Comment on the IASB Discussion Paper
'Preliminary Views on Accounting Standards for Small and Medium-sized Entities'

prepared by
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on behalf of the

European Accounting Association's Financial Reporting Standards Committee

We are grateful to the following for making available prior research referred to, or contributing directly to this report:[1] Alicja Jaruga, Brigitte Eierle, Peter Walton, Jill Collis and Robin Jarvis, David Cairns, John Flower, Petri Vehmanen, Günther Gebhardt and Martin Hoogendoorn.

The objective of this Comment is, in line with the EAA FRSC's mission statement, to collate and bring to the IASB's (and/or EFRAG's), attention research by European academics which may be relevant to IASB proposals and to point out research needs for adequate resolution of standard setting issues. Our Comment is structured as follows: Part I provides a summary of the key findings from the literature reviewed, while Part II answers the specific questions posed by the Discussion Paper. Part III contains the literature review and the bibliography.

Part I: Summary of Findings

Our Comment on the Discussion Paper on Small and Medium-sized Enterprises (SMEs) is subject to the caveat that we have not been able to access literature from all EU member states or countries represented by the European Accounting Association. We have however drawn on studies from the UK, The Republic of Ireland, The Netherlands, Germany, Austria, Finland, Italy, Spain, and Poland. As there is little literature available which specifically deals with the development and implementation of Accounting Standards for Small and Medium-sized Enterprises (SMEs), we also considered prior research examining the financial reporting problems and user needs of SMEs more generally, the question of whether IFRSs are, in principle, suitable for individual company accounts and accounts of non-listed enterprises, and the wider question of differential reporting in general. We believe that this research is relevant to the IASB's proposals. Our key findings are as follows:

- Within the EU, SMEs have considerable economic significance. They are subject to reporting regimes with differing degrees of exemptions for SMEs.
- SME financial statement user groups and their needs differ from the users and user needs of large, public-interest enterprises. There are also significant differences between user groups of the smallest versus the larger SMEs.
- The main arguments for differential reporting are undue burdens and disproportionate costs as well as a perceived lack of relevance of statutory accounts to the main user groups.

[1] We do not represent the views of individual contributors. Some contributors have made separate representations to the IASB.

- The main argument against differential reporting is the notion that there should not be different forms of GAAP within the same regulatory framework. Other arguments are the need for comparability, reliability, and the perception that statutory financial statements satisfy some information needs and provide some protection to stakeholders without access to inside information.
- Findings regarding the costs and benefits of reporting by SMEs are inconsistent, even within the same regulatory framework.
- There is a significant gap in the research literature on the users of SME accounts. Relatively little is known about the actual views and needs of owner-managers and other users. Moves for differential reporting are frequently driven by other groups, such as practitioners and academics. A number of researchers warn against premature deregulation without addressing this research gap.
- The national transformation of the EU Regulation on IFRSs and its member state and company options has given rise to a lively debate, reviewing the advantages and disadvantages of implementation of IFRSs also for non-listed groups and individual company financial statements.
- The advantages are usually considered less convincing in the context of SMEs. Costs are perceived to exceed benefits. Larger SMEs are more favourably disposed towards IFRSs.
- The development of an International Standard for Smaller Entities may facilitate wider adoption of IFRSs and weaken the cost argument, as well as improving international comparability.
- The IASB *Framework*'s objective and concepts of financial reporting appear biased towards large entities with public accountability. However, for SME reporting, objectives, strategies and accountability relationships differ. Thus the objectives and concepts underlying IFRSs may not be suitable for SMEs. A different conceptual framework may be required.
- It follows from this that the scope of the standards for SMEs should extend beyond disclosure and presentation requirements and should cover different measurement and recognition rules tailored to SME needs. Presentation and disclosure exemptions are unlikely to achieve genuine cost savings.
- The literature presents different views on the criteria and thresholds for differential reporting. It appears however, that neither size nor legal form are suitable indicators. As this question touches on regulatory issues outside the IASBs authority, guidance and criteria should be suggested by the IASB, but input from the EU is required to achieve convergence of regulation.
- Finally, other models for differential reporting should be examined. A three-tier model may be required, given the existence of considerable differences in the larger and the smallest non-publicly accountable entities.
- An effective mechanism is required to ensure compliance, consistent application and enforcement of SME standards.

Part II: Response to the Discussion Paper

Question 1a. Do you agree that full IFRSs should be considered suitable for all entities? If not why not?

No. As discussed in Part III, prior research suggests that the users and uses of financial statements of SMEs/non-publicly accountable entities differ significantly from those prepared by large listed companies. There are conceptual as well as practical (cost-benefit consideration) obstacles to the adoption of IFRSs by SMEs.

Question 1b. Do you agree that the Board should develop a separate set of financial reporting standards suitable for SMEs? If not why not?

Yes. However, a three tier system may be required. Part III suggests that there are gaps in the research literature on the users and user needs of SME accounts. Further research is needed to determine to what extent the needs of owner-managers and other users of SME accounts differ between larger versus the smallest SMEs, and to what extent they may differ internationally and can be served by a single regulatory framework. While it appears likely that the IASB will be able to develop a set of standards suitable for the larger SMEs, it may be the case that the needs of the smallest SMEs are best served by a system developed by national regulators, taking into account the entities specific economic environment. (See also our reply to question 3b.)

Question 1c. Do you agree that IASB Standards for SMEs should not be used by publicly listed entities (or any other entities not specifically intended by the Board), even if national law or regulation were to permit this? Do you also agree that if the IASB standards for SMEs are used by such entities, their financial statements cannot be described as being in compliance with IFRSs for SMEs? If not, why not?

The answer to this question depends largely on whether Standards for SMEs would cover presentation and disclosure exemptions, or also significant differences in measurement and recognition principles. If the later was the case, publicly accountable enterprises should not be permitted to apply the Standards for SMEs.

Question 2. Are the objectives of IASB Standards for SMEs as set out in preliminary view 2 appropriate and, if not, how should they be modified?

No. Further research should be undertaken by the IASB before the detailed objectives can be determined. Prior research suggests that the practicality and benefits of a global set of standards for SMEs are uncertain, that the user needs of SMEs may not be the same internationally and that the IFRSs' conceptual framework may not be relevant for SMEs in its current form. We agree with objective (d), but are not convinced that this will be achieved by the current proposals.[2] While objective (e) appears desirable, it is likely to apply only to the largest SMEs, since research suggests that 'stages of growth models' do not apply (John and Healeas, 2000; see also Hamilton and Lawrence, 2001).

Question 3a. Do you agree that the Board should describe the characteristics of the entities for which it intends the standards but that those characteristics should not prescribe quantitative 'size tests'? If not, why not, and how would an appropriate size test be developed?

Assuming that the Board will develop Standards for SMEs, it should develop characteristics or criteria describing the entities for which it considers the standards suitable. This should take the form of guidance. It should *not prescribe* quantitative or qualitative characteristics; this should be left to the authority of national legislators or the EU. Size tests may be indicative of economic significance but should be treated as indicative rather than determining criteria.

Question 3b. Do you agree that the Board should develop standards that would be suitable for <u>all</u> entities that do not have public accountability and should not focus only on some entities that do not have public accountability, such as only the relatively larger ones or only the relatively smaller ones? If not, why not?

It seems unlikely that a single set of standards would be suitable for all entities that do not have public accountability. Rather a three tier systems, as suggested in the ISAR's SMEGA, or by Haller (2003) appears more relevant. The IASB could focus on developing standards for the larger entities. Further research is required to determine whether it is best placed to develop regulation for the smallest ones; or whether the objectives, user needs and national environments of these smallest SMEs are too diverse, suggesting that their regulation should remain within the remit of national authorities. It is unlikely that the smallest entities, which operate only locally, will be significantly affected by global issues (see e.g. Riistama and Vehmanen, 2004).

Question 3c. Do the two principles in preliminary view 3.2, combined with the presumptive indicators of 'public accountability' in preliminary view 3.3, provide a workable definition and appropriate guidance for applying the concept of 'public accountability'? If not, how would you change them?

Yes.

[2] Compare the findings in Part III suggesting that application of the UK's FRSSE does not offer significant benefits to SMEs.

Question 3d. Do you agree that an entity should be required to use full IFRSs if one or more of the owners of its shares object to the entity's preparing its financial statements on the basis of IASB Standards for SMEs. If not, why not?

No. Such a veto right should be tied to a minimum share capital, or, in line with the IASB's principles-based approach, be left to national regulators or the EU to determine (see Haller and Eierle, 2004, in Part III).

Question 3e. Do you agree that if a subsidiary, joint venture or associate of an entity with public accountability prepares financial information in accordance with full IFRSs to meet the requirements of its parent, venturer or investor, the entity should comply with full IFRSs, and not IASB Standards for SMEs, in its separate financial statements? If not why not?

Again, this may be an issue for national regulators or the EU, and depends partly on the resolution of question 3c. It can be argued, however, that this requirement would create a competitive disadvantage for affected SMEs, as compared to its SME competitors which are not part of a group.

Question 4. Do you agree that if IASB standards for SMEs do not address a particular accounting recognition or measurement issue, the entity should be required to look to the appropriate IFRS to resolve that particular issue? If not, why not, and what alternative would you propose?

Yes.

Question 5a. Should an SME be permitted to revert to an IFRS if the treatment in the SME version of the IFRS differs from the treatment in the IFRS, or should an SME be required to choose only either the complete set of IFRSs or the complete set of SME standards with no optional reversion to individual IFRSs? Why?

No. In principle there should be no optional reversion to IFRSs. However, the answer to this question depends to a large extent on whether the Standards for SMEs will contain different recognition and measurement principles. If this was the case (as our literature review suggests would be desirable), then selective reversion to full IFRSs would lead to inconsistencies and decreased comparability. If the Standards for SMEs addressed only disclosure and presentation exemptions, our concern would be less critical. It may also be possible (exceptionally) for management to argue that the treatment under the full IFRS would be required to achieve *fair presentation.*

Question 5b. If an SME is permitted to revert to an IFRS, should it be:

(a) required to revert to the IFRS in its entirety (a standard-by-standard approach);
(b) permitted to revert to individual principles in the IFRS without restriction while continuing to follow the remainder of the SME version of the IFRS (a principle-by-principle approach); or
(c) required to revert to all of the principles in the IFRS that are related to the treatment in the SME version of that IFRS while continuing to follow the remainder of the SME version of the IFRS (a middle ground between a standard-by-standard and principle-by-principle approach)?

Please explain your reasoning and, if you favour (c), what criteria do you propose for defining 'related' principles?

Not applicable, given our answer to 5a, unless the Standards for SMEs addressed only disclosure and presentation exemptions, in which case option (b) appears the most relevant. Haller and Eierle's (2004) paper suggests that option (a) would be problematic, in particular for complex standards such as IAS 39, where a selective application of the standard's relevant provisions seems more appropriate.

Question 6. Do you agree that the development of IASB Standards for SMEs should start by extracting the fundamental concepts from the Framework and the principles and related mandatory guidance from IFRSs (including Interpretations), and then making modifications deemed appropriate? If not approach would you follow?

No. As suggested in Part III, it appears unlikely that the theory and principles relevant to large listed companies are relevant to SMEs, especially smaller owner-managed SMEs. Corporate governance, stakeholder relations and strategies are fundamentally different, as are users' information needs (see literature in Part III, Section 4). Further research is required to investigate stakeholder, including management information needs, for SMEs, and to what extent these are internationally similar enough to determine suitable concepts for an international reporting framework for SMEs.

Question 7a. Do you agree that any modification for SMEs to the concepts or principles in full IFRSs must be on the basis of the identified needs of users of SME financial statements or cost-benefit analyses? If not, what alternative bases for modifications would you propose, and why? And if so, do you have suggestions about how the Board might analyse the costs and benefits of IFRSs in an SME context?

See our response to Q.6. Further research is required.

Question 7b. Do you agree that it is likely that disclosure and presentation modifications will be justified on the basis of user needs and cost-benefit analyses and that the disclosure modifications could increase or decrease the current level of disclosure for SMEs? If not, why not?

As discussed in Part III, UK experience suggests that disclosure and presentation modifications *alone* do not necessarily result in lower levels of disclosure and cost savings. The UK's FRSSE focuses on exemptions for disclosures only, and retains the same recognition and measurement principles as full UK financial reporting standards. However, the items addressed in the disclosure exemptions do not usually occur in practice in SME accounts, suggesting that no real reductions of disclosures or savings are made (John and Healeas, 2000; see also ICAS, 2002). This would suggest that more significant changes, i.e. also with regard to recognition and measurement principles, would be required to achieve the cost-benefit and user needs objectives.

Question 7c. Do you agree that, in developing standards for SMEs, the Board should presume that no modification would be made to the recognition or measurement principles in IFRSs, though that presumption could be overcome on the basis of user needs and a cost-benefit analysis? If not, why not?

As suggested in the answer to 7b, modifications based only on disclosure and presentation appear not to have resulted in significant cost savings in the context of the UK FRSSE. A three-tier level of reporting may be more appropriate, with only disclosure exemptions for the 'largest' SMEs, but different recognition and measurement principles applying to the 'smaller' ones. For example, as pointed out by Riistama and Vehmanen (2004), 'fair values' are not very relevant to small locally operating enterprises.

Question 8a. Do you agree that IASB standards for SMEs should be published in a separate printed volume? If you favour including them in separate sections of each IFRS (including Interpretations) or some other approach, please explain why.

Yes.

Question 8b. Do you agree that IASB Standards for SMEs should be organised by IAS/IFRS number rather than in topical sequence? If you favour topical sequence or some other approach, please explain why.

No strong views.

Question 8c. Do you agree that each IASB Standard for SMEs should include a statement of its objective, a summary and a glossary of key terms?

Yes.

Question 9. Are there any other matters related to how the Board should approach its project to develop standards for SMEs that you would like to bring to the Board's attention?

Before progressing with this project, the Board should initiate in-depth research regarding the users, and user needs of SME financial statements.

Part III: Literature Reviewed

1. Advantages and disadvantages of differential reporting in general

In the EU, SMEs have enormous economic significance. In the UK, in the late 1990s SMEs accounted for 80% of companies filing accounts and 50% of non-government employment (Dugdale et al., 1998). In total 99% of businesses in the UK are small firms (Collis and Jarvis, 2000, with reference to DTI, 1999). Other EU member states, including for example Germany, have a traditionally even larger and more influential SME sector than the UK. In Italy and Spain, in 1990, SMEs made up 99.96% of the total number of business entities, and accounted for 82.84% and 91.9% respectively of employment (Paoloni et al., 1999). In Poland[3] large scale privatisation gave rise to a rapid growth of the SME sector, which currently represents 99.8% of active enterprises and employs more than 60% of the labour force (Jaruga and Fijalkowska, 2004). Most of the sector represents micro-enterprises, with medium-sized enterprises[4] making up less than 1% of all enterprises in 2001 (ibid.).

As compared with the US, in the EU larger numbers of SMEs are affected by company law (and, presumably, other regulation), making compliance costs more relevant and enforcement more difficult (Bollen, 1996). However, in (continental) Europe, 'most countries have never required all incorporated entities either to prepare comprehensive accounts or to undergo audit' (Harvey and Walton, 1996: 26). This suggests initially that UK SMEs (benefiting historically from fewer exemptions) may suffer an undue cost and burden even beyond that experienced by continental European enterprises; however, the partial (and likely increasing) divorce of regulatory issues from legal form make the issues examined here relevant for all types of enterprises, i.e. not only incorporated businesses with limited liability. The question arises as to whether a regulatory framework developed initially for firms reporting within an Anglo-American governance and capital market context, such as that developed by the IASB, can usefully be adapted to the needs of SMEs in EU member states (and elsewhere).

The main arguments for differential reporting (made predominantly in national contexts) are the undue burdens and disproportionate costs of reporting carried by smaller businesses (Harvey and Walton, 1996, with reference to the UK; also Collis et al., 2001), in spite of some existing exemptions (Bollen, 1996, with reference to the Netherlands). (For a detailed examination of such costs see for example Barker and Noonan, 1995/96). These costs were perceived to outweigh the benefits accruing to

[3] The same is likely to apply to other transitional economies and new EU member states.
[4] With between 50 and 249 employees.

users (Consultative Committee of Accounting Bodies, 1994,[5] as quoted by Dugdale et al., 1998). Jaruga and Fijalkowska (2004:15) argue that, in Poland, 'even not very sophisticated accounting is perceived by many SMEs as a costly and time-consuming procedure'. A further reason for differential reporting is the perceived lack of relevance of (full) statutory financial statements to SME accounts users, in particular for internal reporting purposes (e.g. Harvey and Walton, 1996). Additional arguments are: narrower user groups, usefulness for a narrower range of decisions, less complex transactions and less need for sophisticated analysis of highly aggregated information (Collis et al., 2001).

The main argument against differential reporting is the need for universality (i.e. companies should not be subject to different rules giving rise to different 'true and fair views'). However, the results of a recent IASB survey of national accounting standard setters suggests that that many countries have a separate set of GAAP for SMEs or are developing such a separate GAAP (Pacter, 2004).[6] Other reasons against differential reporting are the need for comparability, reliability, the public interest argument, the 'publicity doctrine' (publishing accounts is the price for limited liability), the fear of making smaller companies 'second class citizens', the perceived threat that larger companies would press for similar advantages (Harvey and Walton, 1996; see also Barker and Noonan, 1995/96 and Collis et al., 2001), and the risk of the creation of a two-tier accounting profession (Collis et al., 2001)[7]. With regard to comparability, Barker and Noonan (1995/96) point out that deregulation could mean in particular that small companies cannot be compared with other small companies.[8] A further argument against differential reporting is that, also for SMEs, statutory financial statements satisfy some of the information needs of and present some protection for minority shareholders and other stakeholders, in particular business contacts (Harvey and Walton, 1996). It is however unclear whether and to what extent it would reduce creditor protection (Collis et al., 2001).

Some (earlier) UK studies (e.g. Carsberg et al., 1985, as discussed by Keasey and Short, 1990) seem to suggest that compliance was not perceived to be unduly burdensome. This may have been the result of a lack of awareness of (opportunity) costs, and other costs, such as loss of privacy, etc. (ibid.; see also Paoloni et al., 1999, with regard to Italy). This is supported by Harvey and Walton (1996), who suggest that the move for differential reporting has been driven by practitioners and academics – business proprietors (and users) have not taken part in the debate.[9] Harvey and

[5] The CCAB document predates the UK's FRSSE, but not the publication exemptions provided by the fourth directive and the UK's Companies Act.

[6] This argument is less relevant if only differential disclosures are concerned (ibid.). E.g. John and Healeas (2000: 5) found that 'FRSSE will simplify 'big GAAP' requirements and still be consistent with company law' (see also Collis et al., 2001).

[7] This of course already exists in some EU member states.

[8] See also Paoloni and Demartini (1997), who find that, as a result of the different implementation of options of the fourth directive in EU member states, harmonisation of SME reporting and of SMEs' regulatory burdens is limited. The authors suggest that the differences are due to differences in institutional and other environmental factors (e.g. centralised government, prevalent banking and family interests etc.).

[9] A similar point is also made, with respect to the implementation of IFRSs in Germany, by Zabel (2002). He urges SMEs and SME audit firms to take position and influence developments. Further, Barker and Noonan (1995/96:12), when summarising the arguments raised in the context of earlier consultation in Ireland, note: 'the point was made that the profession could gain great PR advantage by responding to the public demand for simplification and de-regulation for smaller enterprises'.

Walton suggest that owners may have no full appreciation of the benefits of differential reporting.

Keasey and Short suggest that the burden as a proportion of total costs may decrease, and the benefits increase, as firm size increases (although the accounting burdens in general were not perceived by firm owners to be specific to certain firm characteristics investigated[10]). They found that only half of the interviewees in their study considered accounting requirements to rank in the top half of administrative burdens. 60% found the production of accounts beneficial (for purposes of raising finance, etc.).

Collis and Jarvis's (2000) UK based findings of perceptions of owner-managers suggest that the main benefits of financial reporting experienced by SME directors are confirmation and verification of results, while the main disadvantage is cost (financial and time/inconvenience). They did not find that disclosure of information accessible to competitors was perceived as a disadvantage. Their findings suggest that company size is a relevant factor in experiencing costs and benefits, as the perceived benefit was identified for companies with a turnover of ≥ £ 1m, while the perception of cost disadvantages was identified for companies with a turnover of < £ 1m.

Collis and Jarvis also found that not all businesses eligible made use of publication exemptions available, that they made this decision based on their accountant's advice, and that cost benefits were given as a reason in either case. However, '… cost is not a major factor in the filing choices of small companies' (Collis and Jarvis, 2000, p. viii). Collis and Jarvis (2000) argue that the main beneficiaries of deregulation would be smaller SMEs, and that regulators have not sufficiently considered the perceived advantages of statutory financial reporting.

The relevance of the UK's Financial Reporting Standard for Smaller Entities (FRSSE) has been examined by John and Healeas (2000).[11] Their findings suggest that some small companies might not adopt FRSSE because of the intention/likelihood of growth (but see below). There were further concerns regarding tax-neutrality, and a perceived cost-neutrality of the application of the FRSSE: 'Although the intention behind FRSSE was probably to make rules simpler, and the process of accounts preparation less time-consuming, this objective has not been achieved, largely as a result of the Companies Act requirement to prepare full accounts for the shareholders' (John and Healeas, 2000:6).

This finding is supported by a study by the Institute of Chartered Accountants of Scotland (ICAS) (2002), which was an update on an earlier study, and attempted to establish the extent of the FRSSE's adoption and of voluntary disclosures. Of the sample of 100 companies, 49 had adopted FRSSE, 51 had not. However, among the non-adopters, adoption of the FRSSE would have had no significant impact on disclosures and therefore on costs; i.e. adopters had not benefited from a significant reduction of disclosures.

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[10] Inter alia ownership type, perceived benefits from accounts preparation, number of employees, etc.
[11] Their study is based on a literature review and 10 key informant interviews.

Barker and Noonan (1995/96: 12; with reference to deregulation consultations in Ireland) suggest that, while arguments for deregulation 'were expressed forcibly, there was no evidence to support the extent to which they are held or the extent to which they are actually experienced by small businesses in Ireland'. This lack of evidence is also a problem highlighted by Collis et al. (2001: 181), who argue (in a UK context) that 'despite a considerable gap in the literature relating to the users and uses of the statutory accounts for small companies, in the current rush towards regulatory relaxation for smaller entities policies are formulated in ignorance'.

2. Users and user needs

The IASB assumes a narrower group of financial statement users for SMEs than for large public-interest entities, and a different weighting of the importance of the users (Haller and Eierle, 2004).

There has been a considerable interest in differential reporting in the UK. Much of this literature considers specifically the users and user needs of SME financial statements. Harvey and Walton (1996) suggest that financial statements of larger companies reflect more complex transactions and highly aggregated data, are used by a larger set of users, and for a wider set of decisions, than SME accounts, which implies that more extensive disclosures are appropriate. It is also argued that they have a duty of (public) accountability towards their external providers of equity finance. This does not apply to SMEs, whose stakeholders have other means of access to internal information (John and Healeas, 2000).

The main user groups of SME financial statements identified by the UK literature are 'employees, managers, providers of loan finance, trade creditors and the Inland Revenue' (ICAS, 1998, p. 12; see also Collis and Jarvis, 2000; Collies et al., 2001;[12] also Riistama and Vehmanen, 2004, with regard to Finland). Paoloni and Demartini (1997), based on an Italian survey, identify two main user groups: tax authorities and banks (representing the public interest) and management. A distinction can be made between users with and without economic or statutory power to demand information (ICAS, 1998). Small and medium-sized companies' users seem to differ significantly, e.g. medium-sized companies seem to make their accounts available to customers (Collis, et al., 2001). SME owner managers also read financial statements of other businesses (ibid.).

Riistama and Vehmanen (2004) argue that the needs of SME accounts' users differ from user needs in MNEs. For example, the value of the firms at any point in time is less relevant than their ability to generate positive cash-flows, and their profitability and liquidity. ICAS (1998) suggest that SME accounts users need assurance on profitability, solvency, events of the previous year, future prospects, and the quality of management. Paoloni, Cesaroni and Demartini (2003) examine the information needs and impact on financial communication of investors of venture capital in SMEs. They argue that venture capital investors have broader information needs than are satisfied by external financial reporting conventions – additional information has to be prepared by firms.

[12] This confirms findings of prior research (Page, 1984; Carsberg et al., 1995; Barker and Noonan, 1996; as quoted in Collis et al., 2001).

There are diverging findings on the usefulness of statutory financial statements to the main users (esp. management) of SME accounts. Dugdale et al. (1998) suggest that statutory financial statements are a useful source of information for management purposes for very small companies, but this usefulness decreases as companies grow and develop more specific information systems. This is also supported by the findings of Collis et al. (2001), and by Paoloni et al. (1999) for Spain. However, given the SME sector as a whole, Collis and Jarvis (2000) found that statutory financial statements were not perceived as useful as other information (e.g. management accounts, cash flow statements, budgets, bank statements) for management purposes. They argue that this is because of the large company orientation of financial reports. According to John and Healeas (2000), statutory financial statements were not perceived as useful for decision making: 'very few of the owner-managers have a proper understanding of the contents of statutory accounts. … They often take the view that the statutory accounts are of no practical use for decision making and prefer to use management accounts and a cash flow forecast' (John and Healeas, 2000: 7). Paoloni et al. (1999) found that, in Italy, statutory financial statements are considered by SMEs as a legal requirement, but not as a very useful information tool, in particular not for external users. However, for some small firms the statutory financial statements (or the data required to prepare them) do contribute to management's information needs. Paoloni and Demartini (1997) argue that the usefulness of financial statements for management should be improved and that legislation should determine the minimum information disclosure required to safeguard the interests of those stakeholders without access to inside information.

Marriott and Marriott (1999) argue that the general purpose model of statutory financial statements in the UK fails to meet the needs of two main user groups - owner-managers and banks - and suggest adoption of a customised reporting model, providing more understandable and tailored information for individual company needs.[13]

A main problem for regulators is the significant gap in the literature on the users of SME accounts (e.g. Jarvis, 1996; Dugdale et al., 1998; Collis and Jarvis, 2000; see also Paoloni et al., 1999 with regard to Italy and Spain). There is, for example, a lack of examinations of the use of financial statements by trade creditors, credit agencies, public sector agencies, and other user groups not identified by earlier research (Jarvis, 1996). Jarvis argues that the lack of market prices for SMEs means the financial statements are more important to external users than they may be for listed companies, where market data may be more objective (than financial statements). Based on the identified gaps in the research literature, Jarvis (1996) and others (e.g. Dugdale et al., 1998; Collis and Jarvis, 2000) warn against premature deregulation, which could result in increased information asymmetry, detrimental effects on investment in and growth of SMEs, decreased usefulness of financial statements (Jarvis, 1996) also as management information tools, affecting the quality of management (Dugdale et al., 1998). Collis *et al.* (2000: 182) suggest that:

> 'in relaxing the regulation of financial reporting by smaller entities, the emphasis should not be on reducing compliance costs, but on ensuring that

[13] While owner-managers surveyed reacted favourably to the sample customised data, they feared that such services provided by their accountants would be prohibitively expensive.

changes in accounting regulation lead to accounts that are more useful to users.'

3. Costs and benefits of compliance with IFRSs and IASB Standards for SMEs

The 2002 EU Regulation on the application of International Accounting Standards requires application of IFRSs in the consolidated accounts of listed groups, but contains options permitting a wider implementation of IFRSs, i.e. for non-listed enterprises and for individual company accounts. The national transformation of the *Regulation* and the member state and company options has given rise to a lively debate. Advantages of implementing IFRSs also in individual company accounts include:

- Greater standardisation of accounting regulation independent of enterprise characteristics and type of financial statement (i.e. individual or consolidated) (Böcking, 2001; Haller, 2003);
- international comparability and understandability (Haller, 2003; Mandler, 2003b);
- greater information relevance (also beneficial for management) (Marten et al., 2002; Haller, 2003; Mandler, 2003b; etc.) and market efficiency (Bruns and Wiederhold, 2004);
- easier access to finance (Anon., 2004), including credit finance (Marten et al., 2002; Mandler, 2003b);[14]
- greater transparency (Anon., 2004) and accountability (Böcking, 2001).

Disadvantages include:

- IFRSs are not based on a generally accepted theory regarding the decision-usefulness of financial statement information (Löhr, 2003).[15]
- There are conceptual differences in the underlying theory/philosophy between IFRSs and continental European accounting, with regard to intended user groups, objectives and principles (see e.g. Bruns and Wiederhold, 2004, with reference to Germany and Austria).
- In Germany and other continental European countries, financial statements traditionally serve not only information functions, but also the determination of (distributable) income (including taxation) - IFRSs are not suitable for this function, especially as they are not oriented towards the principle of prudence, which serves capital maintenance and creditor protection objectives[16] (Haller, 2003; Schulze-Osterloh, 2003; Mandler, 2003a; Mandler 2003b; Küting, 2004; etc.). Moving away from the prudence principle could be detrimental for firms relying on debt finance (Mandler, 2003b).
- IFRSs are complex and/or costly to implement (Haller, 2003; Schulze-Osterloh, 2003; Anon., 2004; Küting, 2004; Jaruga and Fijalkowska, 2004, etc.).
- IFRSs may have a disruptive effect on legal and commercial contexts (e.g. local rules on the determination of insolvency) (Haller, 2003; Kirsch, 2003).

[14] A number of German authors suggest that banks may increasingly favour IFRS based financial statements for credit-rating purposes (e.g. Kahle, 2003; Peemöller et al., 2002).

[15] Löhr therefore also questions their usefulness for satisfying the information needs of the capital markets.

[16] However Böcking (2001), writing in favour of a wider implementation of IFRSs, argues that such problems could be tackled by developing independent tax accounting and distribution rules, as well as different mechanisms to ensure creditor protection (see also Böcking, 2002; Herzig and Bär, 2003; Bruns and Wiederhold, 2004; etc.).

- The delegation of rule-making by the legislator to a private sector international organisation may give rise to constitutional concerns (Haller, 2003).
- International private-sector standards are no acceptable legal basis for taxation (Arbeitskreis Bilanzrecht …, 2002).
- A convergence of IFRSs with US GAAP could lead to a limitation of options (Mandler, 2003b). IFRSs (and notional 'convergence') may be a way of introducing US interests through the back door (see e.g. Kahle, 2003).
- IFRSs give rise to less objective balance sheet values and increase the scope for creative accounting (Küting, 2004).
- IFRSs are subject to more frequent changes than the previous (legal) frameworks, leading to increased compliance costs (Kahle, 2003).

Schulze-Osterloh also questions whether the EU endorsement process is appropriate and comprises a proper control of the standards' content. He further addresses the lack of equivalence in language translation and the fact that therefore the English language and Anglo-Saxon legal traditions dominate.

While Marten et al. (2002) suggest, based on German data, that non-listed enterprises underestimate the benefits of IFRSs, their advantages are usually argued to be less convincing in the context of SMEs. The main argument in their favour in an SME context is harmony of German accounting (Mandler, 2004). Thus the German literature demands an exemption from IFRSs for smaller enterprises (Mandler, 2004). For SMEs the costs of implementing IFRSs far exceed benefits and there is a limited need for (international) comparability (Haller, 2003). Further, SMEs rely on debt finance provided by their bank, they do not rely on the capital market (Mandler, 2004). Mandler (2003b) points out that, given the multi-purpose function of German financial statements, in particular SMEs have in the past benefited from the need to prepare only one set of financial statements which would also serve taxation purposes; this benefit would be lost and separate financial and tax accounts would have to be prepared. Further, German SMEs have traditionally not been in favour of transparency and frequently avoided publication of their results. They would therefore be affected most by additional publication/disclosure requirements (Mandler, 2003a; Mandler, 2004); i.e. greater transparency may in fact be (or perceived to be) harmful (see also Haller, 2003).

Mandler (2003a; see also Mandler, 2003b and Mandler, 2004) reports findings of a 2002 survey of SMEs and academics on their views regarding a reform of German financial reporting. The author found considerable differences in the views of smaller (≤ 250 employees) and larger SMEs. The results suggests that smaller SMEs were opposed to compulsory introduction of IFRSs, and an option was only weakly supported. The larger SMEs were more strongly in favour of an option. Academics were more enthusiastic about reform but not in favour of options. According to a survey of large North-Rhine Westphalian SMEs carried out by German KPMG and Professor von Keitz (FH Münster), factors influencing companies' decision for or against implementation of (full) IFRSs include legal form, size, being part of a group already applying IFRSs; and planned or actual external rating through rating agencies. Two thirds of the non-listed firms intend to or already have converted to IFRSs; of those undecided, further 80% would convert if the IASB published facilitated requirements for SMEs (Anon., 2004).

Haller (2003)[17] argues that the EU options may lead to greater disharmony, unless there is some member state convergence in regulating reporting for non-listed enterprises. He further suggests that established national principles should be introduced in the debate regarding the international development of accounting and accounting standards and suggests means of facilitating a broader adoption of IFRSs into national systems. One step would be the development of an International Financial Reporting Standard for Smaller Entities (IFRSSE) by the IASB, which would weaken the argument of poor cost benefit ratios for application of IFRSs by SMEs. This view is also taken by Haller and Eierle (2004). Further advantages of an IFRSSE would be easier implementation of the member state option to adopt IFRSs also for non-listed enterprises and to create more consistent national accounting systems. This would serve national and international comparability and easy transition to full IFRSs for enterprises aiming for capital market listing. Further, many transitional economies have to follow world bank requirements to apply (full) IFRSs to all enterprises, which is far too demanding for SMEs (Haller and Eierle, 2004).

Based on cost/benefit considerations, and the assumption of the development of an IFRSSE, Eierle (2004) suggests a model for differential reporting on the basis of IFRSs/IFRSSE for all enterprises in Germany. This is based on arguments of legal uniformity and clarity, and a consistent financial reporting basis. Further arguments are comparability of information and increased information value to users as well as the easier transition from small non-listed to listed status without the necessary change of financial reporting regime. It also is in line with the EU's long term aim of a harmonised regulatory accounting framework.

4. Conceptual differences/problems

A key problem for the development and implementation of an IFRSSE are perceived conceptual differences and problems. For example, in the UK context, it cannot necessarily be assumed that the conceptual framework, the *Statement of Principles*, and its underlying theory and principles (which are based on the information needs of large public company stakeholders), are equally relevant to SMEs (see e.g. Collis and Jarvis, 2000). Agency relationships differ and small companies usually pursue different strategies, are more likely to satisfice, and aim for survival and stability rather than profit-maximisation and growth (Collis and Jarvis, 2000; see also Hamilton and Lawrence, 2001). Further: '… the stewardship function is largely absent in small companies. Instead, the accounts appear to play an agency role between the owner-manager and the bank' (Collis and Jarvis, 2000, p. x). Thus a 'large company template' may be unsuitable for SMEs. Instead, regulators should examine how owner-managers use statutory accounts and considering developing a conceptual framework for SMEs (ibid.)

The Italian literature (in the discipline of *Economic Aziendale*) suggests that before examining the need for a specific set of rules for the preparation of SME Financial Statements, we need to address what we consider the main objective of financial reporting. This question is a central prerequisite to the determination of a consistent

[17] Haller examines suggestions made by parties involved in/affected by financial reporting regulation in Germany. None of these parties suggests the compulsory implementation of IASs for all enterprises in 2005, however, many seem to suggest that in the long term the IASs should become relevant also in individual company accounts, and that, as long as this does not conflict with taxation and distribution requirements, the rules of the German commercial code should be revised to be more in line with IASs.

set of accounting principles (see e.g. Besta, 1920, Vol. II: 11; Zappa, 1920: 24; Ceccherelli, 1939: 12).[18] A central issue is how to reconcile a desired consistency of objectives of financial statements and accounting principles with the specific informative needs of different users (see e.g. Amaduzzi, 1949: 433). This question, i.e. whether a single set of rules for the preparation of financial statements would be able to address all user needs, or whether different frameworks are required ("multiplicity" or "singleness" of the Financial statements) has been widely debated in Italy (see, among others, Amodeo, 1970: 875; Onida, 1974: 5-7; Ferrero, 1991: 33).

The consensus of the theoretical debate on the objective of financial statements in Italy appeared to be that a single conceptual framework with in principle the same objective for financial reporting and the same framework of rules and accounting principles should be applicable to all firms, but with some differentiation based on sector, the needs of the tax authorities, and firm size. Financial statements should be designed to provide useful information for the needs of the different categories of users (investors, creditors, banks, fiscal authorities, customers, suppliers, etc.). The common objective of financial reporting, as identified by Italian theorists, was the provision of information on the capacity of firms to create income (*reddito*) (Zappa: 1950). Thus although some differential reporting would be required with regard to specific circumstances, this would affect specific detailed rules only, but not the underling principles of financial reporting. The same accounting principles should apply to all firms; different sets of principles would not be required. It is however questionable whether the IASB's *Framework* is such a *universally suitable* conceptual framework.

It follows from the above that, if the IASB Framework was based on a *general* idea about the objectives of financial statements, then it should be considered useful for every category of firm, SMEs included. IFRSs should be suitable for all entities. However, if the IASB's Framework's stated objective for the preparation of financial statements was, as is currently the case, less general, the accounting principles would not be suitable for all entities. The IASB's *Framework* and standards are relevant mainly for companies with securities listed on international capital markets, i.e. firms with public accountability. That they are perceived to have this focus is apparent in the fact that by far the largest body of literature addressing IFRSs and their implementation refers to large and listed enterprises (see Appendix for examples). Thus the *Framework*'s objectives of financial statements are not in line with the needs of SMEs. This suggests that the IASB should either extend its focus by modifying the present version of the *Framework*,[19] or develop a separate conceptual framework and set of IFRSs for SMEs.

Riistama and Vehmanen (2004) also disagree with the IASB's presumption that GAAP for SMEs can be developed on the basis of IFRSs, based on the same concepts. They argue that IFRSs are developed for large and multinational enterprises, which raise finance globally and therefore also require global accounting rules. The much larger number of SMEs and not-for-profit organisations worldwide face different conditions, operate locally and rely on different forms of funding, and

[18] Similar arguments are found in German accounting theory (see Franceschi, 1978: 29-40).
[19] Such a change would not really be feasible, because it would require modification of individual IFRS.

operate frequently with no or little separation of ownership and control. The fair value of their assets is often impossible to determine because it depends on the entities' ability to (continue to) operate. This gives rise to a requirement for different qualitative characteristics and a different accounting framework.

5. The criteria and thresholds for differential reporting

Research suggests different views on the criteria for differentiation. Haller (2003) argues that, while the IASB should determine such criteria, it would not be practicable to determine globally applicable values. Eierle (2004) argues against legal form as a basis because firms with different legal forms often have similar economic structures, i.e. the legal form does not reflect actual (economic) substance (see also Haller, 2003). Bollen (1996)[20] argues that firm size as criterion for differential reporting (as introduced by the EU directives) may not be ideal, because: firm size is relative and depends also on other factors (e.g. industry); the cut-off between small and medium-sized is subjective; size is a weak indicator of costs and benefits of financial reporting experienced and the role of financial information. The Italian and Spanish literature unanimously suggests that a strictly quantitative approach is unsuitable (e.g. Paoloni et al, 1999; Paoloni, Cesaroni and Demartini, 2003). Size is also not easy to define and its relevance may depend on a company's sector (e.g. with respect to number of employees) (John and Healeas, 2000), the national context, etc.; i.e. in spite of the apparent objectivity of quantitative variables its significance is subjective, depending on the specific circumstances.

John and Healeas (2000) suggest that small firms usually remain small or fail, i.e. the assumption of stages of growth models does not apply (see also Hamilton and Lawrence, 2001). However Haller (2003), with reference to IFRSs, considers the EU's size criteria such as turnover, balance sheet total and number of employees to be more practicable and reliable than the IASB's proposed qualitative criteria, would however prefer to replace 'turnover' with 'value added'. Eierle (2004) also argues that firms size and (non-)listed status are in general in line with a stakeholder orientation, which in turn is indicative of quantitative (numbers of users) and qualitative (heterogeneity of user groups, complexity of business transactions, economic significance) characteristics of the enterprise.[21]

An alternative criterion is the degree of the separation between ownership and control of firms (relating to the difference between public and private firms); this could be assessed by factors such as ownership share held by management; transferability of shares and number of shareholders (Bollen, 1996).

Such a 'public accountability' differentiation criterion has been chosen by the IASB, following the Canadian model (Haller and Eierle, 2004). Haller and Eierle (2004) and

[20] Not with reference to IFRSs.

[21] Eierle (2004) suggests for Germany that large enterprises - based on size criteria (of balance sheet total, value added, number of employees) or capital market listing should be subject to compulsory application of IFRS in group and individual company accounts and not be eligible for exemptions (financial statement preparation, audit, publication or enforcement). Enterprises qualifying as small, based on size criteria (of balance sheet total, value added, number of employees) and non-listed status should be exempt from the requirement to prepare group accounts, should have an option to prepare IFRSSE based accounts and should be eligible for certain exemptions regarding audit, publication requirements and enforcement.

Flower (2004) point to the paradox that the IASB refers to SMEs while not choosing size, but (non-)public accountability as the basis for differentiation. Haller and Eierle argue that the criteria introduced in the Discussion Document still allow much room for interpretation, and, as much of this is delegated to national governments, for international convergence. Haller and Eierle (2004) now suggest that the EU should define criteria and size limits for its member states to ensure consistency.[22] This suggestion also relates to Flower's (2004) main concern, namely that the IASB is not a regulatory body and can therefore not prescribe which firms should use which standards. He argues that the Discussion Document's Questions 1c and 3d suggest that the IASB is overstepping its authority by addressing regulatory questions.

Haller and Eierle (2004) are critical of the IASB's suggestion that the vote of an individual owner may be sufficient to prevent application of standards for SMEs, and argue that such a veto right should be tied to a minimum share capital. They argue that the IASB should return to its principles-based approach and leave the specific determination of the veto right to the national regulators. This allows consideration of specific national requirements/particulars, although Haller and Eierle accept that it contains the danger of non-comparability of SME accounts within the EU. Thus an international or at least EU based consensus/regulation would be desirable.

6. Scope of differential reporting

In the UK, the development of the FRSSE was accompanied by a debate on whether the creation of a standard for SMEs would constitute a separate 'GAAP' ('Big GAAP, little GAAP' debate), and whether this would create a different 'true and fair view'. This, in turn, gave rise to the question of whether a different basis for 'true and fair view' should be allowed to exist within the same jurisdiction. The problem did not arise because the FRSSE focused on exemptions for disclosures only, and retained the same recognition and measurement principles as full UK financial reporting standards. However, the items addressed in the disclosure exemptions do not usually occur in practice in SME accounts, suggesting that no real advantages were gained (John and Healeas, 2000; see also ICAS, 2002). Thus 'the change brought about by FRSSE is cosmetic, rather than fundamental' (John and Healeas, 2000, p. 6).

It has been suggested that the IFRSSE also should differ from full IFRS mainly with regard to disclosure requirements, and that differing recognition and measurement/valuation principles and rules should be avoided (e.g. Haller, 2003; Eierle, 2004). Haller argues this approach alone would maintain uniformity, understandability and comparability of performance measurement. This however raises the question of how the problem experienced in the UK can be avoided, namely that no real benefits will arise from the application of the IFRSSE. The IASB's own survey of national accounting standard setters suggests that the large majority of respondents felt that the IASB should also provide recognition and measurement differences for SMEs (Pacter, 2004). This is also supported by the arguments examined in section 4. Also Hüttche (2002) argues for a dedicated framework for SMEs – small enterprises have different information needs than larger ones; differential reporting based on simplified IASs with the same principles as full IASs are unlikely to achieve cost savings nor to meet the needs of SMEs.

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[22] Stock exchange listed companies should not be permitted to apply the IFRSSE.

7. Other models

Alternative models are examined in the literature. The IASB should take into account that differential reporting exists already in many jurisdictions. Among the other models examined in the literature is included the United Nations' ISAR working group's SMEGA-Model. SMEGA refers to IFRSs and suggests three levels of application: large and listed enterprises; medium-sized enterprises; small enterprises with up to 50 employees. Only the last level benefits from radical simplifications: only the balance sheet and profit and loss account and much reduced notes have to be produced; only 5 IASs apply, the fair presentation principle does not need to be applied (Mandler, 2004; see also Hüttche, 2002). Haller (2003) also envisages the possibility to exempt the smallest of enterprises entirely from the requirements of double-entry bookkeeping and allow them to prepare accounts based on cash flows. Paoloni et al (1999) argue[23] that for some types of small businesses, cash-based accounting systems may be more appropriate. As part of a government policy promoting SMEs, the current Polish system provides large exemptions from financial reporting requirements for SMEs; even accounting requirements for the purposes of taxation are differentiated according to an entities size and business sector, providing dramatic exemptions from or simplification of accounting and even book-keeping requirements for the smallest SMEs in certain sectors (Jaruga and Fijalkowska, 2004).

Riistama and Vehmanen (2004) argue that the 'Monetary Flow Theory of Accounting', based on the realisation and matching principles and the historical cost approach, would be a more suitable, globally acceptable framework for SME reporting. They suggest a set of qualitative characteristics for SMEs. Riistama and Vehmanen argue that it would be possible to reconcile the suggested approach and IFRSs – compatibility could be achieved if IASs/IFRSs were reviewed from the perspective of SMEs and historical costs were used instead of the fair value approach. In a UK rather than international context other (and to varying degrees radical) suggestions for alternative SME reporting frameworks, were made by Harvey and Walton (1996), ICAS (1998), and Marriott and Marriott (1999).

8. Other considerations relevant to the Discussion Document

Haller (2003) suggests that ideally the regulations of full IFRSs relevant to SMEs should be condensed into a single International Financial Reporting Standard for Smaller Entities (IFRSSE). Haller and Eierle (2004) are critical of the IASB's demand that an SME electing to follow a treatment in an IFRSs rather than an alternative permitted in the SME standards must apply the relevant IFRS in full. They consider the IASB's approach problematic, in particular for complex standards such as IAS 39, where a selective application of the standard's relevant provisions seems more appropriate.

The implementation of IFRSs will also require (national) enforcement agencies Mandler (2004). Compliance and enforcement have been problematic for full IFRSs (see e.g. Cairns, 2000). Given that compliance or the timeliness of compliance for SMEs may be traditionally an even greater problem in some member states (see e.g. Bollen, 1996, for The Netherlands; Mandler, 2003a, for Germany) and given differences in the statutory audit requirement for SMEs and effectiveness thereof,

[23] Not with reference to IFRSs.

compliance, consistent application and enforcement are likely to provide an even greater problem for SME standards.

10. Summary and Conclusions

The above review provided an overview of academic literature we believe to be relevant for the IASB's discussion paper on Accounting Standards for Small and Medium-Sized Entities, and which we hope will reflect the different accounting traditions in Europe. This has allowed us to identify significant questions and problems which we believe need to be addressed by the IASB before it proceeds with the project on SME reporting. The financial reporting regulations of the IASB are influenced by the user needs of a traditionally Anglo-American corporate governance tradition, requiring reporting to external providers of equity finance. SMEs, and in particular SMEs from a continental European corporate governance and regulatory tradition, have fundamentally different financial reporting requirements. The essential question is therefore whether the most suitable form of financial statement for SMEs is a scaled down version of the framework developed for large and listed enterprises or whether a conceptually different approach is required. Given also the suggestion that deregulation and the move towards IFRSs appear to be driven strongly by groups other than SME proprietors/accounts users, and that in fact serious gaps exist in the literature regarding their needs, we believe that further research is urgently required.

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