The Future of Private-Company Financial Reporting

BY BRUCE POUNDER, CMA, CFM

As I noted last month in my first "Financial Reporting" column for *Strategic Finance* magazine, most of the changes that are occurring in corporate financial reporting today are the result of a single phenomenon: the global convergence of financial reporting standards. But it's important to recognize that "Convergence" is bringing different kinds of changes to different kinds of companies. In particular, private companies are experiencing the effects of Convergence differently from public companies. In this column, I will focus specifically on private companies and describe a global standards-setting project that is poised to take the lead role in shaping the future of private-company financial reporting in the United States and around the world.

Big GAAP—Little GAAP

In the U.S., there are roughly 1,000 private companies for every public company. Yet the process by which U.S. Generally Accepted Accounting Principles (GAAP) are set has traditionally focused on meeting the needs of users of financial statements issued by public companies. While that focus can be justified from a public-policy standpoint, it has resulted in a widespread perception that U.S. GAAP is "out of sync" with the needs and capabilities of preparers, auditors, and users of financial statements that are issued by private companies.

Stakeholders in the private-company financial reporting process have long argued that "one size does *not* fit all" with regard to financial reporting standards. Because public companies are commonly presumed to be "big" entities and private companies are commonly presumed to be "little" entities, the debate over whether there should be different standards for different kinds of entities has traditionally been known as the *Big GAAP—Little GAAP* debate. But so far in the U.S., that debate has resulted in relatively few differences in financial reporting standards based on the size or ownership characteristics of reporting entities.

Convergence Disrupts the Status Quo

In a few years, the U.S. Securities & Exchange Commission (SEC) will almost certainly require public companies in the U.S. to adopt the single set of country-neutral financial reporting standards that U.S. GAAP and International Financial Reporting Standards (IFRS) are converging into. At that time, stakeholders in the private-company financial reporting process will face an unprecedented opportunity to define the future of private-company financial reporting—a future that could be very different from the future of public-company financial reporting. So what might that future be?

An obvious possibility is that private companies could simply choose to adopt the same country-neutral financial reporting standards that public companies will be required to adopt. While that choice would enable private companies to enjoy the economic benefits of globally converged standards, private companies would still suffer disproportionately from the cost and operational complexity associated with standards that are primarily oriented toward the needs and capabilities of public companies.

An alternative scenario in the U.S. is that private-company financial reporting stakeholders could take control of the U.S. standards-setting process since, at that point, the only users of U.S. GAAP would be private companies. U.S. GAAP would then undoubtedly be subject to an "extreme makeover," transforming into a far simpler and more cost-effective set of standards. The smaller the reporting entity, the greater the relief there would be from having such standards. And by creating a "Little GAAP," the U.S. would join the many other countries that have already developed different standards specifically for small and medium-sized entities (SMEs), nearly all of which are private companies.

But that scenario is far from a certainty for two main reasons. First, private U.S. companies would suddenly find themselves having to fund a standards-setting infrastructure that in recent years has been funded mainly by public companies. Second, adding to the world's collection of country-specific "Little GAAP" would distance private companies from country-neutral standards and the economic benefits thereof—benefits that public companies will enjoy as a result of Convergence.

Thus, the ideal situation for private companies would be to have a set of high-quality, country-neutral financial reporting standards designed around their needs and capabilities without the associated costs of developing and maintaining such standards. Fortunately, such a set of standards (which when printed is about the size of a typical issue of *Reader's Digest*) is nearing completion and is scheduled to be published in early 2009 by the International Accounting Standards Board (IASB).

On September 23, 2008, Bruce Pounder will discuss Convergence and IFRS planning options for private companies as a panelist at Financial Executives International's Private Company Forum in Chicago. For more information, visit www.financialexecutives.org.

IFRS for Private Entities

For the past five years, in parallel with its efforts to develop and maintain IFRS for use by for-profit enterprises of all kinds, the IASB has been working to develop a shorter, simpler version of IFRS specifically for use by entities that lack "public accountability." According to the IASB, "An entity has public accountability if: (a) it files, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or (b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity." Thus, most private companies fall within the target audience of the IASB's *IFRS for Private Entities*.

An Exposure Draft (ED) of the standard was published as *IFRS for Small and Medium-sized Entities* in February 2007. Numerous comments were submitted during the nine-month exposure period, and extensive field testing was subsequently conducted by more than 100 private companies in the U.S. and 19 other countries. Then in May 2008, the IASB changed the name of the draft standard to *IFRS for Private Entities* in order to describe the standard's target audience more accurately.

The IASB's *IFRS for Private Entities* project has benefited from the strong staff leadership of Paul Pacter and Michelle Fisher, along with the input of an international working group, which last met in London in April 2008. My IMA colleague Richard Ricketts and I were invited to observe that meeting as representatives of IMA's new Small Business Financial and Regulatory Affairs Committee. At our first Committee meeting in March 2008, Committee members identified the IASB's project as being highly relevant to a significant portion of IMA's membership, so it was very helpful for Richard and me to have had the opportunity to attend the working group meeting in person. Additionally, Paul Pacter provided an excellent follow-up teleconference presentation to the entire Small Business Committee during our second meeting in June.

Reality Check

Although the *IFRS for Private Entities* project has enjoyed widespread support from private-company stakeholders worldwide, not everyone agrees that a separate set of financial reporting standards for private companies is necessary or desirable. For example, IMA's Financial Reporting Committee (FRC), in commenting on the ED in June 2007, raised several concerns and expressed the Committee's opinion that "Rather than inventing a new set of 'simpler' standards for SMEs only, the IASB (and FASB) needs to work toward a less complex principles-based system for all companies." Other observers have noted that U.S. adopters of *IFRS for Private Entities* may find the transition to a less-rules-based set of standards challenging to implement as a result of having to exercise professional judgment to a greater degree than most U.S. preparers and auditors are accustomed.

Of course, *IFRS for Private Entities* is likely to require some fine-tuning over time and may be more readily adopted in some jurisdictions vs. others. But its advantages will be impossible for the millions of private entities in the world to ignore. IMA, along with other bodies such as the U.S. Private Company Financial Reporting Committee, will continue to pay close attention to future developments in this area. Meanwhile, financial managers in private companies can familiarize themselves with the ED of the standard and full details of the project at the IASB's website (www.iasb.org/Current+Projects/IASB+Projects/Small+and+Medium-sized+Entities/Small+and+Medium-sized+Entities.htm).

Unlike public U.S. companies and private companies in other countries, private U.S. companies will be able to decide for themselves whether and when they want to switch to global standards. The forthcoming *IFRS for Private Entities* is an option that all private-company financial managers should be aware of. ■

Bruce Pounder, CMA, CFM, DipIFR (ACCA), is president of Leveraged Logic, a provider of consulting and educational services to financial professionals. He is chair of IMA's Small Business Financial and Regulatory Affairs Committee and the liaison from that Committee to IMA's Financial Reporting Committee. You can reach Bruce at BPounder@LeveragedLogic.com.