



UNIVERSITY  
OF MANITOBA

Asper School of Business  
*Faculty of Management*

Janet Morrill, Ph.D., C.G.A.  
Professor of Accounting  
181 Freedman Crescent  
Winnipeg, Manitoba  
Canada R3T 5V4  
Tel. (204) 474-6854  
Fax (204) 474-7545  
E-mail: Janet\_Morrill@UManitoba.CA

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Peter Martin  
Accounting Standards Board  
Comment on Canadian Adoption of Proposed *International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SME's)*

Dear Peter,

Thank you for circulating this exposure draft and providing us with the opportunity to respond. This is clearly a complex and important issue and we have been very impressed with the care that has been taken in considering the exposure draft and in ensuring that a wide range of interested parties have been consulted.

In our opinion, it makes good sense to develop a separate set of standards for SME's. For the most part, the approach of the IASB's proposal, in terms of the level of depth and complexity, strikes us as being appropriate for the Canadian SME environment. However, we believe such a set of standards should be developed domestically. We do not believe that an internationalized set of principles-based standards is either feasible or necessary for small and medium sized companies, and that the IASB will find it difficult to generate a coherent set of high quality standards over time for SME's. Our reasoning is as follows (note that these comments have also been sent to the IASB).

#### Feasibility of International Standards for SME's

While it appears to us that a different set of standards is necessary for small and medium sized enterprises (SME's) than the set of standards used for large public companies, it is not clear to us that it is feasible to have an *international* set of financial reporting standards. For brevity and simplicity, it is desirable to have a more "principles-based" set of standards, as this document appears to be, and is confirmed by Sections 10.2 to 10.4. Our concern is that such a principles-based set of standards may not be appropriate in countries with less sophisticated legal, regulatory and auditing infrastructures, as academic research would attest (for example, see Xiang, B. "Institutional Factors Influencing China's Accounting Reforms and Standards", *Accounting Horizons* 12(2) (June 1998): 105-119). Furthermore, the countries most likely to want to adopt an IASB standard are very likely to be in this situation, as a lack of resources to produce domestic accounting standards is also likely to result in the lack of infrastructures recommended above.

Another concern is the ability of countries with limited resources to identify circumstances that would render the use of international standards inappropriate, especially given that we are sceptical that even more "sophisticated" countries are doing this well. The ability to do this may be even more critical for SME's than it is for large companies, as SME's are perhaps exposed to and influenced by their local context to a greater extent.

A further complication is a finding from a recent study of European public and private entities that private entities are more likely to engage in earnings management than public companies (Burgstahler, D. C., L. Hail and C. Leuz. 2006. The Importance of Reporting Incentives: Earnings Management in European Private and Public Firms. *Accounting Review* 81(3): 983-1016). Earnings management by private firms is particularly dangerous for at least two reasons. First, as noted above, many countries do not have sufficiently robust and qualified oversight mechanisms in place to control earnings management effectively. Secondly, private companies in general are not subject to financial analyst scrutiny as public firms are. This lack of scrutiny might further encourage earnings management.

#### Need for International Standards for SME's

The idea that large, publicly traded companies should all follow a set of international standards appears to be gaining wide acceptance. However, notwithstanding the arguments laid out in the Basis for Conclusions document BC15-BC27,

we are less certain that the same factors are in play for smaller entities. In many cases, the users are much closer to the companies (domestic banks, suppliers, customers) and/or the users have a sufficiently large stake in the companies (venture capitalists, parent companies) that they can either “untangle” domestic GAAP or insist that the company use IFRS’s. Therefore, in addition to the feasibility of International Standards for SME’s, we also question whether there is the same compelling reason to develop them.

Counteracting these arguments, however, is the possible efficiencies that can be gained by having one international standard setting body. While this is important, having domestic accounting standards for SME’s does not necessarily consign each country to reinventing its own wheel. It appears that, particularly in recent times, countries can achieve efficiencies in their own standard setting processes by identifying and borrowing standards adopted by other countries that best suit their environment and objectives.

#### Accounting for SME’s in Canada

Notwithstanding our concerns of the feasibility of an International set of accounting standards for SME’s, we believe an approach similar to that proposed by the IASB could be adopted in Canada. As it stands, we have some suggestions regarding the existing proposal if it were to be considered by the ASB for Canadian SME’s:

#### *Use of the IASB Conceptual Framework*

We are concerned by the nearly wholesale adoption of the IASB Conceptual Framework for SME’s, particularly the decreased emphasis on stewardship. The IASB Conceptual Framework seems to see stewardship as subsumed by the resource allocation decision, which in turn seems likely to lead to standards that place primary emphasis on predictive value as a key criterion. While this may be appropriate for large public companies, it may be problematic for small companies where stewardship in the conventional sense could play a greater role. In SME’s that are owned by small family groups, SME’s whose financing depends on debt covenants, or SME’s that award management bonuses based on financial statement numbers, a greater emphasis on past results, reliability of numbers, and conservatism is likely to be highly valued by financial statement users.

#### *Wording of the Professional Judgment Paragraphs*

As mentioned in our discussion of feasibility of an International Standard for SME’s, a principles-based framework as suggested by paragraphs 10.2 to 10.4 may be inappropriate given preliminary evidence that private companies engage in more earnings management, particularly in countries lacking a strong regulatory infrastructure. We are also uncomfortable with the use of the word “may” in these paragraphs. Does “may consider” IFRS’s mean *should* consider? Does the use of the word “may” provide any guidance to preparers and auditors, or reassurance to the users of the financial statements? Is the IASB’s intention to grant permission to use IFRS’s (in which case “may” is the appropriate word) or to provide guidance (in which case “should” would be better)?

#### *Accounting for Pensions*

Kevin Shand, Cameron Morrill and I sent a separate ED response on the pension accounting section to the IASB, which we have appended here. Our largest concern is that the proposed standard, according to our analysis, would result in very large fluctuations in pension expense due to the requirement that all actuarial gains and losses be recognized in income in the period in which they occur (rather than amortization over the EARSL). We believe the magnitude of these fluctuations would be overly punitive to SME’s, particularly due to the impact it could have on debt covenants.

Thank you for your attention. Please do not hesitate to contact us if you require clarification of these matters.

Sincerely,

Janet Morrill, Ph.D., C.A., C.G.A  
Department of Accounting and Finance  
I. H. Asper School of Business  
University of Manitoba  
Winnipeg, MB R3T 5V4

Cameron Morrill, Ph.D., C.A., C.G.A  
Department of Accounting and Finance  
I. H. Asper School of Business  
University of Manitoba  
Winnipeg, MB R3T 5V4



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Asper School of Business  
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Cameron Morrill, Ph.D., C.G.A.  
Associate Professor of Accounting  
181 Freedman Crescent  
Winnipeg, Manitoba  
Canada R3T 5V4  
Tel. (204) 474-8435  
Fax (204) 474-7545  
E-mail: Cameron\_Morrill@UManitoba.CA

International Accounting Standards Board

July 3, 2007

RE: IASB exposure draft on SME's – Comment on defined benefit pension accounting issues  
(Paragraphs 27.14 – 27.26)

Dear Sir/Madam,

Janet Morrill, Kevin Shand and I have been working on a paper on pension accounting standards. Based on both the results of our paper and our experience working on the paper, we have a number of comments on the proposed treatment for defined benefit pensions in the IASB exposure draft on Small and Medium sized enterprises (paragraphs 27.14 – 27.16).

Our paper uses simulation analysis to examine the behaviour of pension expense, the pension accrual (i.e., the liability or asset that would have been recorded on the balance sheet under the current Canadian standard, CICA Section 3461) and the funded status of the plan (i.e., the liability or asset that will be presented under the proposed exposure draft). We used "At Risk," a commercial program used by actuaries, that we programmed to generate 5,000 20-year streams of economic data using the Wilkie Model. For each of those streams of economic data, we calculated the pension accounting numbers under various pension accounting alternatives: 1) the current CICA 3461, 2) current CICA 3461 without a corridor, 3) current CICA 3461 using market related values, 4) the proposed IASB standard for SME's, 5) the proposed IASB standard with a corridor, and 6) FRS 17. We ensured that our results held under different types of pension management by examining the impact of holding different percentages of the pension plan in equities (0%, 30%, 60% or 100%) and the impact of two different funding strategies. We considered a minimum funding strategy where the company makes only the minimum required contributions to the plan, or a deficit funding strategy, where the company tries to minimize the liability on their balance sheet.

We examined various characteristics of the accounting numbers. We looked at:

- the volatility of pension expense,
- the representational faithfulness of pension expense:
  - the degree to which pension expense correlated with pension contributions across all companies and all years, and
  - the correlation between pension expense and "non smoothed" pension expense that eliminates all accruals and smoothing mechanisms that some contend mask pension plan performance, and
- the predictive value of pension expense:
  - the correlation between pension expense and the following year's pension expense, and
  - the correlation between pension expense the following year's pension contributions

The advantage of using a simulation approach is that we can examine different accounting standards over a very wide range of economic conditions. Empirical papers that examine the impact of different pension standards, while very useful, are limited in this regard. For example, if you examine the effect of a new standard, you have only a few years of economic results before and after the standard is introduced, all firms experienced the same economic results, and the pension expense numbers could be affected by things such as changes to the plan, changes to the workforce, and so on.

Our findings and recommendations are as follows:

#### Immediate Recognition of Actuarial Gains and Losses (par 27.22)

Our results quantify the increase in volatility in pension cost that firms would likely experience under the proposed rules in the IASB-SME exposure draft (paragraph 27.21 – 27.22). Our results show that immediate recognition of actuarial gains and losses, as compared to amortization over the expected average remaining service life (EARSL) as is done in Canada and the US, results in a huge increase in volatility. Imposing such a burden on small and medium sized enterprises seems overly onerous. This is particularly the case for the many SME's that are financed by debt which often carries debt covenants. The likelihood of debt covenant violation generally increases with income volatility.

Our results also indicate that the volatility does not result in substantially better information. In our opinion, our measures of representational faithfulness and predictive value are not appreciably better given the high cost that the increased volatility may entail.

Finally, we found that if the Board chooses to require immediate recognition of actuarial gains and losses, adopting a corridor exemption similar to the Canadian and North American standards offers tremendous advantages. Not only is the volatility substantially reduced, the predictive value and representational faithfulness of pension cost numbers improve.

#### Reporting the defined benefit liability in the balance sheet (par 27.14 – 27.15)

Our findings indicate that the funded status of the plan (or defined benefit liability) tends to be reasonably highly correlated with the pension accrual item currently reported on the Canadian balance sheet (i. e., total pension cost recognized to date less total pension contributions to date). Specifically, we found that the average Pearson correlation between the balance sheet accrual item and the funded status of the plan ranged between 0.4 and 0.6 for balanced pension plans. This correlation increased significantly for firms that followed aggressive pension funding strategies. Moreover, the magnitudes of the accrued liability and the funded status of the plan are, on average, within 10% of each other for plans with at least some equity holdings.

These findings have some important implications. The conditions in the past few years that gave rise to concerns about the current accounting rules for publicly accountable firms (whereby firms reported small liabilities and even pension assets when their plans were actually underfunded) may have been anomalous. Our results suggest that the current balance sheet pension information under Canadian GAAP is not misleading and there may be no need to change it. Alternatively, the relatively close association between the current balance sheet accrual and the funded status of the plan suggests that the economic consequences of the changes proposed in this exposure draft might be minimal and the

transparency of the balance sheet information might be significantly enhanced.

Economic impact of using a corporate bond rate as a discount rate (par 27.17)

Finally, while doing this paper with Kevin Shand, an actuary, we encountered some difficulties with the handling of the pension liability. Our concerns related especially to the use of a fluctuating corporate bond rate as the discount rate. It is common practice, and in most jurisdictions required, that actuaries calculate the projected benefit obligation (PBO) using the expected rate of return on plan assets while, for accounting purposes, the long term corporate bond rate is used to calculate the PBO.

We understand the theoretical argument for using the bond rate but found that using the bond rate gives rise to an important practical difficulty. Since the expected rate of return is always at least equal to, and generally greater than, the bond rate, the actuarial liability is always equal to or less than the accounting liability. Similarly, the required contributions to the plan calculated by the actuary are always equal to or less than the contributions that would be arrived at if the actuary used the corporate bond rate for the liability. As a result, the contributions to the plan are “insufficient” from an accounting point of view. If companies cannot make greater contributions to their plan than that required by the actuaries on a tax-deductible basis, they face a difficult choice: They must either make excess contributions on a non-tax-deductible basis (highly inefficient), or they must see their accounting liabilities increase significantly. We therefore suggest that the Board seriously consider whether continued use of a long term corporate bond rate is wise.

Please do not hesitate to contact us if you require any further elaboration of these comments, and if we can be of any assistance to the Board in their deliberations. We would also be pleased to send along an electronic copy of our paper if that might be of interest to you (simply e-mail me at [Cameron\\_Morrill@UManitoba.CA](mailto:Cameron_Morrill@UManitoba.CA)).

Thank you for your consideration and for the opportunity to participate in the standard-setting process.

Sincerely,

Cameron Morrill, PhD, CGA  
Janet Morrill, PhD, CGA, CA  
Kevin Shand, FSA, FCIA