

International Financial
Reporting Standards
What it means for private
company reporting



IFRS: What it means for private company reporting

This point of view discusses the movement toward International Financial Reporting Standards (IFRS) and its implications for private company financial reporting in the United States. It also discusses some financial reporting issues which may be unique to private companies, and the efforts of the International Accounting Standards Board to develop a set of global standards geared specifically to private companies, IFRS for Private Entities. Finally, the paper discusses the potential benefits and challenges of using either IFRS or IFRS for Private Entities, as well as, some key questions and considerations for private company financial statement users and preparers.

The global move toward IFRS

Over the last several years, the world's capital markets have undergone tremendous expansion, diversification, and integration. And with that, there has been a movement away from local financial reporting standards toward global standards. In 2005, the 25 member states of the European Union came together and decided to adopt a common set of financial reporting standards: International Financial Reporting Standards, or IFRS. IFRS are now used for public reporting purposes in more than 100 countries ranging from Australia to the United Kingdom, with others to follow over the next couple of years.

U.S. policymakers are now considering whether IFRS should be used here in the United States. In August 2007, the Securities and Exchange Commission (SEC) issued a "concept release" that requested comment on whether U.S. public companies should be permitted to use either IFRS or U.S. Generally Accepted Accounting Principles (U.S. GAAP) as a basis of accounting in preparing their financial statements for SEC reporting purposes. And last year, the SEC issued a proposed "IFRS roadmap" that sets forth a possible path to eventual adoption of IFRS by all U.S. public companies, which could begin within the next five to seven years.

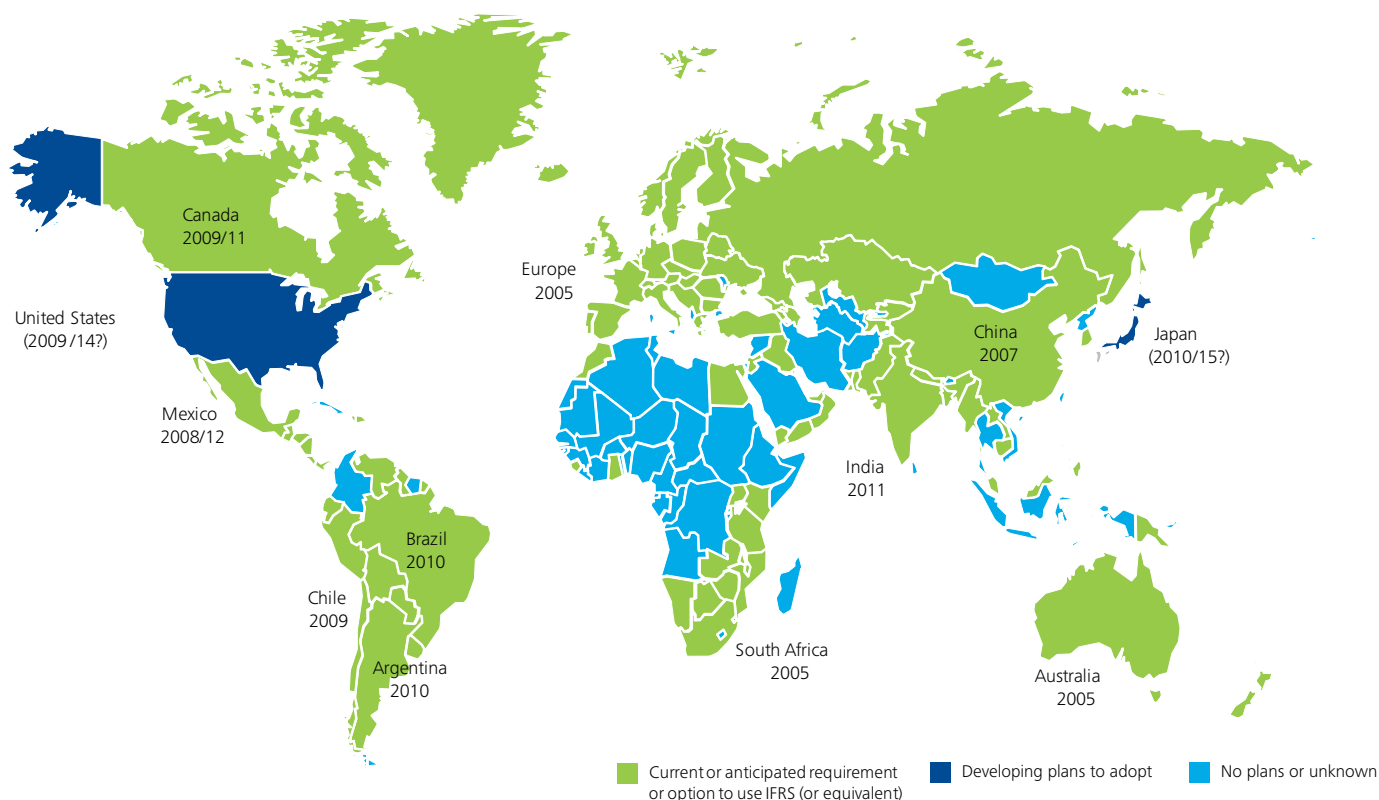
So what does this mean for the future of financial reporting for U.S. private companies?

Similar to the practice in other countries, reporting by U.S. private companies has been largely based on what is required for public companies. U.S. GAAP, which is currently required for all U.S. public companies, has been "pushed down," in a sense, as the basis of reporting for U.S. private companies. Although U.S. private companies are not required to use a particular basis of accounting in preparing financial reports, most users of private company financial reports look to U.S. GAAP or some form of it as a basis of preparation.

As the discussion about IFRS and public company reporting continues in the United States, there will likely be a related impact on private company reporting. Today, more than 80 countries permit or require IFRS for some or all private companies. It is also worth noting that some U.S. private companies currently use IFRS as a basis of reporting. Their usage of IFRS is likely due, in large part, to these companies having a foreign parent, investor, or venture partner that uses IFRS.

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IFRS adoption as of April 2009: The global move towards IFRS



Private company reporting: complexity, cost, and user needs

Over the last few years, U.S. GAAP requirements have taken on an increasing level of complexity. This trend has been troubling for many companies, public and private, as well as for financial statement users. In 2008, the SEC’s advisory Committee on Improvements to Financial Reporting (CIFR) issued its final report and recommendations geared toward increasing the usefulness of financial information while reducing the complexity of the financial reporting system. In the report, CIFR noted that the complexity in U.S. GAAP was driven in large part by the volume of formal and informal accounting guidance. The increase in complexity has likely contributed to higher compliance costs that may not be worth the benefit, especially for private companies.

Although the scope of the CIFR report was focused on reporting by public companies, many of the issues it describes are also applicable to private companies. Some of the complex U.S. GAAP requirements are only marginally relevant to private companies and their stakeholders. In addition, some of U.S. GAAP’s more complex recognition, measurement, and disclosure requirements may not be useful to private company financial statement users.

Over the years, the American Institute of Certified Public Accountants has studied the relevance of certain financial reporting requirements for private companies. These studies include examinations of how well U.S. GAAP meets the needs of private company users and whether the cost of providing U.S. GAAP financial statements is justified compared to the benefits they provide to users. This research, as well as experience in working with private companies, indicates that some specific U.S. GAAP requirements – including certain aspects of deferred income taxes, leases, guarantees, intangibles, variable interest entities, and share-based payments – may lack relevance or usefulness to many private company constituents.

Users of private company financial reporting may place a different emphasis on their financial reporting needs than users of public company financing reporting. Although both public and private companies may use financial reporting for similar purposes such as to guide management and operators in the day-to-day management of the business, to measure operating results and to provide relevant information to creditors, vendors, and customers, there may be different areas of emphasis for users of private company financial reporting. For example, the users of private companies’ reports might place greater emphasis on liquidity, solvency and short-term cash flow planning than do the users of public companies’ reports.

Users of private company financial statements could also have shorter decision-making horizons and more limited resources than public company financial statement users.

These differences have contributed to an ongoing debate about whether separate reporting standards should be developed specifically for private companies. And this debate is not unique to the United States. Since the global movement toward IFRS, many constituents from several countries have asked the International Accounting Standards Board (IASB) to develop a tailored set of IFRS for private companies.

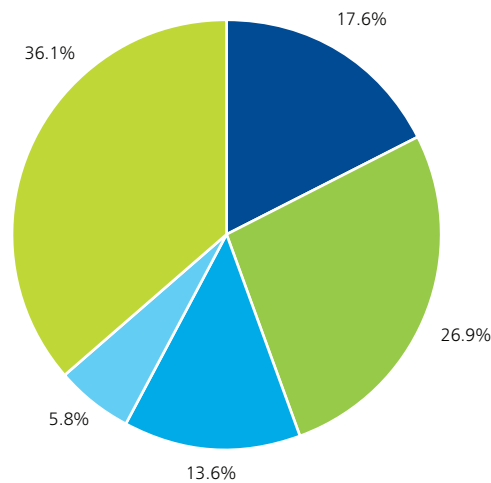
In 2003, the IASB began a project on reporting by small- and medium-size enterprises that was geared toward

private company reporting. This project, known currently as *IFRS for Private Entities*, is near completion. With the expected release later this year of IFRS for Private Entities, interest in IFRS-based reporting for private entities is likely to increase, both among private companies themselves and observers who may view IFRS for Private Entities as a “proof of concept” for the potential adoption of IFRS for all U.S. public companies.

Overview of IFRS for Private Entities

IFRS for Private Entities are intended for any entity that does not have public accountability. In developing IFRS for Private Entities, the IASB focused on the typical needs of a typical mid-size private company; however, IFRS for Private Entities may be used by any non-publicly accountable entity regardless of size.

When IFRS for Private Entities is finalized, which best describes the direction of your company?



- Have no plans to adopt until full IFRS is mandated for U.S. public companies
- Will assess the costs/benefits of adoption
- Will consider adoption in the near-term
- Have no interest in adoption
- Don't know/not applicable

Source: Deloitte's Private Company Dbriefs webcast, "IFRS: Why Private Companies Should Take Note" held on January 28, 2009. Polling results presented herein are solely the thoughts and opinions of survey participants and are not necessarily representative of the total population of private companies.

A non-publicly accountable entity is an entity that does not have public accountability and publishes general purpose financial statements for external users. This definition excludes companies that have debt or equity securities that are publicly traded, and it also excludes financial institutions such as banks, securities broker/dealers, pension funds, mutual funds, and insurance companies.

IFRS for Private Entities modify “full” IFRS (i.e., IFRS used by public entities) with the intent of providing private companies a simplified, self-contained set of financial reporting standards while, at the same time, better meeting the needs of their financial statement users. Areas in which the proposed IFRS for Private Entities may be simpler than both full IFRS and U.S. GAAP include the accounting for financial items such as investments in securities, goodwill, revenues, and income taxes.

Financial reporting under proposed IFRS for Private Entities: Comparison with U.S. GAAP in selected areas

Topic	Differences from U.S. GAAP
Financial statement presentation and disclosure	<ul style="list-style-type: none"> • Generally uses liquidity format for balance sheet • May have a combined statement of comprehensive income and retained earnings • Simplified disclosures in areas such as share-based payments, pensions, leases, and financial instruments
Financial assets and liabilities	<ul style="list-style-type: none"> • Greater use of cost for financial assets and liabilities • Simplified classification and de-recognition criteria
Revenue recognition	<ul style="list-style-type: none"> • Focused on general principles versus complex detailed guidance
Property, plant, and equipment	<ul style="list-style-type: none"> • Depreciation based on a “components” approach
Goodwill and indefinite life intangibles	<ul style="list-style-type: none"> • Amortized over a period not exceeding 10 years • No annual impairment test requirement
Asset impairment	<ul style="list-style-type: none"> • Requires an assessment of impairment indicators at each reporting date • Impairment based on the asset’s “recoverable amount” versus fair value • Reversal of impairment charges, if certain criteria met
Employee benefits and pensions	<ul style="list-style-type: none"> • Immediate recognition of actuarial gains/losses • Subsidiaries may recognize a charge based on a reasonable allocation of the group charge from parent
Inventory	<ul style="list-style-type: none"> • LIFO prohibited
Income taxes	<ul style="list-style-type: none"> • Simplified “temporary difference” approach for income taxes • Non-current classification

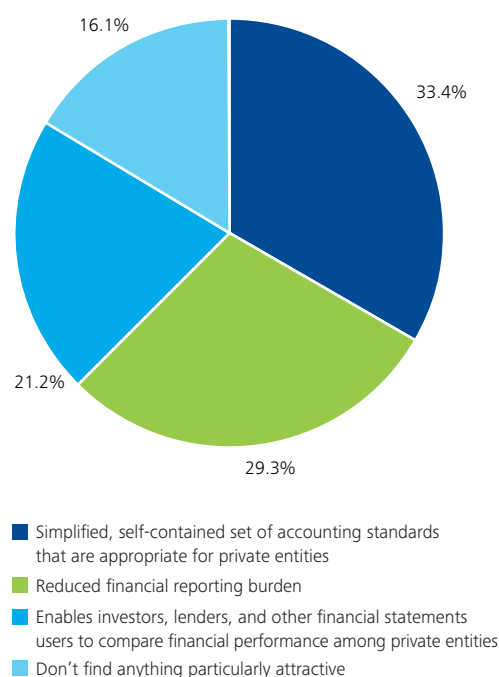
Approximately 250 pages in length, the proposed IFRS for Private Entities are organized by topic. IFRS for Private Entities are focused on improving financial reporting by:

- Removing choices, eliminate topics that are not relevant for private entities, and simplify 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 particular attention given to cost/benefit considerations.

Source: [International Financial Reporting Standards for Non-publicly Accountable Entities](#), pages 3-4; February 18, 2009.

What aspects of IFRS for Private Entities do you find most attractive?



Source: Deloitte's Private Company Dbriefs webcast, "IFRS: Why Private Companies Should Take Note" held on January 28, 2009.

Once IFRS for Private Entities are issued, they will be available for use immediately, giving U.S. private companies another option for financial reporting (in addition to U.S. GAAP and full IFRS). IFRS for Private Entities contain the same first-time adoption exemptions as in full IFRS, which permit a company to apply prospectively certain requirements. These exemptions can facilitate a cost-effective transition to IFRS for Private Entities for companies that choose to adopt.

Like full IFRS, IFRS for Private Entities emphasize the use of judgment over prescribed "bright-line" rules. The intent is to allow private company executives to focus on the economics of a transaction and analyze business objectives rather than sifting through pages of "bright-line" guidance to determine the proper accounting treatment.

The IASB does not intend to update IFRS for Private Entities for future changes to IFRS, although it intends to have a post-issuance review every couple of years. This review could result in the IASB publishing an omnibus exposure draft of proposed amendments to IFRS for Private Entities, which may add stability to the financial reporting process and enhance the efficiency of compliance.

Benefits and challenges

The benefits of global standards are not limited to public companies, as markets are also becoming integrated for private companies, both large and small. More and more private companies are looking to do business across borders and obtain financing from foreign sources. Reduced complexity, greater transparency, increased comparability, and improved efficiency are all potential benefits of IFRS and IFRS for Private Entities. Both IFRS and IFRS for Private Entities also may reduce the burden of financial reporting on private companies, thereby reducing compliance costs.

Not only might private companies benefit from a common set of reporting standards, but the users of their financial statements, particularly those in different jurisdictions, would likely benefit as well. Users such as lenders, vendors, customers, venture capitalists, and non-management owners will need to understand only one set of standards in their dealings with private companies in different jurisdictions.

Adoption of IFRS or IFRS for Private Entities is not without potential challenges. To begin with, the adoption of IFRS or IFRS for Private Entities will require understanding how

these standards differ from U.S. GAAP as well as the legal and financial consequences of those differences.

However, for both public and private companies as well as the greater financial reporting community, one of the biggest challenges may be a cultural one. With the use of IFRS or IFRS for Private Entities, companies, external auditors, and users will need to adapt to an accounting and financial reporting framework that requires more judgment and less reliance on detailed rules and “bright lines.” Companies will be required to understand base principles and objectives, how judgments are made, and how they are applied. Such an approach to accounting may require a change in mindset.

In addition, there will likely be tax implications for companies that adopt IFRS or IFRS for Private Entities. One of the biggest hurdles to using IFRS or IFRS for Private Entities may be their prohibition of the LIFO method of inventory valuation. Action by Congress or the IRS with a viable approach to this issue will likely be necessary before many private entities may seriously contemplate a conversion. The approach could be a potential repeal of the LIFO method for federal income tax reporting, however, which has been recently suggested by both Congress and the Obama administration. Further, although the basic conceptual approach to accounting for income taxes under IFRS is similar to U.S. GAAP, the IASB has suggested that there may be some simplification in the overall approach under IFRS for Private Entities. The adoption of IFRS for Private Entities will likely require thoughtful consideration of its potential impact on intercompany financing arrangements, tax reporting methods, and overall tax planning objectives, particularly for complex organizations with international operations.

The way forward

IFRS or IFRS for Private Entities may be a welcome alternative to U.S. GAAP for many private companies. The factors that drive the choice of a reporting standard, however, are unique to each company’s objectives and growth strategies. In making the choice, private companies will

likely benefit from carefully evaluating the options and measuring the potential costs and benefits.

Private companies should carefully consider their capital requirements to support their growth strategies. If the ultimate goal is to go public, a private company may wish to consider full IFRS in order to align with the anticipated U.S. transition to IFRS for public companies. If going public is not a goal, private companies will need to understand if their lending institutions and creditors are comfortable with IFRS for Private Entities as they evaluate a possible switch.

The following questions can help leaders of private companies frame their analysis:

- Given our financial reporting requirements and future plans, what advantages and disadvantages would arise from our adoption of either IFRS or IFRS for Private Entities?
- Does IFRS or IFRS for Private Entities help the organization increase the efficiency of its financial reporting procedures? What are the costs of implementing IFRS or IFRS for Private Entities?
- How acceptable would the use of IFRS or IFRS for Private Entities be to the users of our financial statements?
- What will be the impact on aspects such as culture, tax, and financial reporting metrics? Are any competitors moving to IFRS or IFRS for Private Entities?
- How will IFRS or IFRS for Private Entities affect after-tax cash flows and the efficient deployment of capital across the enterprise?

Ultimately, financial reporting standards are intended to provide stakeholders with transparent, reliable financial information to guide effective decision-making. IFRS and IFRS for Private Entities may be a significant step forward for private companies seeking a set of financial reporting standards that fulfills this intention.

Deloitte IFRS Resources and Contacts

Mike Becher

Partner, Deloitte & Touche LLP
+1 317 656 4300
mbecher@deloitte.com

Jeff Carr

Partner, Deloitte Tax LLP
+1 813 273 8327
jcarr@deloitte.com

Nathan Andrews

Partner, Deloitte Tax LLP
+1 919 546 8055
nandrews@deloitte.com

National IFRS Leadership Team

D.J. Gannon

Partner, Deloitte & Touche LLP
+1 202 220 2110
dgannon@deloitte.com

Nick DiFazio

Partner, Deloitte & Touche LLP
+1 313 396 3208
ndifazio@deloitte.com

Additional resources

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