

## **Evolutionary developments in accounting standard setting for private entities and SMEs**

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### **ABSTRACT**

Financial reporting is a necessary component of sustained local and international commerce. Various systems of accounting and reporting are evident in the world today. The needs of users of financial information for private entities and small and medium size enterprises (SMEs) are vastly different from those users of financial information of publicly traded and widely held companies. This paper examines some of these systems in place to deal with this bifurcation, beginning with the Anglo American roots in the United States and the dilemma of standard setting for diverse entities, then turns to developments in other countries, primarily on the Pacific Rim, before focusing specifically on China. The paper concludes with rationale for the movement toward efficient and effective accounting standard setting with decentralized professional control.

The paper includes an overview of historical development in the United States to promote financial reporting for private companies versus public companies as well as progress in other countries in developing differential standards related to differences in entities and financial markets served by accounting information. The paper provides support for continuing global efforts such as International Financial Reporting Standards for Small and Medium Sized Business (IFRS for SMEs) to recognize the importance of standards appropriate for small and medium sized and privately held entities as opposed to large public companies. The authors suggest further research to study how standards may be adapted to local needs and variability in firm size and ownership.

**Keywords:** China financial reporting and accounting standards, Private companies accounting standards, Private companies financial reporting, Private companies international financial reporting, SMEs

## INTRODUCTION

This paper focuses on the dynamics of business financial reporting in select countries by firms of various sizes and ownership, especially as influenced by developments in the United States through the Financial Accounting Standards Board (FASB) and American Institute of CPAs (AICPA), as well as the ever increasing momentum for adoption of international standards by the United Kingdom based International Accounting Standards Board (IASB). The problems in establishing accounting reporting systems are addressed, and the current standard setting mechanism of each is evaluated. Other than English speaking economies, the paper focuses primarily on East Asian countries where there has been much internal growth as well as international trade since 2000. The paper touches only tangentially on recent developments in the European Union, which are adequately covered by other authorities, such as Ernst & Young (2013), PricewaterhouseCoopers (2013), and Deloitte (2013).

The authors investigate the efforts of several countries in the international environment to develop meaningful accounting and auditing standards based upon the differential size and ownership of the entities and the markets served. The paper begins with a historical development of efforts in the United States to promote financial reporting for private companies versus public companies. The paper includes discussion of relevant trends in western economies, and points to the development of differential standards related to differences in entities and different financial markets served by accounting information.

Juurikkala (2012) challenges the belief that intrusive regulation of financial markets enhances welfare. Juurikkala suggests that increasing regulations do not solve problems of lack of market discipline, pricing inefficiencies and financial innovation--but that better results come from freer markets and simpler rules--and that the goal of helping people make better choices can generally be achieved through less regulation. The authors of the current paper take a similar view--particularly with regard to privately held companies--in suggesting that the extent of financial reporting regulations required of public companies are particularly excessive for private companies who are often forced to conform to the public company "generally accepted accounting principles" (GAAP) or equivalent in order to compete for financial resources.

### Appropriate Selective GAAP

The current authors recognize the efforts of the International Accounting Standards Board (IASB) in developing and publishing in July, 2009 the International Financial Reporting Standards for Small and Medium Sized Business (IFRS for SMEs) and continuing in February, 2013 with the work of the SME Implementation group. U.S. developments in 2013 with the creation of the Private Company Council (PCC) of the FASB and the issuance of the AICPA's (AICPA, 2013) Financial Reporting Framework for Small and Medium Sized Businesses (FRF for SMEs) reinforce the momentum to address financial reporting issues of firms other than the large, widely held businesses. The establishment of relevant standards tailored for small and medium-sized and privately held businesses has implications world-wide.

Selective appropriate standards are needed for many businesses. This paper's conclusions include recognition of the need for additional development of differential approaches in the area of managerial accounting for decision-making as well as financial accounting for external decisions. The authors suggest further research in accounting and auditing standards in developing countries as well as emerging economies to study how standards may be adapted to local needs and variability in firm size and ownership.

## MAJOR DRIVERS FOR SPECIALIZED REPORTING

The United States is currently bifurcated on its auditing standards for public versus private companies with the creation of the Public Company Accounting Oversight Board (PCAOB). The PCAOB came into existence with the passage of the Sarbanes Oxley Act, U.S. federal legislation directed to correct ills associated with accounting and auditing scandals. This major development set the stage for the future establishment of auditing standards separate from the traditional Auditing Standards Board (ASB)--the latter now primarily concerned with private companies, and hence significantly, the audits of small and medium business.

With respect to financial reporting, the more recent recognition by the Financial Accounting Foundation (FAF) to permit a standard setting process outside of the traditional Financial Accounting Standards Board (FASB) agenda for private company reporting is an even greater testament for specialization in standards for small and medium business.

### Specific Definition

While small and medium sized businesses are not necessarily private companies, most are—and it follows to develop a definition of private companies. A private-sector company is a non-publicly traded, for-profit business meeting the definition provided by the Accounting Standards Codification (ASC)—any entity that does NOT meet any of the following conditions:

- Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.
- It is a conduit bond obligor for conduit debt securities that are traded in a public market
- It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
- It is required to file or furnish financial statements with the Securities and Exchange Commission.
- It is controlled by an entity covered by the preceding four criteria (ASC 105-10-20) (Lynch, 2012).

The U.S. need for private company GAAP or “PCGAAP” is demonstrated by the data corroborated by various sources that over 50% of the U.S. economy in terms of gross domestic product comprises private companies, and that in terms of the companies themselves, the figure is over 90% (Hollein, 2012). If other economies are in any way considering modeling their entity development at least partially on the U.S. experience, an understanding of the process and conclusions of standard-setting in the U.S. would seem to be a critical part of that analysis.

### Practitioner Concerns

Accounting practitioners are becoming increasingly frustrated with GAAP standard setting—parties associated with private companies see rules appropriate for public companies trickling down to them with additional burdens. Costs of auditing and assurance services escalate when professionals are required to have “one-size-fit-all.” Users of financial statements have to mull through irrelevant disclosures to distill the quality of the reporting entity. How did

this situation evolve, what is the current status, and what is the future of standard setting for private company reporting?

The accounting profession is in a dilemma when it comes to financial reporting for privately-held companies. On the one hand, having active, authoritative bodies in place to regulate and propose updated standards for financial accounting and reporting would appear to provide objective guidance. On the other hand, the profession is also plagued with the existence of multiple reporting jurisdictions and the multiplicity of the authoritative bodies. In most U.S. states a wide range of private companies exist, and they can vary significantly in size and complexity.

## User Orientation

In developed economies such as the United States, the absence of clear guidance on issues specific to some of these private companies and SMEs may result in painstaking financial reporting and additional effort in rendering audit and other attestation services. Those who favor specialized reporting for private entities argue that public company financial reporting and disclosure is focused on compliance with the United States SEC and federal regulations. When the same accounting standards are applied to private concerns, the orientation to the user market is lost. The user needs of private companies are often different from the public companies.

The dichotomy that emerges between the need for accounting principles for different types of entities, sometimes misleadingly identified as “big GAAP v. little GAAP,” is one of increasing interest both theoretically and practically. Private company financial statement users such as owners and bankers, insurers and venture capitalists, may not be provided with the most useful information about private companies through the “usual/typical” financial reporting standards followed by public companies. In addition, financial reporting and disclosures required of public companies may not be cost effective for private companies.

## U.S. Developments in Private Company Financial Reporting

U.S. GAAP emerged with the industrial revolution and provided a platform for financial reporting that almost looked like “one size ‘could’ fit all.” Rapid economic expansion following World War II led to a flurry of merger and acquisition (M&A) activity—and the voluntary committees of the American Institute of CPAs (AICPA), the Committee on Accounting Procedure, and subsequently, the Accounting Principles Board, were not equipped to deal with the increasing scope and scale required. The AICPA’s own “Report of the Study on Establishment of Accounting Principles” (AICPA, 1972) resulted in the creation of independent process of standard setting through the Financial Accounting Foundation (FAF) and its nongovernmental standard setting group, the Financial Accounting Standards Board (FASB). While a few differential reporting options were allowed to exist, primarily through disclosures such as earnings per share, business segments and leases, the authoritative voice of the FASB dictated requirements for generally uniform reporting requirements for all firms.

As indicated in Table 1 (Appendix) the AICPA took the lead as the major U.S. sponsoring organization for the reporting interests of private entities.

Starting in 2005 momentum builds with another AICPA study, the “Private Company Financial Reporting Task Force Report” known as the “Castellano Report” (AICPA, 2005). The FASB responded in 2006 with its “Invitation to Comment, Enhancing the Financial Accounting

and Reporting Standard-Setting Process for Private Companies" (FASB, 2006). The AICPA and FASB jointly initiated the Private Company Financial Reporting Committee in 2007. The AICPA Council in October 2009 voted strongly in support for GAAP differences for private companies, and then in December 2009, along with FAF and the National Association of State Boards of Accountancy (NASBA), formed the 18-member Blue Ribbon Panel on Financial Reporting (AICPA, 2011). That body issued its report in January 2011, supporting a new separate standard setting body, but the FAF's issuance in October of the same year of its "Plan to Establish the Private Company Standards Improvement Council" (PCSIC) still proposed an advisory body reporting to the FASB (Financial Accounting Foundation, 2012a). Comment letters were due in January of 2012, and the FAF followed with four roundtables throughout the United States, concluding in March, 2012 (Kordecki and Bullen, 2012). In May, 2012 the Financial Accounting Foundation (2012b) issued its final plan which approved the establishment of the Private Company Council (PCC) to improve the setting of financial accounting standards for private companies.

The PCC held its inaugural meeting in December, 2012 and identified four areas to research for agenda consideration (FASB, 2012). These areas were consolidation of variable interest entities, accounting for "plain vanilla" interest rate swaps, recognizing and measuring at fair value intangible assets other than goodwill acquired in business combinations, and accounting for uncertain tax positions, topical areas not likely to be germane to most small businesses. In its February, 2013 meeting (FASB, 2013a), the PCC voted to add the first three of these items to its agenda. The Council also voted to seek more input on a proposed PCC/ FASB private company decision-making framework which identifies criteria to determine whether it is appropriate to adjust financial reporting requirements for private companies.

In April, 2013 the FASB (2013b), along with the PCC sought stakeholder input by exposing for public comment its "Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies." Regarding the guide, FASB Chairman Leslie F. Seidman (2013) stated "Many private companies issue financial statements in accordance with U.S. GAAP for the benefit of their investors and lenders. This proposed guide is intended to help the FASB and PCC identify the unique needs of users of private company statements, while also reducing the complexity and cost of preparing those statements."

In addition to the FASB's PCC, the AICPA had been working on the issue of private company financial reporting. In November, 2012, a special Task Force of the American Institute of CPAs (AICPA, 2012a) issued an exposure draft "Financial Reporting Framework for Small and Medium-Sized Entities" (FRF for SMEs) requesting comments by January 30, 2013. Since the Financial Accounting Foundation had recently created the Private Company Council to address the GAAP needs of privately held non-SEC issuers, including many small and medium size entities, the AICPA attempted to fill the void with guidance for those entities typically involved with non-GAAP financial statements. In its press release of November 1, 2012 announcing the FRF for SME's exposure draft, the AICPA (2012b) stated "More than 20 million privately owned small-and medium-sized entities in the U.S. that are not currently required to prepare U.S. generally accepted accounting principles (GAAP)-based financial statements will soon have a new streamlined and cost effective financial reporting framework available to them."

## From OCBOA to FRF

As noted by Cohn (2012), the AICPA said it would develop “other comprehensive basis of accounting” (OCBOA) financial reporting framework to meet the needs of some privately held small and medium-sized entities, as well as the users of the financial statements of these entities. In reporting on the AICPA development, Hood (2012) notes the framework is geared to those more than 20 million private U.S. businesses that are not currently required to follow GAAP—with the goal of providing a reliable, relevant and simplified financial reporting solution. The Financial Reporting Framework (FRF for SMEs) discusses how other comprehensive bases of accounting (OCBOA) and GAAP exceptions may be converted into an acceptable framework. Tysiac (2012) noted that the proposed Financial Reporting Framework for SMEs is designed to emphasize familiar accounting concepts such as historical cost and the matching of revenues with costs. Melancon (2012) noted that the framework will provide an additional option in the choices private companies have from OCBOA reporting to GAAP exceptions. It is too early to discern the effects of the framework, as individual practitioners are just now being presented with the final AICPA document at the time of this paper.

Whereas the AICPA is taking the lead on non-GAAP financial reporting, regarding GAAP financial reporting, the sponsoring organization column in Table 1 (Appendix) is enlightening as it shows how the shift has occurred from AICPA and essentially State Society involvement, toward the more federalist approach of the FAF. The AICPA’s response with the FRF for SMEs is undoubtedly a measure that swings the pendulum back. Regardless of sponsoring organization, the key is that there have been movements developing in recent years to deal with the financial reporting needs of private companies and SMEs separate from those of large public and multinational corporations (MNCs).

### **Thorn in the U.S. Experience—Big GAAP versus Little GAAP**

In its initial roundtable, held in Atlanta, Georgia, on January 18, 2012, the FAF cited concerns with bright line distinction between “big GAAP” and “little GAAP.” Other voices argued on the basis of financial statement user needs, not necessarily company size. The FAF concern of schism between “little GAAP” and “big GAAP” is the Trustees’ view that markets and the accounting profession will be dominated if any significant movement toward separate boards is pursued. Strong alternative views, including those of state CPA societies and the AICPA, pointed to the need of serving smaller and mid-size entities without overall sacrifice in financial reporting. The FAF arguments of excessive costs associated with bifurcation or differentiation in standards and complexity do not appear to be supported by facts. Several key questions should be addressed.

### **Key Question Issues**

Would appropriately developed differential sets of GAAP be an improvement? The benefit/cost test would have to be applied. It is clearly evident in the US domestic economy that selective differential accounting for tax v. financial reporting is good. GAAP should be appropriate to the reporting entity. If businesses find formal financial reporting too costly, they will urge bankers and other users to accept tax returns as a substitute for properly prepared, and appropriately attested to, financial statements.

Will two sets of GAAP confuse users and result in less useful financial statements to those users? Most users of financial statements have some minimum level of sophistication. If

the base pronouncements are essentially similar, then various interpretations and practice implementation guides would be able to assist users and preparers on differences, just as being done today on EPS, segment reporting, and pension disclosures. The Blue Ribbon Panel recommendations concluded that the information to the users will be far more, rather than less, useful (Blue-Ribbon Panel on Standard Setting for Private Companies, 2011).

Would differential standards for private companies take longer to be created under a separate Board or under the FASB? The PCSIC proposal contained constraints that would create a structure that allows for deliberation, but could also lead to delay—such as acting on key issues only four to six times per year. A separate board or committee autonomy, of course, could accelerate decision-making but this would be subject to board organization, authority, and funding. With over three thousand responding affirmatively to the Blue Ribbon Panel's January, 2011 report, the expectation was reasonable for the Plan to call for the creation of a fast-acting, private company focused, separate board.

Is the FAF Plan Viable? Would two sets of GAAP make initial public offerings (IPOs) more difficult? If an entity has been relying on some alternative and reduced form of accounting and reporting prior to IPO, then additional costs will be incurred. Reconciliations can be derived, and this is an expected cost in capital market formation. The FASB should continue to do what it does best—provide standards for public companies—permitting the markets in private arenas to flourish under appropriately set standards.

The approach supported by many constituents of the Blue Ribbon Panel was to make private company standards different as necessary and appropriate from the required generally accepted accounting principles (GAAP) standards for public companies—an "exceptions approach" rather than starting over to develop totally new standards for private companies. In response to the Plan for the PCSIC, over 7,000 general comment letters were received by the FAF using standard template language supporting the AICPA's position. Another 299 detailed comment letters were received, with most again supporting the AICPA and providing detailed rationale. Some of the issues that these respondents raised are included in Table 2 (Appendix).

The preceding questions and issues were partially addressed in the final deliberations of the FAF as it made improvements to the standard setting body, now identified as the Private Company Council (PCC) which appears to provide four major takeaway's consistent with the AICPA's views:

- Chair of the PCC will not be a sitting board member on the FASB—a win for greater independence.
- A more responsive PCC with fewer members—9 to 12 rather than 11 to 15.
- Issues addressed on a timelier basis with minimum of 5 meetings per year rather than 4.
- FAF's continual oversight and then a 3-year sunset review rather than absolute FASB control (American Institute of CPAs, 2012).

The FAF was quick to point out that controls were still in place, but that the mechanism of the FASB will be clearly one of "endorsement," rather than "ratification," of the PCC's work, and that the establishment of a special purpose committee of the Trustees of the FAF, the Private Company Review Committee, will have primary oversight over the PCC (FAF News Release, 2012). While the path has been rugged in the U.S. for establishing differential standards, emerging economies now have a template upon which to draw.

## APPLICABILITY TO OTHER ECONOMIES

World economic growth is concentrated in key developing countries, especially the “BRIIC” nations of Brazil, Russia, India, Indonesia, and China. Foreign direct investment in China for 2011 was \$124 billion, increasing 8% over the prior year (Schuman, 2012). Extension of legal and perhaps accounting governance mechanisms from an Anglo-American context to these economies may not be the most effective track (Carcello, Hermanson, and Ye, 2011). However, the evolutionary development that occurred in the U.S. might be influential.

Other countries have gone to two or more sets of GAAP. For example, the UK provides reporting relief for smaller entities. In Canada, private entities are given the choice of applying either full International Financial reporting Standards (IFRS) or a new GAAP. Emerging markets, including those in China, may be slow in arriving at accountability maturity, as long as low levels of disclosure persist (Epstein, 2012). Brazil has to its advantage an active Institute of Independent Auditors (IBRACON), which has been instrumental in the implementation of IFRS for SMEs, and since many of the country’s entities are very small, the decision to allow adoption of this alternative set of GAAP provides for reduced complexity, and greater transparency, comparability, and efficiency (James, 2011). Brazil seems to out-perform China on application of state-supported companies’ profitability and innovation; however, China’s score has steadily risen on the Global Competitiveness Index, while the score of U.S. has dropped in recent years (Kurlantzick, 2012). As the Appendix Table 3 illustrates, investments in China state-owned enterprises have significantly increased in recent years.

## Other English Speaking Countries

“One size does not fit all” in either the United Kingdom or New Zealand. In the U.K., its Accounting Standards Board (ASB) has arrived at a 3-tier system ranging from those listed on exchanges to medium-sized, down to smaller entities, while the New Zealand External Reporting Board (XRB) separates entities on the basis of public accountability, with significantly more disclosure for the large issuers (Kamnikar, Kamnikar, and Burrowes, 2012).

Millions of companies--more than 95% of the companies in the world--are eligible to use IFRS for SMEs, but only 45,000 listed companies on the 52 largest stock exchanges in the world would meet the design of the full SMEs according to the IASB’s own “A Guide to the IFRS for SMEs.” Table 4 found in the Appendix provides summary numbers on the importance of providing a financial reporting mechanism for private-sector enterprises.

## Canada and Australia

Lawrence Herman writes that the Canadians’ use of private-sector standards and best practices is really an extension of European medieval *lex mercatoria*, a major practice and increasing factor in international business (Herman, 2012). His thesis continues with the argument that in the medieval trade community the fragmentary and obsolete rules of feudal and Roman law were not responsive to local and international commerce. What then arose was a creation by merchants of a “superior law.”

The argument can be extended—pure private sector rule making exists to the extent that the International Financial Reporting Standards (IFRS) generated by the IASB are adopted by more and more countries. As one pundit points out, this is a growing trend in the delegation of regulatory authority from governments to a single private-sector body (Haufler, 2005). Then, drawing upon both Herman and Haufler, the further argument surfaces that several private-sector

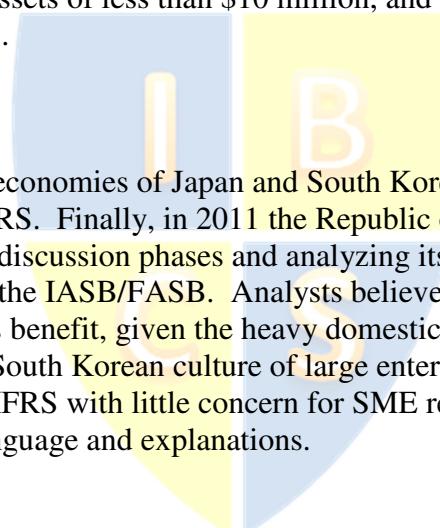
bodies may be even more advantageous than only one from a consortium of centralized governments: the implication being that “one size does NOT fit all,” and that the needs of the emerging small business otherwise may still be neglected.

Australia implemented mandatory adoption of full IFRS in 2005, and Chua, Cheong and Gould (2012) report that this has resulted in better accounting quality than under the earlier Australian GAAP. Laing and Perrin (2011) attribute Australian accounting success to the buy-in of the advantages of IFRS, not being hamstrung by conceptual framework as in the U.S. and the Australian energy toward rapid adoption of harmonization.

### **Malaysia and Singapore**

The approach in Malaysia by the Malaysian Accounting Standards Board (MASB) is to strive for full convergence with full IFRS and not permit IFRS for SMEs except for foreign companies listed on local exchanges. On the other hand, Singapore, also dedicated to the advantages of forging good relationships with international companies, explicitly permits IFRS for SMEs meeting a size threshold in that two of the following criteria must be met: (1) revenue of less than \$10 million, (2) assets of less than \$10 million, and (3) less than 50 employees (Ibarra and Suez-Sales, 2011).

### **Japan and Korea**



The relatively strong economies of Japan and South Korea appeared to be aligned for very early adoption of full IFRS. Finally, in 2011 the Republic of South Korea made the adoption, but Japan is still in discussion phases and analyzing its own Japanese GAAP relative to the conceptual framework of the IASB/FASB. Analysts believe the Korean full convergence to IFRS will be to that country's benefit, given the heavy domestic and foreign investments (Ibarra and Suez-Sales, 2011). The South Korean culture of large enterprise employment may be a driving force in favor of full IFRS with little concern for SME reporting, drawing upon fewer disclosures and simplified language and explanations.

### **Vietnam**

Vietnamese accounting and financial reporting is primarily for the benefit of government and centralized agencies with little concern for financial management and business communication. Dang-Duc (2011) subscribes to the theory that the Vietnam Ministry of Finance has operated in a vacuum with the benefit of any conceptual framework. With no framework developed internally, nor information shared with the neighboring countries of Thailand, Malaysia, and China, learning gains are missed. Dang-Duc (2011) suggests further that the basic principle in Vietnam was adaptation to a socialist market economy, and it is unknown whether that country will consider IFRS for SMEs. Phuong and Nguyen (2012) suggest that this is not necessarily undesirable and may even be preferential when compared to the “big-bang” wholesale adoption of much of the regular IFRS by the European Union in 2005. However, Ibarra and Suez-Sales (2011) conclude that Vietnam’s failure to act on the wagon of success is impeding its relationship with international companies.

## **ADAPTABILITY FOR CHINA**

Historical development in China of GAAP can be traced in the immediate short run to the founding of the Communist Party in 1921, the People's Republic of China (PRC) in 1949, and the requirement that resources essential to production be garnered under the state-owned enterprise (SOE) system. Departures from this tradition came in 1993 with the assistance of Deloitte Touché Tohmatsu as consultant to the Chinese government (Ibarra and Suez-Sales, 2011).

## Chinese Accounting Standards

Numerous exposure drafts of documents for Chinese Accounting Standards (CAS) were published and then in 2001 the Ministry of Finance (MOF) issued a new comprehensive "Accounting System for Business enterprises" seeking to provide comparability among enterprises. Accordingly, China's development of standards was very methodical and deliberate, including forward looking views in harmony with IFRS. However, there were no significant distinctions among the standards between entities of various sizes or other classifications. China has made statements it is committed to adopt full IFRS (Ibarra and Suez-Sales, 2011).

Corporate governance in China through accounting and oversight is seen in the requirement of the need to rotate external auditors at least every five years, and the requirement that at least one-third of company boards must comprise independent members. These and other rules for standard accounting practices have filtered down from listed companies to rural financial institutions and asset-management companies (Country Finance China, 2011). With China's fast growing economy and the increased demand for accountants, the government has made a commitment to spur specific development in the accounting profession on the basis of scale—to build 10 large CPA firms and 200 mid-sized, home-grown accounting firms by 2015 (Lamoreaux, 2011).

The Chinese government proceeded with rapid development of its own specific Chinese accounting firms. Table 5 (Appendix) illustrates this growth. Zhou explains that the dampening between 1997 and 2006 is attributable to the central government's plan to develop those 10 large and 200 medium sized domestic accounting firms over a five year time horizon in order to compete with foreign firms (Zhou, 2012.) This centralized plan is one that focused on the largest firms, but made no provisions for the smallest. Dissolutions and mergers of firms were undertaken to increase firm size. Also Zhou points out that in 2002, the Ministry of Finance reasserted oversight responsibility for the accounting and auditing professions, so standard-setting was not clearly distinct from centralized government authority. Problems of independence continue as the Chinese Institute of CPAs (CICPA) must serve a dual role—being responsible to the Ministry of Finance because in reality it is an agent of the MOF— while trying to be an advocate for the professionalism of its CPA members.

China established in 2005 a Company Law reform, providing the setting for Chinese courts to interpret derivative suits, which would appear to be a positive for increased corporate governance (Huang, 2011). Huang's study found that in all reported derivative action decisions that the entity involved was an LLC a privately held company, meaning there has been no action against public companies and state-owned enterprises. This imbalance may create a risk v. return inversion that could impede the development of capital markets. The majority of the defendants included managers, owner-operators, and a few limited third parties. It is not clear what the potential exposure has been to external auditors, but the actions so far seem to be

stressing breach of contract between the entity and the outsiders, but not directly involving the outside expertise of professionals such as accountants and auditors. If the stakeholders view the auditors as not independent from the state, this may be a reason for not directing action against them, and a symptom of impediments to progress and advancement.

State ownership may be another variable. As documented by Yu (2013), state ownership has decreased significantly in China after 2006, but remains high in critical commodities of oil, gas, and mining. Yu attributes that higher levels of state ownership is superior to where government support and political connections are operative. Chen, et al (2011) further write that state owned enterprises are punished less severely than private companies. Then selective regulation works against non-government startups, and suggests that IFRS for SMEs may not be viable.

The quality of financial reporting is a continuous issue. Wang and Wu (2011) find that investor's reliance on reported earnings is extremely low relative to the U.S. market, suggesting that accounting credibility in China has low value, providing poor-quality financial information. Gordon (2011) offers a partial explanation in the differences in numbers that are reported by the Chinese versus what would be done under U.S. GAAP—“...Chinese companies simply have difficulty understanding how U.S. financial reporting is done.” Shehane, Huan, and Ali (2013) provide a more positive approach, identifying Chinese business interrelationships that result in quality management, and hence improved overall business outcomes.

## Barriers to Progress

An interesting dynamic in China is the rise of private enterprises, and how they are surpassing the state-owned enterprises in some areas in numbers—the development of a strong corporate sector in China presents some interesting opportunities for commerce (Chow, et al., 2012). In a large empirical study, researchers found that audit opinions in China mean comparatively little compared to other countries (Czernkowski, Green, and Wang, 2010). If this is the case, then the type of accounting used—GAAP or non-GAAP, irregularities, uncertainties and omissions, and other departures are not of central interest to the Chinese investor. Taken to the extreme, if auditing does not matter, then the underlying accounting does not matter, and then how, who, and what the standards are for auditing and accounting are not of major consequence.

The impact of risk and corporate governance must be factored into the analysis if effective accounting and auditing are to occur. Governance in particular was only introduced into China in the 1990s, and while catching on strong, this country is still last in Asia to recognize the need for a distinct governance structure outside of nepotism (Han and Zhang, 2011). Chuanyin Xie argues optimistically that China, as the largest and fastest growing transitional economy, private firms must emerge and risks will be taken to innovate and work toward profit maximization (Xie, 2012). Xie believes that risk will be examined beyond a regulatory impact, but does not provide for any other set of controls, such as an external accounting or auditing profession to assist in this endeavor. Owner-managers will manage risk and grow more successfully using the guidance of the external professionals.

However, financial statements do matter. Improved accounting information was required to comply with the Accounting System for Business Enterprises (ASBE IAS) in 2001 for listing A&B firm shares. The flexibility of having multiple reporting systems even for publicly held entities was pointed out by researchers (Chalmers, Navissi, and Qu, 2010), as they found that ASBE IAS-GAAP while superior to China-GAAP could be aligned together to create a more

transparent financial reporting environment, and produce more relevant and reliable financial information. This argument could be extended to non-listed entities if an agreement is reached on what improved standards should be followed for entities in various classifications.

The absence of various management skills in small and medium-sized companies might be another detriment to the development of these entities. Wang and Prieto (2009) found that Chinese private companies face increasing challenges in that with growth there is greater need for soft management skills, and resolution is needed on issues resulting from mixed ownership managed by families, and solving the succession problem for those family businesses that may not have the luxury of succession choice due to the “one child policy.” If managers attempt to primarily emulate actions they perceive as appropriate for state-owned enterprises, management style may actually impede innovation and company development. One researcher states that the Chinese belief system that “a good scholar can become an official” may in part be responsible for managers not wanting to adopt an approach of broader strategic skills necessary for success (Ping, Mujtaba, and Jieqiong, 2012).

## SUGGESTIONS FOR FURTHER RESEARCH

This paper attempts to show how the U.S. model of differential standard setting may be a catalyst in other areas of the world. Constraints vary widely, as do culture and behavior as well as politics. Separate differential standards may work for some, but not all, economies. It will be interesting to view the dynamics between the FASB with its PCC, the AICPA with its Financial Reporting Framework for SMEs, and of course, the longer established IFRS for SMEs. Extensions of the more recent FASB and AICPA efforts may yield gains in other countries. What does seem to work well for the countries studied is the presence of an independent professional organization that is able to work around the shortcomings of excessive government and political regulation.

The area of managerial accounting is also an instrument of change. Differences between nations have given rise to a new breed of accounting for internal decision-making. Some countries, like China, will continue to focus on methodologies that seem to work very well, such as consensual approaches to management and the development of team targets rather than individual goals (Silver, 2012). Financial accounting, on the other hand, calls for much greater consistency and comparability as reports must go into the hands of external users.

The IASB, the body primarily responsible for development of International Financial Reporting Standards (IFRS), and the IFAC, the supporter of numerous accounting bodies, including the International Public Sector Accounting Standards Board (IPSASB) and the development of those standards have agreed in principle and have issued a memorandum of understanding toward enhanced cooperation in developing both private and public sector accounting standards (IFAC/IASB News Release, 2011). IFRS for SMEs was a positive development, but may not satisfy all the private company needs in diverse developing economies.

One U.S. state society CPA leader concludes that the debate will never be over. As small business emerges, their needs of loan covenants, credit decisions, and personal guarantee of personal assets along with the business assets will prevent full absorption into the main stream that a single set of accounting standards will not work equally well for public and private companies (Fitzgerald, 2012). In building a less vulnerable and more sustainable future, one researcher says that an Asian power shift is necessary away from the state-owned enterprises and

businesses that have been long dominant (Schamotta, 2012). Other areas that could be explored include investigation of the contributions of traditional branches of western accounting in managerial and tax as well as financial accounting. What should be the role of sustainability and integrated reporting? A new breed of managers now address the environment, health, and safety issues, while still trying to run the supply chain efficiently and effectively in Chinese industries (DeGroot, 2012).

Further work could be done inside the University classrooms. Educators and practitioners should become familiar with efforts to achieve international convergence of accounting education standards. Developing international education standards (IES) and implementing them in various countries would contribute to a common base of education and practical experience for all professional accountants, and facilitate mobility of professional accountants (McPeak, Pincus, and Sundem, 2012). Moreover, with a global view of understanding in principles, then each individual economy would be better able to select the most appropriate type of GAAP.

Academicians and practitioners should work toward encouraging greater development of private standards that satisfy the special needs of business in developing countries and emerging economies. The models developed in western industrialized countries should neither be totally accepted, nor totally abandoned, but should be tailored to adapt to local needs. In many cases, this will require the development of a two-tier system, since the larger, publicly held entities have a different set of stakeholders. In financial accounting terms, the users of the financial statements and their analyses are often far different. Carefully identified underlying generally accepted accounting principles should be modified to build overall synergies in local markets, just as the broader principles provide guidance in the larger capital markets. While some developing economies are still years away in differentiating their markets by firm size and complexity, the time is now to plan for the accounting and auditing platforms that will enhance those positive developments.

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## APPENDIX

Table 1 U.S. Private Company Historical Developments (source: constructed by the authors)

DATE	ITEM	SPONSORING ORGANIZATION
March, 1972	Report of the Study on Establishment of Accounting Principles ("Wheat Committee Report") issued	AICPA
February, 2005	Private Company Financial Reporting Task Force Report ("Castellano Report") issued	AICPA
June, 2006	Invitation to Comment, Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies	FASB
January, 2007	Private Company Financial Reporting	AICPA/FASB

	Committee created	
December, 2009	Blue Ribbon Panel formed	AICPA/FAF /NASBA
January, 2011	Blue Ribbon Panel Final Report released	AICPA/FAF/ NASBA
October, 2011	Private Company Standards Improvement Council Plan (PCSIC) exposed	FAF
October, 2011	AICPA Council Resolution— “all options” to be considered	AICPA
January, 2012	Comment Letters submission on Improvement Council concluded	FAF
March, 2012	Roundtables on Improvement Council concluded	FAF
May, 2012	FAF approves establishment of Private Company Council (PCC)	FAF
November, 2012	Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs) Exposure Draft issued by AICPA	AICPA
December, 2012	PCC holds inaugural meeting, identifies four areas of study	PCC/FASB
January, 2013	Comments on AICPA's FRF-SMEs conclude	AICPA
February, 2013	PCC adds three projects to its agenda and votes to seek more input on private company decision-making framework	PCC/FASB
April, 2013	FASB exposes private company decision-making framework for public comment	FASB
June, 2013	AICPA issues FRF for SMEs available for immediate adoption	AICPA

Table 2 Extended Issues in Plan for PCSIC (source: constructed by the authors)

ISSUE	STATEMENT OF THE ISSUE
1	Reporting structure should be independent of FASB.
2	International financial reporting is a consideration.
3	AICPA should be able to provide advisory input.
4	User needs are more important than preparer or auditor needs.
5	Transition of entity from private to public is complex and costly.
6	Audit fees on private entities will rise as result of big GAAP.
7	PCSIC will cause a drag on time for private standard setting.
8	Reporting structure should be independent of FASB, but should be responsible to the FAF.

Table 3 SOE Assets (data drawn from Kurlantzick, 2012)

	2002	2010
Total assets of China's 121 largest state-owned enterprises	\$360 Billion	\$2.9 Trillion

Table 4 Private Companies (data drawn from Kurlantzick, 2012)

Country	Private-Sector Enterprises
United States	28 million
Europe	28 million
United Kingdom	4.7 million
Brazil	6 million

Table 5 CPA Growth (data drawn from Zhou, 2012)

	1988	1993	1997	2006
Chinese Accounting Firms	200	2,400	6,900	5,600
Chinese Certified Public Accountants	2,000	10,000	62,460	69,700