFRS for Private Entities* locally, rather than 'reinventing the wheel' in each jurisdiction.

THE IASB'S DEFINITION OF A 'PRIVATE ENTITY'

The proposed *IFRS for Private Entities* is intended for an entity with no public accountability. An entity has public accountability (and therefore should use full IFRSs) if:

- it has issued, or is in the process of issuing, debt, equity or other instruments in a public market; or
- it holds assets in a fiduciary capacity for a broad group of outsiders. Examples of such an entity include a bank, an insurance company, a securities broker/dealer, a pension fund, a mutual fund and an investment bank.

This definition avoids a quantified size test and, instead, adopts a public accountability principle. An entity that is regarded as small in some jurisdictions may be regarded as very large in others. A single, quantified, global size test (such as amount of revenue or assets or number of employees) does not distinguish entities with public accountability from those without it.

'PRIVATE ENTITY' IS A BETTER TERM THAN 'SME'

In developing the exposure draft (ED), the International Accounting Standards Board (IASB) chose to use the term small- and medium-sized entity, or SME, because that term is widely used throughout the world. In fact, laws and regulations in dozens of jurisdictions have established quantified tests for determining SMEs in those jurisdictions – sometimes there are even differing guidelines under different laws or regulations in a single jurisdiction.

Many comment letters on the ED agreed with the Board's description of entities that should be allowed to use the proposed IFRS for SMEs (the title of the ED) – namely entities that do not have public accountability. Most concurred with the Board that the IASB should not establish quantified size criteria. However, most comment letters disagreed with the title of the Standard as use of the terms 'small' and 'medium-sized' implies a size test. They said that even though the term 'SME' is well-recognised, it is understood to mean different things in different jurisdictions, and no jurisdiction describes SMEs in the same way as the ED. Hence using the term SME to describe non-publicly accountable entities is potentially confusing. Furthermore, SME implies that larger non-publicly accountable entities are not in the scope and, conversely, that small publicly accountable entities might be in the scope.

For those reasons, in May 2008, the IASB decided to switch to the term 'private entity' and hence also retitle the standard the *IFRS for Private Entities*. The definition of 'private entities' remains identical to the proposed definition of 'SMEs' in the ED.

GENERAL-PURPOSE FINANCIAL STATEMENTS

The IASB's definition means that the proposed IFRS for Private Entities is intended for any entity that does not have public accountability, regardless of size – but with the following very important qualification. The proposed *IFRS for Private Entities* is designed to produce general-purpose financial statements that present an entity's financial position, results of operations and cash flows. If those financial statements are audited, an auditor would be able to express an opinion as to whether they present fairly (or give a true and fair view of) the entity's financial position, results of operations and cash flows.

It is a matter for each jurisdiction to decide which entities without public accountability should be required to produce general-purpose financial statements. In some jurisdictions, all limited liability companies are required to publish general-purpose financial statements – often tens of thousands, if not millions, of companies. In other jurisdictions, such a requirement is not imposed on very small entities, or small entities can opt out. Which entities should produce general-purpose financial statements is not a decision for the IASB. It is a public interest issue that must be addressed by legislators and regulators jurisdiction by jurisdiction.

Where an entity that does not have public accountability is required to prepare general-purpose financial statements, or chooses to do so, the proposed *IFRS for Private Entities* is appropriate – perhaps even ideal, because it has been tailored to the needs of such a company and it is 'the global standard'.

SUITABILITY OF THE *IFRS FOR PRIVATE ENTITIES* FOR TINY ENTITIES: THE SO-CALLED 'MICRO ENTITIES'

Tiny entities with fewer than 5 or 10 employees are sometimes called 'micro entities'. The proposed *IFRS for Private Entities* is suitable for any of those micro entities that are required, or choose, to prepare general-purpose financial statements for external users. External users such as lenders, vendors, customers, rating agencies and employees need specific types of information but are not in a position to demand reports tailored to meet their particular needs. They must rely on general-purpose financial statements. This is as true for micros as it is for larger private entities. Financial statements prepared using the proposed *IFRS for Private Entities* are intended to meet those needs.

Today, in well over 80 jurisdictions around the world, full IFRSs are required or permitted for some or all private entities, generally including the micros. If full IFRSs have been judged suitable for all entities, then the proposed *IFRS for Private Entities* (the ED is roughly 10 per cent of the size of full IFRSs and includes many accounting and disclosure simplifications) will surely also be suitable. The guidance in the ED is simple and straightforward. That guidance may cover some transactions or circumstances that micro private entities do not typically encounter, but the IASB does not believe that this imposes a burden on those entities. The topical organisation of the ED will make it easy for micro private entities to identify those aspects that are relevant to their circumstances.

Access to capital is a major problem for micro private entities throughout the world, but particularly in developing countries. Lenders, development institutions and others who help micros obtain capital consistently say that the absence of credible and transparent financial reporting is a major shortcoming. An important goal of the IASB in developing an *IFRS for Private Entities* is to help remove the so-called 'information uncertainty' that has impeded micro financing.

But, as noted earlier, it is not the IASB who decides whether the micro entities should be required to prepare general-purpose financial statements for external users. That is a public policy decision of the government or other regulatory body in each jurisdiction. Globally, some jurisdictions require all limited liability entities to prepare and publish general-purpose financial statements. (Publishing could be filing with a government agency or posting on a website.) Other jurisdictions exempt the micro entities from such a reporting requirement, or impose a reporting requirement considerably less than a set of general-purpose financial statements.

IASB'S FOCUS ON PRIVATE ENTITIES WITH ABOUT 50 EMPLOYEES

In deciding on the content of the proposed *IFRS for Private Entities*, the IASB focused on a typical entity with about 50 employees. The IASB used the 50-employee guideline not as a quantified size test for defining private entities but, rather, to help it decide the kinds of transactions, events and conditions that should be addressed in the ED. The IASB's goal in doing so was to make the ED a stand-alone document for such typical private entities, and also for entities smaller than 50 employees.

SUITABILITY FOR UNLISTED COMPANIES WITH MORE THAN 50 EMPLOYEES

The proposed *IFRS for Private Entities* is intended to meet the reporting needs of any entity that does not have public accountability (that is, it is not listed or a financial institution). That would include large unlisted companies. However, it is not the IASB that decides which standards should be required or permitted in any jurisdiction. That is a public policy decision that rests with the regulators and the profession in each jurisdiction. Some jurisdictions may well decide that unlisted companies over a specified size – those judged to be economically significant in that jurisdiction – also have a sufficient degree of public accountability in that jurisdiction to warrant requiring them to use full IFRSs.

SUITABILITY IN DEVELOPING ECONOMIES

The ED is roughly a 250-page document. Although that is considerably reduced from the 2700 pages of the 2008 bound volume of full IFRSs, some people question whether a 250-page *IFRS for Private Entities* is still too much of a burden for small entities in developing economies. In assessing that issue, it is essential to consider why a private entity in a developing country is preparing financial statements – to whom is it reporting, and why? The proposed *IFRS for Private Entities* is not too much for financial statements intended for lending, investing and donor funding decisions. In fact, it has been designed precisely for those kinds of users. If financial statements are for reporting to development institutions, it would depend on what they require. Many now require full IFRSs or full national accounting standards, so the proposed *IFRS for Private Entities* would be a substantial reduction in the reporting burden.

WHETHER A THIRD, VERY SIMPLE TIER OF ACCOUNTING STANDARDS IS NEEDED

Some believe that a third, very simple tier of accounting standards is needed. They suggest a very brief – say 20-page – standard should be developed for the micros, particularly in developing countries.

The IASB did not consider developing such a standard, and is unlikely to do so in the future. Such a standard would necessarily be limited to broad principles of accrual basis accounting (some even suggest a cash basis or modified cash basis) and specific recognition and measurement principles for only the most basic transactions, requiring perhaps only a balance sheet and an income statement with limited note disclosures.

Although this approach might result in relatively low costs to private entities in preparing financial statements, the resulting statements would not meet the objective of decision-usefulness. Such statements would not provide adequate information about the entity's financial position, performance and cash flows that is useful to a wide range of users in making economic decisions. Moreover, financial statements prepared using such a simple and brief set of accounting requirements might not serve the entity by improving its ability to obtain capital – which is the endgame of financial reporting standards.

USE OF THE *IFRS FOR PRIVATE ENTITIES* BY SMALL PUBLICLY TRADED COMPANIES: ISSUES IN DEVELOPING COUNTRIES

The IASB has proposed that small publicly traded companies would not be eligible to use the proposed *IFRS for Private Entities*. In the Board's judgement, listed companies, large or small, have elected to seek capital from a broad group of outside investors who are not involved in managing the business and who do not have the power to demand information that they might want. Full IFRSs have been designed to serve public capital markets.

There is no question that in a number of developing countries, many (even most) listed companies have fewer than 100 employees (and in many cases fewer than 50). They are definitely small companies. But they are not private entities as the IASB defines that term.

In a number of developing countries, the stock exchange imposes only limited financial reporting requirements for its listed companies. Some people argue that the quality of financial reporting by small listed companies would be improved if they followed the proposed *IFRS for Private Entities* rather than their current financial reporting framework mandated by the regulators or the exchange. In other developing countries the stock exchange imposes full IFRSs on its listed companies. Small listed entities in those countries often lack the expertise and resources to apply full IFRSs properly, and some people argue that the quality of implementing financial reporting requirements would be improved if they followed the proposed simplified and more manageable *IFRS for Private Entities*. Nonetheless, in these two cases, the proposed *IFRS for Private Entities* would not permit small listed entities to prepare financial statements under it and describe those financial statements as in compliance with it. This is because an entity that raises capital in public capital markets takes on an obligation to report to investors – often small investors – who provide long-term risk capital and have no involvement in running the business or power to demand the financial information that they want. They have to 'take what they get', and full IFRSs are designed for their needs.

There is also the converse: whether large unlisted companies should be required to use full IFRSs. That is not a matter for the IASB to decide. Rather, it is a public policy decision that each jurisdiction must make. Size alone is not part of the IASB's definition of public accountability. But a jurisdiction certainly could adopt a policy that entities over a certain size (perhaps in terms of revenue, assets or number of employees) should publish financial statements that conform to full IFRSs rather than the *IFRS for Private Entities*.

PRIVATE ENTITY FINANCIAL STATEMENTS PREPARED PRIMARILY FOR THE TAX AUTHORITIES OR TO DETERMINE DISTRIBUTABLE INCOME

The proposed *IFRS for Private Entities* is designed to produce general-purpose financial statements intended to meet the needs of investors, lenders, creditors, rating agencies, employees, customers and others outside the business.

Determining taxable income requires special-purpose financial statements – ones designed to comply with the tax laws and regulations in a particular jurisdiction. As the proposed *IFRS for Private Entities* is an accounting standard that will be applied globally by private entities, it cannot deal with tax reporting in individual jurisdictions. But profit or loss determined in conformity with the proposed *IFRS for Private Entities* can serve as the starting point for determining taxable income in a given jurisdiction by means of a reconciliation that is easily developed at national level. A similar reconciliation can be developed to adjust profit or loss as measured by the proposed *IFRS for Private Entities* to distributable income under national laws or regulations.

OWNER-MANAGERS AS USERS OF A PRIVATE ENTITY'S FINANCIAL STATEMENTS

It is not the purpose of the proposed *IFRS for Private Entities* to provide information to owner-managers to help them make management decisions. Managers can obtain whatever information they need to run their business. (The same is true for full IFRSs.) But general-purpose financial statements will often also serve managers' needs by providing insights into the business's financial position, performance and cash flows.

WHERE A PRIVATE ENTITY WOULD LOOK IF IT CANNOT FIND THE ANSWER TO ITS ACCOUNTING QUESTION DIRECTLY IN THE *IFRS FOR PRIVATE ENTITIES*

The IASB designed the ED as a stand-alone document for typical private entities with about 50 employees. The ED therefore covers the kinds of transactions and other events and conditions that companies of that size are likely to encounter. There is no mandatory fallback to full IFRSs.

If a private entity cannot find the answer to an accounting question directly in the proposed *IFRS for Private Entities*, it is required to select an accounting policy that results in relevant and reliable information. In making that judgement, the private entity should consider, first, the requirements and guidance in the proposed *IFRS for Private Entities* dealing with similar and related issues. In other words, it should try to analogise from the guidance given in the proposed *IFRS for Private Entities* for similar transactions. If that does not yield an answer, it should consider the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles that are set out in Section 2 *Concepts and Pervasive Principles* of the ED.

In making the judgement described in the paragraph above, private entities may also choose to look to the requirements and guidance in full IFRSs, including interpretations, dealing with similar and related issues, though to do so is not a requirement.

HOW THE ED WAS DEVELOPED

The principles in the ED are not always the same as those in full IFRSs. Nor as detailed. The first step in developing the ED was to extract the fundamental concepts from the IASB's *Framework for the Preparation and Presentation of Financial Statements* and the principles and related mandatory guidance from IFRSs. The next step was to make appropriate modifications in the light of users' needs and cost – benefit considerations. Five types of modifications were made:

- Topics that are not generally relevant to private entities were eliminated.
- Where full IFRSs provide choices of accounting treatment in a particular circumstance, only one choice is set out in the ED.
- Principles for recognition and measurement of assets, liabilities, income and expense were simplified.
- Many disclosures in full IFRSs that are designed for public capital markets were deleted, and the required presentation was simplified.
- The entire body of standards was redrafted into plain English to enhance clarity.

Whereas full IFRSs are numbered in chronological sequence of issuance, the ED is organised by topic roughly in balance sheet and income statement sequence, which the Board believes is more user-friendly for private entities. It contains 38 sections.

TOPICS IN FULL IFRSs THAT ARE OMITTED FROM THE ED

The following topics in full IFRSs are not relevant to typical private entities and are therefore omitted from the ED, with cross-references to the IFRS if needed:

- general price-level adjusted reporting in a hyperinflationary environment (look to IAS 29 *Financial Reporting in Hyperinflationary Economies*);
- equity-settled share-based payment (the computational details are in IFRS 2 *Share-based Payment*);
- determining the fair value of agricultural assets (look to IAS 41 *Agriculture*, but the ED also proposes to reduce the use of fair

value through profit or loss for agricultural private entities);
- extractive industries (look to IFRS 6 Exploration for and Evaluation of Mineral Resources);
- interim reporting (look to IAS 34 *Interim Financial Reporting*);
- lessor accounting for finance leases (look to IAS 17 *Leases* – finance lessors are likely to be financial institutions that would not be eligible to use the proposed *IFRS for Private Entities*);
- earnings per share and segment reporting, which are not required disclosures for private entities (look to IAS 33 *Earnings per Share* and IFRS 8 *Operating Segments*);
- insurance contracts (insurers would not be eligible to use the proposed *IFRS for Private Entities*).

WHICH OPTIONS IN FULL IFRSs ARE INCLUDED IN THE ED

Where full IFRSs provide an accounting policy choice, only the simpler option is in the ED. Private entities are permitted to use the other option by cross-reference to the relevant IFRS. The simpler options selected are:

- the cost-depreciation-impairment model for investment property (fair value through profit or loss is permitted by reference to IAS 40 *Investment Property*);
- the cost-amortisation-impairment model for property, plant and equipment and intangibles (the revaluation model is allowed by references to IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*);
- recognising all borrowing costs as an expense in the period incurred (capitalisation allowed by reference to IAS 23 *Borrowing Costs*);
- the indirect method for reporting operating cash flows (the direct method is allowed by reference to IAS 7 *Cash Flow Statements*);
- one method for all grants (or private entities can use any of the alternatives in IAS 20 *Government Grants and Disclosure of Government Assistance*).

Additionally, a private entity could choose to follow the full IFRSs on financial instruments (IAS 39 and IFRS 7) instead of following the simplified financial instruments requirements in Section 11 of the ED.

ACCOUNTING RECOGNITION AND MEASUREMENT SIMPLIFICATIONS

Here are some examples:

- *Financial instruments*:
    - *Two categories of financial assets rather than four*: This means no need to deal with all of the 'intent-driven' held-to-maturity rules or related 'tainting', no need for an available-for-sale category and many other simplifications.
    - *A clear and simple principle for derecognition*: If the transferor has any significant continuing involvement, do not derecognise. The complex 'pass-through testing' and 'control retention testing' of IAS 39 *Financial Instruments: Recognition and Measurement* are avoided.
    - Much simplified hedge accounting.
- *Goodwill impairment*: An indicator approach rather than mandatory annual impairment calculations.
- All research and development costs can be recognised as an expense in the period incurred (IAS 38 would require capitalisation of development costs after commercial viability has been assessed).
- The cost method can be used for associates and jointly controlled entities (rather than the equity method or proportionate consolidation as required by IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures*).
- *Less fair value for agriculture*: Only if 'readily determinable without undue cost or effort'.

- *Defined benefit plans*: A principle approach rather than the detailed calculation and deferral rules of IAS 19 *Employee Benefits*. The complex 'corridor approach' of IAS 19 is omitted.
- *Share-based payment*: Intrinsic value method.
- *Finance leases*: Simplified measurement of lessee's rights and obligations.
- *Impairment*: Value-in-use calculation not required.
- *Income taxes*: Most of the exemption rules in IAS 12 *Income Taxes* were eliminated (the two remaining are non-accrual of deferred income taxes in non-deductible goodwill and on undistributed earnings of foreign subsidiaries). Also the explanation of the temporary difference approach is substantially streamlined.
- First-time adoption: Prior period data are not restated if impracticable.

DISCLOSURE SIMPLIFICATIONS

The disclosure requirements in the ED are substantially reduced when compared with the disclosure requirements in full IFRSs. A disclosure checklist for full IFRSs includes more than 3000 items. By way of contract, there are fewer than 400 items in the disclosure checklist that accompanies the ED.

The reasons for the reductions are of four principal types:

- Some disclosures are not included because they relate to topics covered in IFRSs that are omitted from the ED.
- Some disclosures are not included because they relate to recognition and measurement principles in full IFRSs that have been replaced by simplifications proposed in the ED.
- Some disclosures are not included because they relate to options that are not included in the ED.
- Some disclosures are not included on the basis of the different needs of users of private entity financial statements or cost – benefit considerations.

Assessing disclosures on the basis of users' needs was not easy, because users of financial statements tend to favour more, rather than fewer, disclosures. The IASB was guided by the following broad principles:

- Users of the financial statements of private entities are particularly interested in information about short-term cash flows and about obligations, commitments or contingencies, whether or not recognised as liabilities. Disclosures in full IFRSs that provide this sort of information are necessary for private entities as well.
- Users of the financial statements of private entities are particularly interested in information about liquidity and solvency. Disclosures in full IFRSs that provide this sort of information are necessary for private entities as well.
- Information on measurement uncertainties is important for users of the financial statements of private entities.
- Information about an entity's accounting policy choices is important for users of the financial statements of private entities.
- Disaggregations of some of the amounts reported on the face of private entities' financial statements are important for an understanding of those statements.
- Some disclosures in full IFRSs are more relevant to investment decisions in public capital markets than to the transactions and other events and conditions encountered by typical private entities with around 50 employees.

Accompanying the ED is implementation guidance including a checklist of all of the proposed disclosure requirements.[2]

PRESENTATION SIMPLIFICATIONS

Full IFRSs require entities to prepare four financial statements: income statement, balance sheet, cash flow statement and statement of changes equity, plus notes. Under the ED, if the only changes to the equity of a private entity arise from profit or loss, payment of dividends, corrections of prior period errors and changes in accounting policy, the private entity may present a combined statement of income and retained earnings in place of the income statement and statement of changes in equity.[3]

MODIFICATIONS OF IFRSs THAT WERE CONSIDERED BY THE BOARD BUT NOT ADOPTED

There were quite a few. Here are the main modifications that the IASB considered when developing the ED but rejected, with reasoning:

- *Drop the cash flow statement*. Lenders to private entities and other users consistently say that information about cash flows is critical to them. Moreover, it is easy to prepare.
- *All leases operating*. Information about leased assets and obligations is important for lending and other credit decisions. Lenders consistently say that they do not want off-balance sheet obligations.
- *All pension plans defined contribution*. Users of private entities' financial statements find information about the funding status of pension obligations useful and important to them.
- *Completed contract method for all long-term contracts*. This could produce a potentially misleading accounting result for a long-term contractor, with some years of large profits and other years of large losses.
- *Fewer provisions*. Provisions are obligations that meet the liability recognition criteria. Users want these obligations recognised in the balance sheet, with the measurement uncertainties explained.
- *Non-recognition of share-based payment*. Share-based payments to employees should be recognised as remuneration expense because (a) it is intended as remuneration, (b) it involves giving something of value in exchange for services and (c) the consumption of the employee services received is an expense.
- *Non-recognition of deferred taxes*. Deferred taxes are liabilities (or sometimes assets) that can result in large outflows (inflows) of cash in the near future. Most of those who support non-recognition want the amounts, causes and other information disclosed in the notes. Note disclosure would entail the same tracking and computation effort for private entities as would recognition.
- *Cost model for all agriculture*. Not only is fair value generally regarded as a more relevant measure in this industry, quoted prices are often readily available, markets are active and measuring cost is actually more burdensome and arbitrary because of the extensive allocations required.
- *No consolidation*. The individual financial statements of a parent and its subsidiary(ies) are not useful because those entities often enter into transactions with each other that are not on an arm's length basis. Consolidated statements are essential for users when two entities operate as a single economic entity.
- *Derivatives at cost*. This is the same as non-recognition. Real gains and losses are inappropriately ignored until settlement. And real assets and liabilities end up off the balance sheet.
- *Amortisation of goodwill over a specified maximum period, say 10 or 20 years*. An amortisation approach still requires assessment of impairment, so it is actually a more complex approach than an indicator-triggered assessment of impairment that is in the ED. By its nature, goodwill often has an indefinite life. An amortisation approach ignores this. Also, most users of financial statements say they found little, if any, information content in the amortisation of goodwill over an arbitrary period of years.

UPDATING THE *IFRS FOR PRIVATE ENTITIES*

The IASB does not intend to update the *IFRS for Private Entities* every time an IFRS is amended or a new IFRS is issued. That would probably lead to several changes being made to the *IFRS for Private Entities* each year. Most private entities have told the Board that that would be very burdensome. Instead, the IASB plans to consider, about once every 2 years, whether there is need to update the *IFRS for Private Entities* and, if there is such a need, to propose changes in a single omnibus ED.

TRANSLATIONS OF THE ED

Although final IFRSs are translated into around 40 languages under IASB auspices, up to now the IASB has not translated its EDs. The IASB recognises the importance of private entity standards in the non-English-speaking world and therefore the IASB published the ED – not just the proposed standard but also the proposed implementation guidance and the basis for conclusions – in Spanish, French, German, Romanian and Polish.

LETTERS OF COMMENT ON THE ED

The Board received 162 letters of comment on the ED. These have been made available to Board members and posted on the IASB's website www.iasb.org.

A detailed analysis of the letters of comment was prepared by the IASB staff and presented to the Board (and made public) in March 2008. Agenda papers for Board meetings may be downloaded from the IASB's website: www.iasb.org.

FIELD TESTING OF THE ED

Subsequent to issuing the ED, the staff organised a programme of field testing of the ED. The goals of the field testing were to identify parts of the proposed standard that field testers found hard to understand or burdensome; to assess the nature and degree of changes from the field tester's current GAAP or current reporting practices; to assess the accounting policy choices the field testers made; to identify if there were any transactions that the field tester encountered that are not specifically covered in the ED and find out how the field tester accounted for them; and to identify where additional implementation guidance would be helpful to the field tester.

The field test questionnaire was posted on the IASB's website in June 2007 in English, Spanish and French. The deadline for submitting field test reports was 30 November 2007. In total, 116 companies from 20 countries participated in the field tests.

Field test companies were asked to provide background information about the company, submit their most recent annual financial statements under their existing accounting framework, prepare financial statements in accordance with the ED for the same financial year (though without presenting comparative prior year information), and respond to a series of questions designed to identify specific problems the field test company encountered in applying the ED. Field testers were promised that their responses would be treated confidentially. A report on the field tests was presented to the Board in April 2008 (available on www.iasb.org).

KEY ISSUES IN COMMENT LETTERS AND FIELD TESTS

Cross references to full IFRSs. Over 60 per cent of the comment letters that addressed the 'stand-alone' issue would eliminate *all* cross references to full IFRSs, thereby making the *IFRS for Private Entities* a fully stand-alone Standard.

Accounting policy options. By a two to one margin, the letters of comment recommended that all or most options in full IFRSs should be available to private entities.

Anticipating changes to full IFRSs. The *IFRS for Private Entities* should not anticipate possible future changes to full IFRSs, which the ED appears to do so in a few instances. Changes to full IFRSs are subject to a complete and specific public due process. Only after that due process is completed should the Board consider their appropriateness for private entities, in the view of these commentators.

Disclosure. Many letters of comment encouraged the Board to make further disclosure simplifications. Unfortunately, few comment letters proposed specifics. The Working Group (WG) has made a number of recommendations in this regard, which the Board has begun to consider.

Terminology for entities within the scope. Many comment letters recommended that the Board find a better term than SMEs. As noted earlier, the Board has now agreed on private entities.

Scope. Respondents raised a number of issues about applicability of the *IFRS for Private Entities*, including suitability for micros and small listed entities.

Restatements. In general, respondents favoured fewer required restatements of prior periods than now proposed.

Fair value – general. As a general principle, restrict use of fair value. A number of respondents suggested restricting fair value to:

1. Assets and liabilities with a quoted market price or those whose fair value can be readily determinable without undue cost or effort (for example financial instruments, agriculture and so on). Some respondents also thought that necessary characteristics were readily realisable and/or there is an intention to dispose or transfer; plus
2. All derivatives.

Post-issuance review. A number of respondents recommended that the Board commit to a post-issuance review of the *IFRS for Private Entities*, to identify and address implementation problems. This would be more comprehensive than the general review and update planned for approximately every 2 years.

Use by a subsidiary of a full IFRS reporter. Clarify use of *IFRS for Private Entities* by a subsidiary of a full IFRS entity.

Financial statement formats

1. Require a more standardised financial statement format – too many options now. Be more prescriptive of sections and line items and sequencing, as well as note disclosures.
2. Conform to IAS 1 *Presentation of Financial Statements* (revised 2007), including the new requirement for a statement of comprehensive income and a single format for the statement of changes in equity.

Consolidation

1. Exempt smaller entities from the requirement to prepare consolidated financial statements, or allow jurisdictions to decide who prepares consolidated financial statements under the *IFRS for Private Entities*.
2. Or possibly establish criteria when consolidation should be required. Examples of such criteria might be joint management, substantial intercompany transactions and/or borrowings of one entity secured by assets of the other.

Separate financial statements. Allow equity and proportionate consolidation methods when accounting for investments in associates and jointly controlled entities in separate financial statements (that is, allow private entities to mirror the treatment used in the consolidated financial statements to save time and explanations).

Financial instruments: A wide range of comments was received, including:

1. Make cost the default measurement basis, not fair value.
2. Bring back the available for sale category.
3. Allow straight-line amortisation of discounts/premiums, not only the effective interest method.

4. Hedge accounting:
   - Allow a shortcut method for hedging by which, if certain conditions are met, effectiveness could be presumed without a complex calculation.
   - Provide guidance for measuring hedge effectiveness (currently there is some guidance in the Basis for Conclusions).[4]
   - Simplify hedging documentation.
5. Allow purchased options and debt instruments as hedging instruments.
6. Clarify what is required for derivatives and embedded derivatives. Section 11 would require that the full host contract be measured at fair value if there is an embedded derivative.
7. Add guidance on factoring.
8. Do not allow the choice of using full IAS 39. Respondents who held this view generally were opposed to allowing any accounting policy options in the *IFRS for Private Entities*. Also, some said that IAS 39 is too complex or too costly for most private entities to apply, and that allowing its use would reduce comparability among private entities.

Associates and jointly controlled entities (JCEs). The ED permits too many options in accounting for associates and JCEs. Consider removing options or using a hierarchy to determine which measurement basis is appropriate.

Amortisation of goodwill and intangibles. Permit or require amortisation of goodwill and other indefinite life intangibles over a limited number of years. Respondents generally acknowledged that there still would be a need to consider impairment. However, they pointed out that amortisation would lessen the need for an impairment write-down over time.

Business combinations. Various simplifications were proposed, including (a) do not require separation of all or certain acquired intangibles and do not require recognition of contingent liabilities.

Leases. Do not require measurement of a finance lease only at the fair value of leased property (that is, measure at the lower of fair value and present value of minimum lease payments, as in IAS 17). Some respondents went further and proposed treating all leases as operating leases.

Debt – equity classification. Do not require 'split accounting' – that is separating the debt and equity components of a compound financial instrument such as convertible debt. Also, broaden the definition of equity from what is proposed in the ED.

Borrowing costs. Compute all capitalisation on the basis of average borrowing cost (do not require tracing of specific borrowings).

Share-based payment. Simplify measurement of equity-settled share-based payment. The intrinsic value approach is not much of a simplification for private entities. Some suggested that the Board consider disclosure only for equity-settled share-based payments.

Impairment. Require that the future use of the asset determines whether to use fair value (expected sale) or value in use (continued use in business) to measure the recoverable amount of that asset. Also, simplify the requirements for measuring impairment of goodwill.

Pensions. Simplify defined benefit pension plan accounting, for instance, by measuring the obligation at the current liquidation amount. Allow other options for recognition of actuarial gains and losses. Also allow deferral and amortisation of past service costs (as in full IFRSs).

Income taxes. Many respondents recommended simplifying accounting for income taxes. The ED proposes the temporary difference approach that is now in full IFRSs and US GAAP. Suggestions for simplification ranged from allowing or requiring the taxes payable method (no deferred tax recognised) to a 'timing difference' approach.

Related parties. Do not require disclosure of sensitive information or information that could cause competitive disadvantage. Main example given is disclosure of key management personnel (KMP) compensation if entity only has one or two members of KMP.

Assets held for sale and discontinued operations. Remove the held for sale classification; the impairment requirements in the individual sections of the ED cover this adequately together with the disclosures that those sections require. Simplify (or even eliminate) discontinued operation disclosures and restatements.

EDUCATION SESSIONS AT THE MARCH AND APRIL 2008 BOARD MEETINGS

The Board began its re-deliberations of the ED in March 2008. At that March 2008 Board meeting staff presented an overview of the main issues (other than disclosure issues) raised in the comment letters on the ED.

At the April 2008 Board meeting staff presented an overview of the main issues that were identified as a result of the programme for field testing the ED.

Both of those meetings were educational in nature, and the staff did not raise any issues for Board decision.

WG MEETING 10–11 APRIL 2008

The IASB's Working Group on the project met on 10–11 April 2008. This was its fourth meeting. The recommendations of WG members on each issue (other than disclosure) were presented in their entirety in an agenda paper for the May 2008 Board meeting. Recommendations of WG members relating to disclosure were presented to the Board in an agenda paper for the July 2008 Board meeting.

RE-DELIBERATIONS OF THE ED

At the May 2008 Board meeting, the Board began the process of re-deliberating the proposals in the ED by addressing the key issues relating to scope, recognition, measurement and presentation that were raised in the letters of comment on the ED and in the reports prepared by field test entities. Those re-deliberations continued in June through October 2008, and are continuing as this article is being written.

STATUS REPORT AND THE REMAINING STEPS

Board deliberations will continue as needed (currently planned through September 2008). Separate staff recommendations on disclosures and on additional guidance materials were provided to the Board in July 2008, along with the WG's recommendations on disclosures. These were discussed at the September 2008 meeting.

In the first quarter of 2009, staff plans to submit to the Board a revised pre-ballot draft *IFRS for Private Entities*, for written comments. Additional revised drafts will be submitted to the Board up through a ballot draft.

Staff plans to submit to the Board a ballot draft of a final *IFRS for Private Entities* before the end of the first quarter of 2009.

Throughout 2008 and 2009, the private entity project staff will work with the IASCF Education team to develop comprehensive training materials for the *IFRS for Private Entities*. Target date for completion of the training materials is mid-2009 with translations of that material into multiple languages taking place in the second half of 2009.

COMPUTER SOFTWARE BASED ON THE *IFRS FOR PRIVATE ENTITIES*

The IASB itself does not develop computer software. However, at least five software developers have indicated a strong interest in developing software tailored to applying the *IFRS for Private Entities*. Some have already started development.

Incidentally, XBRL International is working on an XBRL taxonomy for the *IFRS for Private Entities*.

POST-ISSUANCE GUIDANCE MATERIALS AND TRAINING

The IASC Foundation, under which the IASB operates, has an education initiative that produces educational materials and organises conferences relating to IFRSs. The education work plan envisages developing comprehensive guidance materials for the *IFRS for Private Entities* in multiple languages, available free of charge for download from the IASB's website, as well as organising seminars and workshops. In addition, the IASC Foundation can provide assistance to professional organisations and others who are developing materials and training for the *IFRS for Private Entities*.

HOW A JURISDICTION MIGHT APPROACH ADOPTING THE FINAL *IFRS FOR PRIVATE ENTITIES*

Each jurisdiction must consider whether and how the *IFRS for Private Entities* could be adopted in that jurisdiction. Things to consider would include:

- *Who should take the initiative?* Deciding on the financial reporting framework in each country is essentially a public interest issue that is fundamentally the responsibility of the government. This includes decisions as to which companies should be required to publish financial information and what standards they should follow. It is a public interest issue because capital availability, investor and creditor protection, and national economic development, including employment growth, are public policy matters. That is why, in most countries, companies laws usually establish broad financial reporting requirements. Those laws often specify the body that has responsibility for setting the more detailed financial reporting standards to implement the laws. Sometimes that body is a government agency. Sometimes it is an independent accounting standard setter. Sometimes it is a professional body representing the accountancy profession. The *IFRS for Private Entities* could be adopted under any of those scenarios. Deciding whether to adopt the *IFRS for Private Entities* is a professional matter that requires involvement of, among others, preparers, auditors, users of financial statements and accounting educators.
- *Which companies should be required or permitted to use the IFRS for Private Entities?* This is a matter for each national jurisdiction to decide – parliament, regulatory agency or professional body, depending on local law. The only restriction that the IASB imposes is that listed companies and financial institutions would not be eligible to use the *IFRS for Private Entities* because they have 'public accountability' and, therefore, should use full IFRSs. The IASB believes that the proposed *IFRS for Private Entities* will be suitable for any entity that does not have public accountability and is required to produce general-purpose financial statements. The IASB therefore encourages jurisdictions to consider the *IFRS for Private Entities* for all such entities.
- *Are there unique local legal issues that should be addressed?* For example, in some countries, national law requires that all companies, including private entities, comply with a specified national GAAP – such as standards issued by a national professional organisation. Or in some countries, national law requires government endorsement of accounting standards before they take effect. Using the *IFRS for Private Entities* would not be a problem in either of those cases. If the local law requires that the audit report refer to conformity with national GAAP, a jurisdiction has at least two courses of action. One is to adopt the *IFRS for Private Entities* as its national private entity accounting standard. In that case, however, the private entities in that jurisdiction would not derive all of the benefits of a global private entity financial reporting standard because their financial statements would not be described in the audit report and basis of presentation footnote as complying with the *IFRS for Private Entities*. In other words, although the private entity complied fully with the provisions of the *IFRS for Private Entities*, its financial statements would not say so. A second course of action, if the *IFRS for Private Entities* cannot be adopted directly, might be described as 'dual reporting'. In dual reporting, the audit

report and basis of presentation note refer to compliance with both national GAAP for private entities and the *IFRS for Private Entities*. This alerts users of the private entity financial statements that those statements comply fully with the *IFRS for Private Entities*.

- *Should local jurisdictions make changes to the IFRS for Private Entities before adopting it as national GAAP for private entities?* There are good reasons why this is not in the best interests of a jurisdiction or its private entities. Most importantly, if a jurisdiction changes the *IFRS for Private Entities*, financial statements could not be described as conforming to the *IFRS for Private Entities* – creating information uncertainty and, most likely, adversely affecting a private entity's access to capital. The financial statements would not be comparable to those of private entities that follow the *IFRS for Private Entities* in full. And there is a danger that the modifications would not be based on the objective, concepts and fundamental principles that are set out at the beginning of the *IFRS for Private Entities*. The due process that the IASB follows in developing all of its standards is comprehensive, and the Board explains the reasons for its conclusions in the 'basis for conclusions' that accompanies each proposed standard and final standard. 'Second-guessing' the IASB is unlikely to raise the quality of a private entity's financial reporting.
- *What is the possible timing of transition?* The IASB expects to vote on the final *IFRS for Private Entities* in the first quarter of 2009 and to issue it shortly thereafter. Because it is a completely new standard, rather than a replacement of, or supplement to, an existing set of standards, the final *IFRS for Private Entities* most likely will not specify an effective date. Rather, it would be available for adoption whenever a jurisdiction decides to implement it. In some jurisdictions, changes to the national law or regulations may be required.

REFERENCES

1 International Accounting Standards Board. (2007) *Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities*. London: IASB.

2 International Accounting Standards Board. (2007a) *Draft Implementation Guidance: IFRS for Small and Medium-sized Entities – Illustrative Financial Statements and Disclosure Checklist*. London: IASB.

3 Starting in 2009, IFRSs will require that entities prepare a statement of comprehensive income, either in addition to or instead of an income statement.

4 International Accounting Standards Board. (2007b) *Basis for Conclusions on Exposure Draft: IFRS for Small and Medium-sized Entities*. London: IASB.