

accounting standards for SMEs

relevant to Professional Scheme Paper 3.6

reporting requirements

■ **The principal aim when developing accounting standards for small to medium-sized enterprises (SMEs) is to provide a framework that generates relevant, reliable, and useful information. The result should be a high quality and understandable set of accounting standards suitable for SMEs. The users of financial statements are likely to be different for SMEs compared to multinational companies. Where there is no public disclosure, the only groups likely to receive the information are management, shareholders, and perhaps government agencies.**

There are a number of accounting standards and disclosures that probably do not provide useful information for the users of SME financial statements, such as the requirement to produce consolidated accounts, to provide for deferred taxation, and to recognise profits on long-term contracts.

There is no universally-agreed definition of an SME. No single definition can capture all the dimensions of a small or medium-sized business, or cannot be expected to reflect the differences between firms, sectors, or countries at different levels of development. Most definitions based on size use measures such as number of employees, balance sheet total, or annual turnover. However, none of these measures apply well across national borders.

The most important difference between an SME and a listed public company lies

in the nature of ownership. The former is characterised by the entrepreneur or family investing their own capital and running the business. The latter is always run by directors acting on behalf of institutional investors who own the majority of shares. It is this divorce of ownership and control that creates the need for directors to be held accountable to shareholders, and to adhere to the disclosure requirements laid down by law and standard setters.

MEETING INFORMATION NEEDS

The International Accounting Standards Board (IASB) makes it clear that the prime users of International Financial Reporting Standards (IFRS) are the capital markets, even though IFRS were not designed specifically for listed companies. The main objective of IFRS is to meet the information needs of the investors in international capital markets, and the standards are increasingly designed to fulfill that role. This means that IFRS are primarily designed for quoted companies and not SMEs. The vast majority of the world's companies are small and privately owned, and it could be argued that IFRS are not relevant to their needs or to their users.

It is often thought that small business managers perceive the cost of compliance with accounting standards to be greater than the benefit. Small companies with limited staff and resources may incur significant

costs in attempting to comply with IFRS. This would imply that a unique financial burden is placed on SMEs because they must pay a proportionately higher cost than multinational companies for the same benefit. SMEs also have the perception that there are a limited number of users requiring such data, and that compliance with accounting standards may disclose strategic information to competitors.

THE DEBATE

The main argument for separate SME accounting standards is the undue cost burden of reporting, which is proportionately heavier for smaller firms. The cost burden of applying the full set of IFRS may not be justified on the basis of user needs. This is because the main users of SME reports are easily identified and are few in number. Further, much of the current reporting framework is based on the needs of large business, so SMEs perceive that the full statutory financial statements are less relevant to the users of SME accounts. SMEs also use financial statements for a narrower range of decisions, as they have less complex transactions and therefore less need for the sophisticated analysis of financial statements.

The main argument against different reporting requirements for SMEs (differential reporting) is that if accounting rules are not held to apply universally, then users of accounts may lose confidence in the rules and it may lead to a two-tier system of reporting. Companies

should not be subject to different rules which could give rise to different 'true and fair views'. However, this assumes that the users are different, which may not be the case, and that the users are too inflexible to understand different accounting bases. Accounting rules already have many areas of choice.

Other arguments against differential reporting include the need for comparability and reliability. Additionally, there is an argument that full statutory financial statements are in the public interest, not only for users but also as a measure of protection for minority shareholders and other stakeholders, satisfying some of their information needs.

The United Nations, in its recent *United Nations Conference on Trade and Development* (UNCTAD) report, supports IFRS as the basis for good financial reporting by SMEs. The UN recognises that the accounting needs of a small business are simple, but as the business gets bigger, so does its need for more sophisticated internal information and disclosure to the outside world. The UNCTAD report also argues that, in practice, IFRS are applicable to SMEs where an accruals-based, historical cost system is the basis of IFRS reporting. Where it is unsuitable is in the reporting for tax, and in complex transactions (including fair value considerations) that are not undertaken by SMEs.

In June 2004, the IASB published its discussion paper on the subject, 'Preliminary Views on Accounting Standards for Small and Medium-sized Entities'. As a result, a framework may be developed to simplify the recognition and measurement principles in IFRS, and this may reduce reporting requirements for SMEs.

One important issue arising from the IASB's SME project is the definition of an SME. The question arises as to whether SME standards should apply to all unlisted entities, or just those listed entities below a certain size. There are arguments for using the legal form of a company as a basis, but firms with different legal forms often have similar economic structures and hence the legal form does not reflect actual economic substance.

PUBLIC ACCOUNTABILITY

A firm's size may not be the ideal criterion for differential reporting because it is relative and also depends on other factors, such as industry sector. Size is a weak indicator of the costs and benefits of financial reporting, and may not be the best way to determine what an SME is. SMEs could be defined by reference to ownership and the management of the entity, as SMEs are not necessarily just smaller versions of public companies. However, the main characteristic which distinguishes SMEs from other entities is the degree of public accountability, and so the definition of what constitutes an SME has to revolve around those entities that do not have public accountability. While the IASB should determine such criteria, it would not be practical to determine globally-applicable values, because the definition of what constitutes an SME will vary from country to country. Therefore, it should be left to individual countries to adopt measures that reflect their local economic and social environment.

One course of action would be for GAAP for SMEs to be developed on a national basis, with IFRS focusing on accounting for listed company activities. The main issue here would be that the practices developed for SMEs may not be consistent and may lack comparability across national boundaries. This may mean that if an SME wishes to list its shares on a capital market, the transition to IFRS may be difficult. It seems that national standard setters are strongly supportive of the development of IFRS for SMEs.

There are a number of approaches to developing standards for SMEs. Under one approach, the exemptions given to smaller entities would be prescribed in the mainstream accounting standard. For example, an appendix can be included within the standard detailing those exemptions given to smaller enterprises. Another approach is to introduce a separate standard comprising all the issues addressed in IFRS which are relevant to SMEs.

The merit of the first approach is that the standard setters are required to address the needs of the users of the qualifying

entities for each specific issue. This requires the IASB to consider involving SMEs in the standard setting process. However, the standards for SMEs will naturally be a modified version of the full standard, and not an independently developed set of standards. If they are based on the same conceptual framework they will allow easier transition to full IFRS if the SME decides to become a public listed entity.

In deciding on the modifications to make to IFRS, the needs of the users will have to be taken into account, as well as the costs and other burdens imposed upon SMEs by the IFRS. Relaxation of some of the measurement and recognition criteria in IFRS has to be made in order to achieve the reduction in these costs and burdens. Some disclosure requirements are intended to meet the needs of listed entities, or to assist users in making forecasts of the future. Users of financial statements of SMEs often do not make such kinds of forecasts. There is a major problem in the development and implementation of such standards. It cannot be assumed that the framework and its underlying theory and principles, which are based on the information needs of large public company stakeholders, apply equally to SMEs. Small companies pursue different strategies, and their goals are more likely to be survival and stability rather than growth and profit maximisation. The stewardship function is often absent in small companies, with the accounts playing an agency role between the owner-manager and the bank.

In the UK, the development of Financial Reporting Standards for Smaller Entities (FRSSE) led to the 'Big GAAP, Little GAAP' debate. This gives rise to the question of whether a different basis of 'true and fair view' should be allowed to exist within the same jurisdiction. This should not be a problem if International Financial Reporting Standards for Smaller Entities (IFRSSE) retains the same recognition and measurement principles as full IFRS, and only focuses on exemptions for disclosures. ■

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