New Directions of Financial Reporting within Global Accounting Standards for Small and Medium-Sized Entities

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Abstract

The International Accounting Standards Board (IASB) is currently working on a project to develop accounting standards suitable for entities that (a) do not have public accountability and (b) publish general purpose financial statements for external users.

This article presents the current status of IASB activity on this new direction of financial reporting. Our study has as key objectives to review the extant of academic literature and to analyze, based on the questionnaire conducted by IASB, the impact of a set of new IFRSs for small and medium entities (SMEs) on practitioners and on professional organizations.

The literature review unearthed a variety of prior studies on SMEs. Currently, in most jurisdictions SMEs are subject to relaxed regulation as determined at the national level, taking on board specific economic and local conditions. However, the increasing significance of SMEs in the global economy, the burden/inapplicability of full International Financial Reporting Standards (IFRS) and the potent arguments in favour of differential reporting have drawn the attention of international regulators and given rise to the proposed new regulatory regimes for SMEs.

We briefly present the content of IASB recent SME exposure draft and, as conclusion we comment the answers received at the questionnaire conducted and their influence on the requirements of the new SME reporting standards.

Keywords: Small and Medium Entities, Financial Reporting, Global Accounting Standards, Accounting Harmonization

Introduction

In most countries, many or even all entities have a legal obligation to prepare financial statements that conform to a required set of accounting principles that are generally accepted in that country (national GAAP). Those statutory financial statements are normally filed with a government agency and thus are available to creditors, suppliers, employees, government and others. The great majority of those entities are small or medium-sized entities (SMEs) – no matter how one might define ‘small’ or ‘medium-sized’. Few countries require these entities to prepare financial statements that comply with the full requirements of the IASB’s standards developed primarily for use in international capital markets.

Small firms are economically significant in all countries. It was estimated that in 1997, there were approximately 6.3 million SMEs in the USA and 9.3 million in the EU. In the EU, the countries with the most SMEs were Germany, followed by Italy, the UK, France and Spain (Karmel and Byron, 2002). This sector accounts for most of the enterprises in each of these countries. For example, in 2001, estimates suggest that 99.1% of all UK businesses were classified as small (less than 50 employees), accounting for 43.3% of private sector employment and 31% of total private sector turnover. Most accounting regulatory regimes recognize differences between larger and smaller enterprises and between those that are listed and unlisted and/or non-publicly accountable (Devi, 2003).

Recognizing the burdens placed upon smaller enterprises by financial reporting, many countries exempt smaller enterprises from statutory audit and subject them to differential reporting requirements. For instance, as a result of EU accounting directives, small and medium-sized companies throughout Europe have the option of filing abbreviated reports with reduced levels of disclosure and all private companies in the US are exempted from the need for GAAP financial statements and audit.

There are some incisive arguments supporting the need for differential reporting and relaxing requirements for smaller entities. Looking, first, at the benefits of reporting, there is the issue of user needs. Much of the disclosures and information required by full financial statements are seen as not relevant to smaller businesses. There is general agreement that the users and user needs of SME financial reports are not the same as for larger entities and the purpose for which financial reports are produced is related to the size and complexity of the entity. Collis (2001) suggests that larger companies use their financial statements for a wider range of decisions and that they undertake more complex transactions than smaller enterprises, providing aggregated information that requires more sophisticated analysis.

The IASB’s conceptual framework identifies key users of financial statements as investors, lenders, suppliers and other trade creditors, employees, customers, government (and their agencies) and the public. However, not all of these are likely to be important for small enterprises. The literature identifies the main users of the financial statements of small entities as banks, directors (or owner-managers and non-manager-owners) and tax authorities. More recent studies also identify venture capitalists, business angels and grant-awarding bodies as users of SME financial statements.

The literature suggests that the main uses for SME financial statements by banks are to determine capacity to repay and to assess profitability, security and liquidity. Owners utilize financial reports for a variety of functions including, to ascertain remuneration awards and dividend payouts, to monitor performance, capital expenditure, budgeting, planning, for loans and financing, as a confirmatory tool and in some countries as a means of minimizing tax liabilities. Tax authorities also tend to be key recipients of SME accounts and prior work shows that that major uses of SME financial statements by the tax authorities include: to determine gross profit, assess directors’ fees, look at tax provisions, ensure that expenses are reasonable and check for a clean audit report.

Although differential reporting is prevalent in many jurisdictions, the exemptions awarded to SMEs from full IFRS compliance varies. The varying needs of users have underpinned the arguments supporting differential reporting for SMEs, although there is little evidence underpinning this. The IASB has undoubtedly succeeded in developing a draft standard that considerably reduces the amount or volume of regulations. The final standard is likely to be less than 250 pages, rather than the 2,400 or so pages of the full IFRSs. However, it is still a longer document than many other accounting standards for small entities. For example the UK 2005 FRSSE is a document of 274 pages, but only 106 pages of actual standard, the South Asian Federation of Accountants' Financial Reporting Standard for SMEs ED is 76 pages while the Hong Kong FRSSE is only 62 pages (HKICPA, 2005; SAFA, 2006). Some of the differences are due to the extent to which these are all stand alone documents. For example, the Hong Kong standard simply offers definitions of such items as financial instruments and then says that, if an entity has any, it must apply the full standard.

Another reason for the differences is the extent to which the standards offer simplifications in disclosure or alternative recognition and measurement rules. For example, the UK standard does not contain any requirements to use fair values for financial instruments instead simply requiring that they are broken down into constituent parts on the basis of economic substance, so that the requirements are very simple, while the IASB standard attempts instead to maintain the measurement and recognition criteria of the full standards, albeit in a much simplified form.

1. Is extending IFRS to SMEs a valid option?

There exists a very small body of academic research on accounting and the SME sector and various authors have made calls for further work in this area, particularly to identify the user information needs of SME financial reports (Flower, 2004; IFAC, 2005; Evans et al., 2005; Baskerville and Cordery, 2006). It may be speculated that this gap in the SME literature can be attributed to the difficulties incurred in gathering data on the smallest SMEs, in particular with respect to the participation of small business owners (Sian and Roberts, 2003).

In June 2004 the International Accounting Standards Board (further called *the Board*) issued a Discussion Paper entitled *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* and Exposure Drafts (ED) of its International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) in August and November 2006. The final ED is expected in early 2007. It is anticipated that this will provide guidance at a much simpler level than full IFRSs, for those SMEs which are required to produce general purpose financial statements that are made available to the general public.

There is the transition argument which suggests that IFRSs for SMEs would ease the transition for growing small entities wishing to seek a listing at some future date, although this does rather assume that a significant number of small entities have a growth objective, which is not always the case (Baskerville and Cordery, 2006).

European Union (EU) member states were required to adopt IFRSs in 2005 for the consolidated financial statements of listed companies and most are currently in the process of aligning national generally accepted accounting principles (GAAP) with IFRSs. Very few member states will make IFRSs compulsory for SMEs and most will instead permit SMEs to follow either IFRSs or national GAAP. Since most countries already have various exemptions and relaxations for SMEs in their national GAAP, "there is a real possibility, in Europe alone, that there could be two dozen or more sets of national standards that purport to be adaptations of IFRSs suitable for SMEs. This is true not only in Europe, of course, but also elsewhere in the world" (Pacter, 2004a, p.74). The EU has already indicated that it will support the SME standards if they are an improvement on the Fourth and Seventh Directives (House, 2006).

The Board believes that IFRSs are suitable for all entities, listed and unlisted, large and small. Nonetheless, the Board recognises that in most developed countries where IFRSs are used, the primary adopters are entities whose securities are publicly traded. In Europe, where all listed companies will be adopting IFRSs in 2005, only two or three small EU and EEA member states (out of 28 total) will require IFRSs for SMEs. Most of the others will permit IFRSs, but they will also permit SMEs to follow national GAAP. Many of those countries are moving to align their national GAAPs with IFRSs, but no two are doing it in the same way. And most of those countries already include, either in their national GAAPs or national laws and regulations, accounting exemptions and simplifications for SMEs. In some cases, there is a separate body of accounting standards for SMEs.

There is a real possibility, in Europe alone, that there could be two-dozen or more sets of national standards that purport to be adaptations of IFRSs suitable for SMEs. This is true not only in Europe, of course, but also elsewhere in the world. The problems that the Board sees in that event include:

- Claims of extraction from, convergence with, alignment with, or similarity with IFRSs are often somewhat exaggerated;
- National standards for SMEs would not necessarily be consistent with the IASB's Framework or Standards;
- National standards for SMEs would not necessarily address the needs of external users of financial statements (which is the IASB's objective);
- Financial statements of SMEs would lack comparability across national boundaries or even within a country;
- National standards for SMEs would not necessarily allow for an easy transition to full IFRSs for entities that wish to enter the public capital markets.

Simply put, in Europe it makes more sense to have one set of accounting standards for SMEs based on IFRSs developed by the IASB rather than 28 different sets. The same is true globally.

Originally, the starting point of the project was full IFRSs and the IASB proposed that disclosure rules would be relaxed and that there would be minimal modifications to the recognition and measurements rules. In a survey conducted by the IASB addressed to national standard-setters, the majority (24 out of 30) felt that simplifications of recognition and measurements rules were required too (Pacter, 2004b) and the IASB position changed to reflect this.

Despite these reservations there has been general support for the IASB's plans. At a meeting in September 2003, the IASB hosted 40 of the world's standards-setters and a survey prior to the meeting suggested that responses from 30 standard-setters supported the IASB's proposal to develop standards for SMEs (Pacter, 2004a). And nearly all indicated that their own national accounting requirements, in one way or another, already provided exemptions or simplifications for SMEs. The IASB has developed a list of some 25 disclosure and presentation simplifications and another 25 recognition and measurement simplifications already in place at the national level for SMEs in those 30 countries. IFRSs already provide several - such as exemption of unlisted companies from providing segment information and earnings per share data. Of the 30 countries that responded to the survey, 29 said that IASB standards for SMEs should include disclosure and presentation simplifications. And 24 of the 30 said that recognition and measurement simplifications are needed as well.

A recent study conducted on the responses to the IASB's discussion paper "Preliminary Views on Accounting Standards for Small and Medium-sized Entities" (2004) similarly suggests that most respondents, some 77%, agreed that the IASB should develop accounting standards for SMEs (IFAC, 2005). Of these a high proportion also supported the suggestion the SME standards should follow, loosely, full IFRSs.

Much of the research on differential reporting has ignored cultural influences. Research focusing on the perceptions of small business managers in Singapore and Australia, found culture-based differences in disclosure preferences of small business entities (Williams and Tower, 1998). Studies in Italy instead conclude that small entities are unwilling to disclose information to other external users (the exception perhaps being communication with venture capitalists and major foreign shareholders) (Demartini, 2005). Owner-managers regard disclosure to external stakeholders as a breach of privacy and Demartini notes that most small entities do not view web pages as a means of circulating financial information. This may be an important consideration for international organizations attempting to establish uniform regulations for SMEs. As some have argued, it may be a task better left to national standard-setters who have a clearer insight into specific local conditions for smaller entities not seeking internationalization.

2. IASB project presentation

As said before, the International Accounting Standards Board is working on a project to develop accounting standards suitable for entities that (a) do not have public accountability and (b) publish general purpose financial statements for external users. Examples of such external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies. This group of entities will be referred to as Small and Medium-sized Entities (SMEs).

An entity has public accountability if:

- it has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;
- it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity;
- it is a public utility or similar entity that provides an essential public service; or
- it is economically significant in its home country on the basis of criteria such as total assets, total income, number of employees, degree of market dominance, and nature and extent of external borrowings.

The Board has formed a Working Group whose members provide views and comments on specific issues that are presented to them.

In June 2004, the Board issued a Discussion Paper, *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*, setting out and inviting comments on the Board's preliminary views on the approach to the project. Comment deadline was 24 September 2004. One hundred twenty responses were received.

The major issues set out in the Discussion Paper were:

- Should the IASB develop special financial reporting standards for SMEs?
- What should be the objectives of a set of financial reporting standards for SMEs?
- For which entities would IASB Standards for SMEs be intended?
- If IASB Standards for SMEs do not address a particular accounting recognition or measurement issue confronting an entity, how should that entity resolve the issue?
- May an entity using IASB Standards for SMEs elect to follow a treatment permitted in an IFRS that differs from the treatment in the related IASB Standard for SMEs?

- How should the Board approach the development of IASB Standards for SMEs? To what extent should the foundation of SME standards be the concepts and principles and related mandatory guidance in IFRSs?
- If IASB Standards for SMEs are built on the concepts and principles and related mandatory guidance in full IFRSs, what should be the basis for modifying those concepts and principles for SMEs?
- In what format should IASB Standards for SMEs be published?

The Discussion Paper did not include proposals for specific financial reporting standards for SMEs. That will come later. Instead, the Discussion Paper focused on the Board's approach to the project.

At its meetings in fourth quarter 2004, the Board considered the issues raised by respondents to the Board's June 2004 Discussion Paper. At the December 2004 meeting, the Board made some tentative decisions on the appropriate way forward for the project. The IASB has considered the issues that respondents raised, and has made some tentative decisions for the project, at the January 2005 meeting:

- The IASB remains committed to this project and will develop an exposure draft of standards for SMEs as the next step. Responses to the Discussion Paper showed a clear demand for these standards and a preference, in many countries for adopting global standards for SMEs rather than locally or regionally developed ones;
- The SME standards will focus on financial reporting by those SMEs with external users of their financial statements (i.e. users other than owner-managers). Jurisdictions could, of course, choose to permit or require them for all SMEs, including very small ones;
- The IASB will not develop detailed guidelines about which entities should use these standards – it will leave this for national jurisdictions to decide. However, it will indicate those entities for which the SME standards are not appropriate. Entities using the SME standards will not be able to assert that their financial statements are prepared in accordance with IFRS;
- The same IASB Framework will apply to all entities. However, the IASB will consider recognition and measurement simplifications for SMEs, as well as disclosure and presentation simplifications. These will be based on user needs and cost-benefit considerations as provided for in the IASB framework;
- Where a recognition or measurement issue is addressed in an IFRS, but not in the SME standards, entities will be required to apply the relevant IFRS;
- An entity following SME standards should follow them in their entirety and will not be able to revert to IFRS on a standard-by-standard or principle-by-principle basis;
- If an entity follows SME standards, this should be made clear in the basis of presentation note and the auditor's report, if any, so that users understand that full IFRS are not being followed;
- When published in printed form, SME standards will be organised topically, such as in balance sheet and income statement order, rather than having an equivalent SME standard for each IAS and IFRS number. However, the topical standards would be cross-referenced to the equivalent IFRS.

SMEs with a current business need for internationally-comparable financial information should carefully consider the costs and additional benefits of moving to full IFRS against waiting for the IASB's SME standards in 2007 or later.

Most respondents to the Discussion Paper felt that recognition and measurement simplifications were needed, but few specifics were proposed. And where some specifics were proposed, the commentators generally did not indicate a specific way for problems to be solved.

At its meeting from April 2005, the IASB concluded that it needs further information to assess possible recognition and measurement simplifications. Consequently the Board decided to hold public round-table meetings with preparers and users of the financial statements of SMEs to discuss possible modifications of the recognition and measurement principles in IFRSs for use in IASB standards for SMEs. The Board instructed the staff to develop and publish a questionnaire as a tool to identify issues that should be discussed at those round-table meetings.

The questionnaire asked two questions:

Question 1. *What are the areas for possible simplification of recognition and measurement principles for SMEs? In responding, please indicate:*

- *the specific accounting recognition or measurement problem for an SME under IFRSs;*
- *the specific transactions or events that create the recognition or measurement problem for an SME under IFRSs;*
- *why is it a problem; and*
- *how that problem might be solved.*

Question 2. *From your experience, please indicate which topics addressed in IFRSs might be omitted from SME standards because they are unlikely to occur in an SME context. If they occur, the standards would require the SME to determine its appropriate accounting policy by looking to the applicable IFRSs.*

The Board received 101 responses to the questionnaire. Those responses were discussed with the Standards Advisory Council (SAC -June 2005); Working Group (June 2005); World Standard Setters (September 2005); round-table participants (October 2005). Following are some of the Working Group’s recommendations.

- IFRSs should consist of tow sets of standards: full IFRSs - designed for entities with public accountability and IFRSs for SMEs - designed for entities without public accountability;
- National jurisdictions decide who uses them;
- Full IFRSs should have some disclosure exemptions for unlisted entities with public accountability;
- In developing IFRSs for SMEs, IASB should have in mind non-publicly accountable entities with about: 50 employees and annual revenue of €10M.
- IASB aim toward SME standards totalling 200 A5 pages in length;
- No general mandatory fallback;
- But should be specific fallbacks where items of limited SME applicability are intentionally omitted;
- Generally, where IFRS allows an accounting policy choices, SME standard should include only the simpler choice;
- Where appropriate allow SME to use the more complex choice in full IFRS;
- Working group is concerned about two conditions in IASB SME definition: providing “essential public service” (full IFRSs use regardless of size) and economic significance in home country. WG view is let each jurisdiction decide.

At the January 2006 Board meeting, the staff presented to the Board a nearly complete preliminary staff draft of an Exposure Draft of an International Financial Reporting Standard for Small and Medium-sized Entities (SMEs). There are 40 Sections in that draft ED, totalling 233 pages. The draft ED is organised into Sections topically, with each paragraph cross-referenced to the IFRS from which it came (*see Appendices*).

The Board discussed and reached tentative decisions on the content of the initial draft ED (the specific standards themselves). Based on those tentative decisions, the draft ED was revised and discussed by the Board in May 2006, followed by further revisions and discussion in June 2006. In July 2006, the Board discussed the financial instruments section in detail. The staff envisages that a final Standard will be issued in the second half of 2007.

3. Arguing in favour of and against IFRSs for SMEs

There seems to be general support for differential reporting rules. For instance research conducted in Australia, questioning practitioners, suggested that 97% of those questioned supported the need for differential reporting (Holmes et al., 1991). Similarly, the AICPA's research into private company reporting suggested that "GAAP for private companies should be developed" and that "fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private companies are met" (AICPA, 2005, p.6). However, there is far less consensus on how the standards for SMEs should be set and exactly which entities fall into this category.

The IASB is writing its SME standard using the same conceptual framework as used for IFRS but reducing the financial reporting burden. Initially this 'top-down' approach meant that the standard would maintain the measurement and recognition criteria, though in certain cases in a simplified form, while reducing disclosure differences (although eventually the IASB abandoned this position and recognized the need for measurement and recognition modifications too). However, this approach was not without its critics, many of whom cited the significant differences between larger and smaller entities (Paoloni et al., 2000; Riistama and Vehmanen, 2004; Demartini, 2005).

There are several factors that may differentiate small enterprises from larger enterprises:

- Many small entities are owner-managed (family interests) and as there is no separation of ownership and management the stewardship purpose of financial statements based on accounting standards is not the same and so perhaps does not have the same significance;
- Because of the small size, managers have few business skills and the values of owner are shared by employees (Baskerville and Cordery, 2006);
- Small entities tend to operate in a unique and uncertain environment. SMEs are not able to operate in the financial market like conglomerates, mainly because of their small size and limited resources and they operate, almost without exception, locally (Riistama and Vehmanen, 2004). They have small numbers of customers and suppliers, an inability to drive prices and some owners do not always have the objective of maximizing profits. Evidence from New Zealand suggests that SMEs tend to be differentiated on the basis of "innovation" and many started spontaneously with an innovative product (Baskerville and Cordery, 2006), although this is debatable particularly in the case of developing countries; and
- They do not have the same sort of obligations and responsibility to their investors as larger entities and mainly rely upon debt rather than equity finance. Since SMEs are not seeking a public listing, their value is of less significance than their capacity to generate positive cash flow and the users of financial statements of SMEs are limited to the owners and the management as well as to the financing institutions that have financed the SME in question (Baskerville and Cordery, 2006).

There are certain arguments in favour of and against an international standard for SMEs. Arguments in favour of an international standard for SMEs include the following:

- It would mitigate the cost/benefit argument used against full IFRSs and create a defined and consistent regulatory framework for those small enterprises maturing to a capital market listing;
- It would be beneficial for SMEs in some transitional economies, especially those required to apply full IFRSs as a result of World Bank directions;
- It would be beneficial to any SME that has users located in different jurisdictions or that wish to use the financial statements of other SMEs;
- Accounting is about reporting economic events and if the event is the same across countries then the reporting should be the same across countries. Differences in users, or legislative, political or cultural differences do not imply that the accounting for the same transactions or items should differ across countries; and
- Having an SME standard means that the cost of regulation is reduced and having a larger group of standard-setters improves the quality of the final product. In particular this is an advantage for developing countries that lack the infrastructure or money to develop their own standards.

The main counter arguments to a single set of recommendations or rules internationally centred on the issue that users do differ across countries, as does the culture and the type of legal system and stage of economic development. This suggests that the importance of many items will differ across countries, implying that it may be appropriate to have different rules in different countries. However, this argument would seem to apply in particular to social or environmental concerns and disclosures in the review of operations rather than the financial statements and associated notes. While it is easy to argue that certain types of transactions vary in importance across different countries (e.g., leased assets, final benefit pensions, share options) it is more difficult to sustain the argument that the appropriate accounting method for these transactions also differs across countries.

A second argument is the additional costs that these may involve. This might be an issue if they cannot be used for taxation purposes and if SMEs are then required to produce additional information for taxation authorities. In this case it might be difficult to argue in favour of an international standard for the smallest SMEs, or those that are not interested in growing or taking part in international activities of any sort if they then also have to incur additional costs to produce tax accounts. However, if they can be used for taxation purposes, international standards could replace national standards or current practice and the financial impact might be expected to be neutral on average.

Equally, the literature presents a case against differential reporting for larger and smaller entities:

- There is the universality argument (i.e., companies should not be subject to different rules giving rise to different "true and fair views") (Barker and Noonan, 1995; Collis et al., 2001; Evans et al., 2005);
- The need for comparability and reliability derives from the universal application of accounting regulations;
- There is the argument that, regardless of size, published accounts are "the price to pay for limited liability" of ownership and management;
- There is concern amongst the profession that such a reduction in regulations for smaller entities may portray small companies as second class citizens and may even risk bifurcation within the profession (Barker and Noonan, 1995);
- It has been argued that it is practitioners and academics that are pushing for differential reporting rather than SME owners and users, who may not even be aware of the pros and cons;

- There is also the argument that more than one set of rules may undermine the credibility of accounts in the minds of users since different rules may result in different results and, in particular, profit figures; and
- Botosan et al., (2006) argue that "if private companies have the business acumen to enter into complex transactions, then it is reasonable to expect them to have or be able to obtain the accounting expertise to account for such transactions. Therefore, the Committee recommends the IASB respond cautiously to requests for GAAP exceptions supported primarily by complexity arguments," (p.180).

On balance, the arguments for differential reporting seem to be stronger. Indeed, as discussed earlier, countries are increasingly adopting differential reporting requirements. Thus, the important argument now appears to be not whether this is an appropriate approach, but rather how the two should differ. For instance, should they be based upon the same conceptual framework or measurement and recognition criteria, with little GAAP being simplified and easier to apply and offering certain exemptions from the full set of regulation? Alternatively, should there be two distinct sets of rules developed separately, despite the possibility that they may not necessarily articulate well with each other?

Despite the belief that differential reporting is useful, the literature indicates that owners of small entities have mixed views on the cost/benefit balance of regulation and producing such information. For example, recent questionnaire-based research (involving owners and financial managers, practitioners and external stakeholders) in the USA suggests that "respondents rated the benefits of preparing or using GAAP financial statements when compared with the cost of preparing them as medium to moderately high" (AICPA, 2005, p.6). However, most respondents were also in favour of a simplified set of GAAP for unlisted corporate entities. Several reasons were given to support the regulations for SMEs namely that GAAP based statements: for use as a decision tool; because they provide useful information; because they provide a standardized language; because they allow for comparability between reporting periods and with other companies; and users prefer an outside accountant's report (AICPA, 2005, p.13).

IASB in its discussion paper argues that smaller entities may need to disclose much more related parties' information. In the Netherlands, evidence suggests that many small firm managers do not consider financial reporting and its regulation to be a key issue for them nor do they expect to gain much by disclosing financial accounting information or appreciate the usefulness of the financial statements to third parties" (IFAC, 2005).

Small companies often have different objectives, for instance they aim for survival and stability, also shareholders are not necessarily the primary users of accounts, but rather banks are. "The experience of some national standards-setters (New Zealand and Italy for example) is that a single conceptual framework can be applied to all firms or entities with further differentiation due to sector, size or external regulatory requirements. However, disclosure exemptions mean that the financial statements may comply with GAAP, but show a different profit result from statements prepared under full GAAP (Baskerville and Cordery, 2006, p.11).

Studies have found that owner-managers use financial statement information for a variety of purposes. Important results include:

- Collis and Jarvis (2000), in a study of incorporated entities in the UK, found that the annual accounts of small companies are commonly used to ascertain remuneration awards made to directors, to compare company performance with previous periods and for purposes associated with loans and financing. Sian and Roberts (2003) also highlights the confirmation and verification roles of financial reports in the UK, finding that annual data plays a confirmatory role rather than being a useful tool for forward planning in the opinion of owner-managers. The most commonly cited use of such statements was to compare income and costs with past periods.

- In Ireland, Barker and Noonan (1995) asked about benefits attached to the financial statements of small entities. Their results showed that they were useful for: planning and decisions (including future planning and decisions regarding directors' benefits and dividends) (35%), tax purposes (21%), bank purposes (19%) and review of performance (11%). Furthermore, although most directors and shareholders did not understand formal financial statements, they were seen as providing "confidence in the calculation of value and performance and they lend transparency" particularly for use by the Revenue, banks and other potential lenders (p.19).
- Studies in Italy confirm that owner-managers, in particular, are important users of accounting information, although delays in the production of accounting information means that its use as a decision making tool is limited (Demartini, 2005).
- Referring to the case of continental Europe, Demartini (2005) notes that many small companies do not have elaborate internal control systems and that financial statements should be "more useful for management control purposes and for banks' credit decisions but, to date, compulsory financial reporting is not aimed at these purposes, given that in most cases it is only prepared to comply with legal requirements" (Demartini, 2005, p.4).
- In the Netherlands, research suggests that user needs are not necessarily being met (IFAC, 2005). In 1990, six years after the introduction of accounting regulations, up to 15% of small Dutch firms continued to not disclose financial statements, and of those that did a significant number failed to file their reports within the time allowed by law. This implies that publicly available financial information is delayed and this raises doubts about the usefulness of such information for users.

Although owner-managers may use accounts in a confirmatory role, accountants viewed financial statements as being useful forward-looking tools with their role in assessing risk for making new loan decisions being seen as more important than their role as a monitoring device (Sian and Roberts, 2003). This suggests that while the typical accrual-based set of financial statements may be demanded by external users they are of little use to many, if not most, owner-managers. This appears to validate the need for specific guidance for smaller entities. In the UK this exists in the form of the Financial Reporting Standards for Small Entities (FRSSE), but there appears to be "a general rejection of the FRSSE and even the use of accounting standards for the smaller companies, i.e., a rejection of the general purpose model" (Marriot and Marriot, 1999). John and Healeas (2000) concur with these findings and note that the FRSSE has had no fundamental effect on the content of financial statements, not least because the FRSSE often simply exempts small enterprises from disclosure rules for complex transactions that are not of relevance to them and because of the Companies Act requirement to produce full accounts for shareholders.

Conclusions

Standards for preparing financial statements must meet user needs, but in the case of SMEs such needs have not really been defined. It is also debatable whether the top-down approach, which views SMEs as small companies growing into larger ones, is appropriate.

The potential of the International Accounting Standards Board's project on small and medium-sized entities (SMEs) should not be underestimated. The vast majority of companies worldwide are small, in some cases owner-managed businesses and in some countries or regions (such as EU) are required to prepare and file annual financial statements. These companies account for the biggest potential volume of users of IFRS but they have so far have been discouraged by its complexity and the need to fully understand 2,500 pages of literature. Therefore the SME project is widely welcomed and there are high expectations about the benefits that a standard for SMEs could bring.

However, it is not only the benefits that must be considered, but also the costs of compliance. Irrespective of who sets the standard for SMEs, having two or even three sets of standards gives rise to greater costs to the economy and to the regulators and preparers who need to learn both sets. Although it may be easier and less costly for nation states to leave it to the IASB to set SME standards, any new tier of regulation adds to the cost burden for preparers and SMEs are not themselves involved in the process.

Financial reporting requirements can impose a significant burden upon smaller enterprises and in particular costs associated with compliance (Page, 1984; Keasey and Short, 1990; Barker and Noonan, 1995; Collis et al., 2001; AICPA, 2005; Kormaier, 2005). These can be identified as follows:

- The cost of producing financial accounting information, including the direct costs of preparing the information (either from within the business or by hiring an accountant), printing and publishing the information and possibly attesting or auditing the information;
- Opportunity costs as managers divert limited resources to prepare such information;
- The potential cost of disclosing information to a competitor; and
- The costs of complying with legal requirements (Paoloni and Demartini, 1999).

Many of these costs are either fixed or do not vary directly with size, but instead are significantly more important for smaller entities.

Furthermore, a recent commentary authored by the American Accounting Association’s Financial Accounting Standards Committee (AAA’s FASC) notes that “survey evidence indicates that external users of small business financial statements do not perceive their needs to be substantially different from decision makers who deal with larger companies” (Botosan et al., 2006, p.180), which mitigates the differing user needs argument.

Even if it is accepted that an international standard for SMEs is useful, there can be several problems with applying the “top-down” approach.

First, there are issues of practicality and although the IASB has suggested that SME GAAP can be derived from full IFRSs, some writers have expressed concern that it is not easy to imagine “how mere simplifications of more than 1700 pages of standards and their interpretations and alike could meet the materially different financial accounting information needs of SMEs” (Riistama and Vehmanen, 2004, p.4).

Second, there is the issue of the full IFRSs being based on a conceptual framework that is oriented to the needs of large enterprises, while the needs of small enterprises are not necessarily the same. The counter-argument is cited in Evans et al. (2005). Studies conducted in Italy contributing to this theoretical debate have concluded that the objectives for financial reporting should be similar for all entities, there exist commonalities in users of such information and therefore the same accounting principles should be applicable to all financial statements, although they comment that “it is, however, questionable whether the IASB’s *Framework* is such a *universally suitable* framework.” Evans et al. comment that the IASB’s framework is geared towards large companies with international listings and either needs amendment before application to SMEs or a new framework be developed for SMEs.

Third, when full standards are used as the base point for the development for SMEs, it is argued that a potentially ad-hoc approach to this may result in gaps in regulation and may well be the subject of a political agenda, although the “top-down approach” has already been adopted with some success in countries such as Sweden and New Zealand (the latter adopts a sector neutral approach – Baskerville and Cordery, 2006).

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Appendices

The Sections of the ED issued by ISAB regarding the International Financial Reporting Standard for Small and Medium-sized Entities (SMEs) are as follows:

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1 SCOPE
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3 GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION
4 BALANCE SHEET
5 INCOME STATEMENT
6 STATEMENT OF CHANGES IN EQUITY AND STATEMENT OF INCOME AND RETAINED EARNINGS
7 CASH FLOW STATEMENT
8 NOTES TO THE FINANCIAL STATEMENTS
9 ILLUSTRATIVE FINANCIAL STATEMENTS
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