September 30, 2009

Little GAAP Has Arrived

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With little fan fair over the summer, private companies now have an alternative set of generally accepted accounting principles (GAAP) to US GAAP. It is called *IFRS for SMEs* and was published by the IASB (International Accounting Standards Board) on July 9, 2009. According to IASB's website; "*The IFRS for SMEs is a self-contained standard of less than 230 pages, designed to meet the needs and capabilities of small and medium-sized entities (SMEs), which are estimated to account for over 95 percent of all companies around the world.*" Don't let the term "SMEs" fool you as any entity, of any size, without public accountability can adopt this set of accounting principles assuming it is permitted by local jurisdictions.

This is a bigger deal then you might initially think since it essentially has forced a resolution to the age-old debate of "big-GAAP" versus "little-GAAP". While the term GAAP simply refers to a standard framework of guidelines for financial accounting, US GAAP has essentially been written for public companies, that is those companies granted permission by the SEC to offer its registered securities for sale to the public. This occurs since US GAAP is written by the Financial Accounting Standards Board (FASB) who is designated by the SEC as the standards author of financial accounting. Those standards govern the preparation of financial statements of public companies and many non-public companies that opt to adhere to US GAAP. The FASB is funded by public companies and their resulting standards are fundamentally written for bigger US companies in the public spotlight. The resulting product of US GAAP stands at around 17,000 pages as opposed to the mere 230 pages of *IFRS for SMEs.* The rest of this article identifies who can use this new streamlined set of rules in recording transactions and in preparing financial statements, as well as some of the big differences and challenges.

Who Can Use *IFRS for SMEs*?

The IASB began a project known as IFRS for private entities in 2003. With more than 80 countries permitting or requiring IFRS (International Financial Reporting Standard) for some or all private companies, it made sense to move full-steam with a set of standards for private company reporting. It is important to remember that *IFRS for SMEs* should not be confused with full IFRS. Although IFRS is considered less cumbersome than US GAAP it still contains approximately 2,500 pages, which is a far cry from 230 pages.

IFRS for SMEs is not for everyone, so it is important to know who precisely can use it. It is intended for use by "small and medium-sized entities," which are defined by the IASB as entities that <u>do not</u> have public accountability but <u>do</u> publish general purpose financial statements for external users. The breadth of the definition depends on the words "public accountability." For purposes of the SME standard, an entity has public accountability if it meets either of the following two criteria:

1. Debt or equity instruments are traded in a public market, or it is in the process of issuing such instruments for trading in a public market.
2. Entity holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (e.g., banks, credit unions, insurance companies, securities brokers and dealers, mutual funds, and investment banks).

Therefore, the term "SMEs" is somewhat misleading since any non-public accountable entity, as defined by the IASB, can use *IFRS for SMEs* regardless of size.

Some Differences

IFRS for SMEs is based largely on the same underlying principles as full IFRS, however on a more simplified basis since it looks to do away with the more cumbersome and expensive standards pertinent to public companies. *IFRS for SMEs* focuses on improving financial reporting by:

- Removing choices, eliminating topics that are not relevant for private entities, and simplifying the recognition and measurement treatments in certain areas
- Enabling investors, lenders, and other financial statement users to compare financial performance among private entities
- Reducing the burden of financial statement preparation for private entities, with attention given to cost/benefit considerations

Some of the key differences with *IFRS for SMEs* as compared to US GAAP or full IFRS are:

- Many of the principles in full IFRS for recognizing and measuring assets, liabilities, income and expenses have been simplified
- Topics typically not relevant to SMEs have been omitted. The *IFRS for SMEs* does not address the following topics that are covered in full IFRSs:
  - earnings per share
  - interim financial reporting
  - segment reporting
  - special accounting for assets held for sale
- The number of required disclosures has been significantly reduced
- The standard has much less application guidance. *IFRS for SMEs* states that users may also consider the guidance of full IFRS that address similar and related issues if *IFRS for SMEs* does not provide what is needed
- Changes to *IFRS for SMEs* will be limited to once every three years to further reduce the reporting burden for SMEs

Of course, there are numerous specific differences in accounting, as well as transition issues, beyond the scope of this article that apply to *IFRS for SMEs*. The IASB has published an *IFRS for SMEs Fact Sheet* that is a handy reference in seeing some of the big difference to full IFRS. Also, keep in mind that not all requirements per *IFRS for SMEs* reduce the burden when compared to US GAAP. For example, while US GAAP does not require comparative financial statements, *IFRS for SMEs* requires at least one year comparative financial statements. Of course, for public companies the requirements of SEC Regulation S-X have long required comparative financial statements, but for private companies *IFRS for SMEs* will now also means at least one comparative year. Finally, companies that choose to adopt *IFRS for SMEs* must adopt the entire set of standards and make an explicit statement in the notes on their financial statements that they comply with *IFRS for SMEs.*

Challenges

As with all significant changes, there are significant challenges in rolling out IFRS for SMEs. There is training, accounting software, pre-existing contractual items from employment agreements to debt agreements, new internal operating metrics, new internal control documentation and testing, income tax considerations, and a host of other items to consider. However, perhaps the biggest challenge is a cultural one as IFRS for SMEs is based on an accounting and financial reporting framework that requires more judgment and less reliance on detailed rules and “bright-line” tests. Companies will be required to understand base principles, objectives, how judgments are made, and how they are applied. This will likely require more involvement from operational leaders thus involving more people than under US GAAP.

Another key challenge for those companies using a last-in, first-out (LIFO) inventory costing method is that LIFO is not permitted under IFRS for SMEs. This could have a material tax consequence for companies with significant LIFO reserves and remains a hotly debated topic regarding either potential convergence of US GAAP to full IFRS or adoption of IFRS. In the 2007 tax reform proposal, *H.R. 3970*, the House Ways and Means Committee estimated that the provision to repeal LIFO for US income tax purpose would raise approximately $106 billion to the US Treasury over ten years. That is a lot of money that will not go unnoticed by Congress.

Conclusion

Companies that do not meet the public accountability parameters of the IASB can now use *IFRS for SMEs* assuming it is permitted by the state jurisdiction in which the audit report is issued. With the AICPA (American Institute of Certified Public Accountants) governing Council’s May 2008 decision to recognize the IASB as an international accounting standard setter, auditors may report on general purpose financial statements presented in conformity with IFRS, including *IFRS for SMEs*, without modification to the opinion as an alternative to US GAAP. The audit report for financial statements would need to state that the financial statements are presented fairly in accordance with *IFRS for SMEs*. The AICPA does note *(#7 of Q&A)* that CPAs should 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 state.

This effectively opens the door for US companies to use *IFRS for SMEs*. However, private companies should consult with their capital suppliers and other key external stakeholders about what kind of financial reporting standards they desire in reports from their borrowers and investees. After all, external financial reporting is for third parties and their requirements must align accordingly.

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This is an article reprint from the Governance Issues™ Newsletter, Volume 2009, Number 5, published on September 30, 2009

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