

COMPLIANCE WEEK

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The Upside to IFRS for Small, Medium Entities

By Colleen Cunningham — August 25, 2009

The International Accounting Standards Board finally issued its long-awaited, International Financial Reporting Standard for small and medium-sized entities (SMEs) in July. This is more important than you think.

Essentially, IFRS for SMEs is a simplified microcosm of full IFRS aimed at meeting the needs of financial reporting for private companies through a cost-benefit approach. The name is somewhat of a misnomer; in this case, size doesn't matter as much as public accountability does. IASB struggled with the name over the project's five-year history, going from "Non-publicly Accountable Entities" to "Private Entities," and coming back full circle to its original name, SMEs.

IASB's definition of an SME states that the entity can have no publicly traded debt or stock, or the entity cannot be deemed as having "public accountability" such as holding assets in a fiduciary capacity for a broad group of outsiders (banks, credit unions, broker-dealers, mutual funds, and so forth). They apparently didn't want to use the term "public accountability" in the title, as they felt it might cause more confusion. For example, Joe's Hot Dog Stand may be publicly accountable to the health department, but obviously that isn't the intent of the standard.

Most countries already have separate standards for private entities, so adding the project to IASB's agenda was not controversial. That same debate has flared up in the United States every now and then for the last 30 years, exploring the merits of "Big GAAP" versus "Little GAAP." Until recently (including my time on both the U.S. Financial Accounting Standards Board's and IASB's advisory committees), I've believed the discussion was a waste of time. After all, if Joe's Hot Dog Stand and IBM are both entering into similar economic transactions, they should be accounted for in similar ways—right?

Well, I recently converted to the other side. Normally I am not a person who is easily swayed, but the world has moved into a different place today. Several dynamics have occurred over the last few years that caused me to change my mind, and they may change yours too.

First, over the last few years, FASB has issued—and continues to issue—increasingly controversial and complex standards that are expensive and complicated to implement. Even large, sophisticated companies are having difficulty complying. Witness the several

restatements that General Electric had to endure over incorrectly implementing Financial Accounting Standard No. 133, *Accounting for Hedging Activities* (the grand dame of complex and convoluted standards, more than 800 pages long).

Second, the Sarbanes-Oxley Act mandated that the Securities and Exchange Commission oversee FASB, and that funding for it come from public companies. Previously, funding came from donations from a much wider constituency.

Third, many private companies in the United States no longer use U.S. Generally Accepted Accounting Principles. Increasingly, private companies in the United States have used another comprehensive basis of accounting (tax basis or cash basis, for example) or have taken a U.S. GAAP exception in their audit report to avoid the burdensome compliance with recently issued accounting standards irrelevant to their users. In many cases, the users of their financial statements have *requested* reporting other than U.S. GAAP, as GAAP increasingly fails to meet their needs.

Fourth, the issuance of IFRS for SMEs. Clearly, the rest of the world has already decided that differential accounting standards make sense.

The users of SME financial statements often differ from the users of financial statements based on full IFRS or U.S. GAAP. Users of the financial statements of private companies (generally, lenders, creditors, or owners) usually focus more on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. That means they do legitimately need an accounting standard for private companies that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

IFRS for SMEs was designed to meet that need. With the issuance of IFRS for SMEs, many SMEs around the world, including private companies in the United States, will have the option of using a much simplified, IFRS-based accounting framework to prepare their financial statements.

Unlike public companies in the United States, private companies are not “required” to use a particular basis of accounting when preparing financial statements. They can prepare their financial statements in accordance with U.S. GAAP as promulgated by FASB, or by using another comprehensive basis of accounting, such as cash- or tax-basis or full IFRS, among others. Now, with the issuance of IFRS for SMEs, U.S. private companies have an additional option.

Some may find the simplified IFRS for SMEs an attractive alternative. The new U.S. Accounting Standards Codification (which is what we’re calling GAAP from here forward) comes in at 17,000 pages; IFRS for SMEs is a mere 230. Private companies may find IFRS for SMEs to be a more relevant and less costly financial accounting and reporting standard than U.S. GAAP.

Last year, the American Institute of Certified Public Accountants voted to recognize IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. The AICPA does note that CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with IFRS for SMEs within their individual state. But this effectively opens the door for U.S. companies to use IFRS.

Get Moving?

While the SEC continues to debate whether to join the rest of the world in adopting IFRS for U.S. *public* companies, private companies in the United States may consider leading the way in this country by adopting IFRS for SMEs.

There are, however, some challenges in adopting IFRS for SMEs here. These include obtaining an understanding of the major differences between IFRS for SMEs and U.S. GAAP; calculating the cost, time and effort to convert to IFRS for SMEs; and winning support from the users of private company financial statements. IFRS for SMEs cannot be perceived as a lesser set of standards; they must provide information useful to make decisions. Ultimately, the market will drive the acceptance of the standard.

The standard also permits subsidiaries of foreign entities that use full IFRS to use IFRS for SMEs for their separate statutory reporting requirements, as long as they meet the definition as “not publicly accountable.” This may be an attractive alternative for both foreign and U.S. companies with subsidiaries that currently prepare their statutory financial reports using full IFRS.

So what are the major differences between IFRS for SMEs and full IFRS? IFRS for SMEs eliminates many accounting topics generally irrelevant to private companies (earnings per share and segment reporting, for example). Additionally, required disclosures are significantly reduced, accounting policy choices are limited to the simpler option, and recognition and measurement are simplified.

Will the rest of the world adopt IFRS for SMEs? We don't know. As countries adopted full IFRS in the last decade, many kept their national accounting rule-makers to continue to set standards for private companies. This is clearly a political issue for each individual country. (I should note here that if private companies in the United States lead the way and adopt IFRS for SMEs, and the SEC then follows suit with IFRS for public companies—FASB will then be obsolete.)

It is likely that IFRS for SMEs will be embraced by developing nations. In fact, South Africa adopted the draft IFRS for SMEs as its national standard in 2007! We should also note that there are less than 20,000 public companies in the United States—but more than 20 million private ones. In recognition of FASB's focus on public companies, in 2005, the AICPA and FASB created the Private Company Financial Reporting Committee. It

meets periodically and has outlined several alternatives that the United States should consider for private companies, including the move to IFRS for SMEs.

If you are a private company in the United States, this may be your ticket out of complying with the needless complexity of U.S. GAAP. It may also be the beginning of the end of FASB.

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