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“Small GAAP: a large jump for the IASB”

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Abstract:

In the last fifteen years, many national standard setters have introduced differential reporting for small and medium enterprises (SMEs). Internationally, SMEs are a diverse and dynamic group which are described under broad characteristics in different countries. SMEs are not issuers or public sector entities and therefore frequently the qualitative criteria of not being publicly accountable may define these entities. Acceptance and imposition of International Accounting Standards (IASs) has reignited the debate on differential reporting, especially since the International Accounting Standards Board (IASB) issued a discussion document in June 2004 on SME reporting.

It is apparent the majority of national standard setters support an IASB-generated alternative reporting regime for SMEs, citing that IFRS developed specifically for listed entities are not relevant for SMEs. Benefits would include lower compliance costs for reporters who would face reduced disclosure due to simplified presentation. This would encourage continuing compliance to the IAS regime thus benefiting users when SMEs produce comparable financial information.

It is the objective of this paper to provide a review of the diversity in jurisdictional approaches to resolve these issues. This includes a discussion of the two approaches: the ‘top-down’ or the ‘bottom-up’ approach, with examples of each. This research has been motivated by the absence in academic literature of sufficient studies examining the underlying issues fundamental to redefining the balance between the accountability and decision-usefulness functions of general purpose financial reporting. To achieve this objective, this paper considers relevant academic and practitioner literature before undertaking an analysis of the issues this literature raises. Unique SME factors, including close-knit agency relationships, and a tendency to aim for survival and stability over profit maximisation and growth suggest a distinctly different focus to the IASB conceptual framework is required.

The prevalence of an unsubstantiated view that SMEs are ‘small entities on the way to becoming large entities’ overshadows the argument on whether and how SMEs should be offered relief from highly technical IAS. Some countries have regulation for SMEs already or are developing a Best Practice Guide for their SMEs. Exemptions may be based on a public accountability test (as in Canada), but Finland finds the Canadian example ‘too vague’ and New Zealand’s sector-neutral stance made the application of this definition too broad.

The IASB may limit definition to broad qualitative and quantitative SME boundaries in its struggle to provide a useful suite of SME accounting standards to nation states. Managing different worldviews and the demands of both preparers and users who are unused to lobbying at a high level, will be challenging for the IASB. Although the IASB originally aimed for a single set of conceptually robust SME standards, they must revisit the specific stewardship focus of SME reporting to gain traction in this project. The SME debate appears as a crucible in which the resolution of such tensions may in time be resolved.

1. Introduction

In the last fifteen years, many national standard setters have introduced differential reporting for small and medium enterprises (SMEs). Internationally, SMEs are a diverse and dynamic group which are described under broad characteristics in different countries. SMEs are not issuers or public sector entities and therefore frequently the qualitative criteria of not being publicly accountable may define these entities. Alternatively, quantitative criteria such as a maximum number of employees, assets or capital invested, and revenue may be used to establish which entities are not 'large'.

Acceptance and imposition of International Accounting Standards (IAS) as a growing worldwide phenomenon has not only changed the role of national standard setters, but also created observable differences in the standards themselves. The focal point has swung to the needs of large, publicly listed entities; away from widely applicable principles and standards and entity neutrality. International Financial Reporting Standards (IFRS) emerging from this process may therefore be complex and difficult for non-specialised practitioners to use; and the ensuing reports may be too complex for general-purpose financial report users to understand. Consequently, the debate on differential reporting has been reinitiated, especially since the International Accounting Standards Board (IASB) issued a discussion document in June 2004 on SME reporting (Deloitte Touche Tohmatsu, 2005).

It is apparent the majority of national standard setters support an IASB-generated alternative reporting regime for SMEs, citing that IFRS developed specifically for listed entities are not relevant for SMEs. Benefits would include lower compliance costs for reporters who would face reduced disclosure due to simplified presentation. This would encourage continuing compliance to the IAS regime thus benefiting users when SMEs produce comparable financial information.

Whilst there are a number of issues relating to identification of SMEs, a predominant concern of standard setters is whether the standards should be a simplification of current IFRS or, alternatively, whether SME standards should represent a whole new set of Generally Accepted Accounting Principles (GAAP). Protagonists' and antagonists' views may seem like 'a storm in a tea cup' but in fact the underlying concerns have wide applicability, not only for the simplification debate, but also for debates on applicability of IAS, and hence whether true harmonisation is an achievable goal. Both the stewardship or accountability role and a decision usefulness role¹ are goals of general-purpose financial reports. Therefore the IASB needs to develop both of these concepts and resolve these debates. It may be a long process.

It is the objective of this paper to provide a review of the diversity in jurisdictional approaches to resolve these issues. This includes a discussion of the two approaches: the 'top-down' or the 'bottom-up' approach along with an example of one country that has grappled with this issue in the past in summarising New Zealand's experiment with a Framework for Differential Reporting.

This research has been motivated by the absence in academic literature of sufficient studies examining the underlying issues fundamental to redefining the balance between the accountability and decision-usefulness functions of general purpose financial reporting. The SME debate appears as a crucible in which the resolution of such tensions may in time be resolved. To achieve this objective, this paper considers relevant academic and practitioner literature before undertaking an analysis of the issues this literature raises. The paper will conclude with a summary of learning from the past, along with a tentative prediction of possible outcomes for the IASB with regards to SME reporting standards.

2. Literature Review

There is a paucity of academic literature on the SME differential reporting debate. Practitioners' perceptions of differential reporting have been the focus of a number of studies (e.g. Holmes, Kent and Downey, 1991; Collis and Jarvis, 2002), whilst Williams and Tower (1998) considered preparers' attitudes and the ensuing cultural differences across two nation states. Periodically, professional bodies request academics to review the debate², and it is in this area that relevant literature occurs. Before reviewing the practitioner literature, a brief description of SMEs follows.

2.1 Defining the SME

John and Heleas (2000) define differences between large, publicly listed companies and small and medium enterprises in the United Kingdom. Firstly, in regards to current Companies Acts and indeed the manner in which financial reporting standards have evolved, there is an understanding that a small company is an entity on its way to becoming a large company. However, a significant majority of companies worldwide are not large, but in fact are quite small (for example 85% of New Zealand enterprises employ five or fewer staff). Further, the most recent statistics released by the Ministry of Economic Development show that for New Zealand firms employing fewer than 19 full time employees, the average firm size had shown a decrease on the previous year (from 5.22 to 5.18 full time equivalent employees)(2004a).). The New Zealand experience suggests that most companies do not grow to be large, and the understanding that they do is a misnomer.

Small and Medium enterprises have distinguishing characteristics other than their size. They are unlisted entities, run by owners who, along with perhaps family members and friends, provide the equity base. Naturally, not all unlisted entities meet

this criterion either, as co-operatives would prove one exception. Alternatively, non-SMEs are managed by employees (not owner/entrepreneurs) who must report to dispersed owners. This separation of ownership and control, which gives rise to accounting standards, is therefore the most significant point of differentiation (John and Heleas, 2000).

Other measures, apart from size and ownership that have been suggested as differentiation points for SMEs include the practice of innovation. New Zealand's Ministry of Economic Development describes them as "vibrant, dynamic, and innovative businesses" and suggests that SMEs

- have begun spontaneously with an innovative product
 - have an owner/manager with few generic business skills
 - have a tight family-like culture where the values of the owner are strongly shared by the staff and will include flexible workplace practices
 - use owners' personal assets (including their home) as security for the business
- (Ministry of Economic Development, 2004a)

Yet SMEs operate in an uncertain environment due to their small number of customers and suppliers; an inability to drive prices; and the fact that owners may frequently make choices not to maximise profits, but some other value (John and Helas, 2000). Establishing where these uncertainties define an entity type, or when they suggest a need to reassess the going concern assumption, is difficult. Further, financial and non-financial information is required to enable comparisons to other similar entities.

Despite a plethora of distinguishing characteristics, the IASB's project has sought a single suitable quantitative or qualitative measure to distinguish SMEs. Whilst the United Kingdom based Bolton Committee (1971) described measures as

segment specific (what constituted a large organisation in forestry was not the same as a large retailer), more recent projects in the United Kingdom, New Zealand and United States have described a “best out of three” qualitative measures system to reduce dependence on segment and sectoral differences³. Applicability of local economies and currencies to a worldwide definition provides challenges. Alternatively, qualitative measures may be used to describe the sector. The most common of these is the public ownership factor (as used in Canada) and this will be explored further in the practitioner literature review section.

2.2 Practitioner Literature

General Purpose Financial Reporting and a financial regulatory system with a coherent infrastructure are beneficial to economic development. Nationally a lack of accountability will deter foreign investment and aid agencies as well as contributing to financial instability (Devi, 2003). From the perspective of the individual enterprise, “lack of transparency and adequate financial disclosure leads to difficulties in obtaining finance and lack of knowledge with which to manage the enterprise” (Devi, 2003, p.7).

The benefits of a set of stable financial reporting standards to individual entities, local and national economies, encourages many nations to enact legislation forcing businesses to produce financial statements that conform to a GAAP suite. The challenge is to produce nationally accepted standards that are both comprehensive enough for large, publicly listed entity reporting as well as being clear and concise enough for SMEs to use; are not unduly burdensome, or irrelevant. In response regulatory systems may provide a base set of standards with exemptions for enterprises not meeting certain criteria (due to size or influence), called a “top-down” system. Alternatively, a new set of standards with simplified measurement and

disclosure requirements can be developed specifically for SMEs, comprising a “bottom-up” solution (Baskerville and Simpkins, 1997) as described in Section four.

The focus of practitioner literature on this topic relates largely to the political process of setting ‘acceptable’ standards. Within the SME area, preparers seek reassurance that the imposition of standards will not impose unnecessary costs. Regulators require compliance with standards to improve the transparency and accountability of financial statements. Further, users are concerned to obtain maximum benefit from the information provided. Therefore it is imperative that any standards are understandable and the ensuing financial reporting is comparable between entities and across different time periods.

3. Unbundling the objectives of Financial Reporting for SMEs

Stewardship and decision-usefulness are prime objectives of general purpose financial reporting. Information that is decision-useful will be value relevant requiring fair valuation of entity assets and liabilities. It is suggested that value relevance is less important for SMEs general purpose financial reporting than stewardship objectives owing to their unlisted nature. Entities such as co-operatives with aims other than the prime profit motive envisaged by the IASB framework, were particularly voluble in making this argument (German Cooperative and Raiffeisen Confederation, 2004); although the argument is also widely applicable to other SMEs (Deloitte Touche Tohmatsu, 2004). Stewardship reporting or accountability reflects demands on a steward managing delegated resources and is the nub of SME financial reporting. The reporting should be in a language that the users understand (Stewart, 1984) and meet common reporting concepts of reliability, timeliness, relevance and verifiability.

Regulation to ensure an optimal provision of accounting information is required, especially for contractual situations. Wolk, Francis, and Tearney (1992) understand the two benefits of regulation from this optimal provision are comparability across entities, and a resulting increase in confidence in the equity and lending markets.

With SMEs, owners closely associated with the entity are likely to obtain management, rather than general purpose financial reports. The need for financial reporting rises from contractual arrangements and, as with publicly listed companies; increased information flows can assist increased confidence in SMEs due to increased fiscal transparency (Watts, 2003). Increased comparability will benefit users of financial reports, but incurs preparer costs. However, user needs have primacy in an interpretative model as accounting, a symbolic mediator, is a facilitating tool to enhance communication with various stakeholders (Palmer and Vinten, 1998).

3.1 Principles of a cost-benefit analysis of regulation

Regulation through codification is evolutionary due to its political nature, but change occurs only when the associated preparer costs are adequately balanced by the expected economic benefits (Brown, 1990). As accounting information is a public good, preparers must be convinced the benefits of producing financial statements have a reasonable cost, they will not comply with standards. Full quantification of those costs is impossible, due to an inability to measure economic benefits of the increased information. Further, it is more likely that relative costs will reduce with increased entity size. Cost and benefit impacts are summarised in Table 1.

Accordingly, “resolving accounting questions is rarely a process of searching for a single correct answer. ...It is an inexact social science in which absolutely right answers are extremely rare” (Brown, 1990, p. 94). The technical considerations

referred to in Table 1; the conceptual considerations already discussed; the economic consequences of regulation and providing accounting information; are all-important.

TABLE 1 ABOUT HERE

Users are typically employees, managers, providers of loan finance, trade creditors and tax authorities as well as shareholders (European Accounting Association, 2004). Yet the number of users of individual SME's financial statements may be quite small. Therefore, even when the relative cost of producing fully compliant financial statements is low, full benefits may not be obtained (Korea Accounting Standards Board, 2004). Consequently standard imposition needs to consider the number and diversity of users, the existence of other non-financial information, as well as the relevance, reliability and timeliness of the financial information provided (Devi, 2003).

Therefore the decision base for selecting which entities fall into the SME catchment impacts the cost benefit argument. When a public accountability argument is the only basis (as in Canada), entity size is irrelevant. Small, publicly accountable entities with few employees may face high accounting costs; but large entities with no public accountability will be exempted from full IAS, due to the alternative conceptual argument.

In order to balance the perceived cost of complying with regulation against expected benefits to those involved with SMEs, differential reporting in regard to financial reporting standards has been utilised for a decade or more in Anglo-American countries such as New Zealand, Australia and the United Kingdom. Well-defined differential reporting standards can meet circumstantial requirements (Devi, 2003), and the differential reporting environments mentioned have retained fundamental concepts, whilst allowing disclosure exemptions for entities that fall

below qualitative or quantitative characteristics. The experience of some national standard 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 (Australian Accounting Standards Board, 2004).

Theoretical issues bifurcate the cost-benefit debate. The purity of conceptual framework application verses the specificity of measurement standards and needs for comparability are contested by those who believe SMEs should be exempted from recognition and measurement standards. The cost-benefit debate does not find an easy resolution because many of those discussing appear to infer that useful decisions about recognition and measurement, on a standard-by-standard basis can be made. In fact the debate we have observed fails to acknowledge that it is the distinctions within objectives of financial reporting impeding resolution. This is because the stewardship focus of SME user reporting takes a retrospective view, thus preferring reliability, whilst decision-usefulness favours relevance. It is typical in SMEs that key decisions are made by the owner, rather than management; and this is what distinguishes the stewardship relationships in small and medium enterprises from pervasive agency relationships in large enterprises.

Costs and benefits analysis is size, as well as jurisdiction, specific as evidenced by differential reporting regimes already in operation. The next section of this article will consider how different jurisdictions have approached SME definition.

3.2 Defining an SME – standard setters’ perspectives

When SMEs have differential reporting or a separate set of standards, two main schools of thought define SMEs. The first is public accountability (qualitative), whilst another is a size (quantitative) measure.

3.2.1 Qualitative measures:

Australia and Canada are two countries that utilise the concept of public accountability to define entities ineligible for reporting relief. In Canada, the concept of public accountability includes all issuers, trustees and public sector entities. Firms without public accountability may utilise differential reporting when all voting and non-voting owners of the enterprise consent to the application of differential exemptions (Devi, 2003). The Canadians are staunch that the use of any ‘bright-line’ tests (such as size) are artificial and do not clearly define the SME issue (Certified General Accountants Association of Canada, 2004)⁴.

The Australian definition of a reporting entity disallows any relief from financial reporting requirements for entities where owners are separated from management, where there is public accountability, or significant economic influence (proxying for size). Like Canada, they avoid a “bright-line” test. However, for entities falling outside the definition of a reporting entity, there are few constraints or requirements.

Other jurisdictions have found the concept of public accountability too vague to be workable as indicated in the response by the Registered Association of Certified Accountants in Finland (HTM-tilintarkastajat ry) to the IASB’s SME Discussion Document. They preferred a notion of listed versus unlisted entities as the defining characteristic. In this case, Public Debt Issuers utilising unlisted instruments only, would conceivably be subject to a lower level of scrutiny than listed companies. The

Finnish view represents a direct focus on the users as either capital markets investors or ‘other’ (HTM-tilintarkastajat ry, 2004).

3.2.2 Mixed methods

New Zealand has utilised both a public accountability test for defining reporting entities as well as size limits to exempt entities from full financial reporting standards. Its experiment with both qualitative and quantitative definitions will be described further in the section which considers “top-down” reporting.

The Philippines also uses a mixed method in defining which entities may elect a reduced level of GAAP when preparing financial reports. PAS 101 *Financial Reporting Standards for Non-Publicly Accountable Entities* states a preference for qualitative measures and reduces the reporting burden on non-issuers which are not in the public sector. However, entities which are deemed economically significant must report using the full suite of Philippine Accounting Standards (IFRS equivalents) (Republic of the Philippines Securities and Exchange Commission, 2005).

3.2.3 Quantitative measures

In the United Kingdom the Financial Reporting Standard for Smaller Entities (FRSSE) sets specific size levels to define an optional programme of modified standards for SMEs. However, the FRSSE has had lower-than-expected take-up as the Companies Act requires limited liability entities to prepare full accounts for shareholders (John and Heleas, 2000). Further, critics suggest that the reluctance of the United Kingdom’s regulatory body to adopt different recognition and measurement rules has limited the potential benefits of the FRSSE (Murphy and Page, 1998).

Size alone cannot describe a SME in varied segments or sectors. It may also be a weak indicator of the costs and benefits of financial reporting or of the role of

financial information (European Accounting Association, 2004). Whilst a combination of size factors (as used in New Zealand and the United Kingdom, for example) may be helpful in establishing the composition of the SME sector, it would be impossible to describe an internationally comparable range of bright-line tests. Alternatively, there may be national guidelines within legislation, which would absolve the IASB from such a decision.

However, whilst standard setters are concerned about compliance and the need to link financial reporting standards to national legal obligations, practitioners are more likely to be concerned with users of financial statements.

4. Differential Reporting: Users and Reporters

4.1 User needs

Users are concerned with the need for financial reports from SMEs to meet a primary stewardship focus; and comparability for SME financial statements, both inter and intra-entity.

John and Heleas (2000) trace the rise of the decision usefulness perspective over stewardship as a primary objective. The Trueblood Report (1973) and The Corporate Report (1975) represented early moves to prefer decision-usefulness over the stewardship concept. Heightened focus on securities markets as a means to resource corporate entities continues to thrust users as decision makers to the forefront, so that it now represents the key objective in the IASB's Framework for the Preparation and Presentation of Financial Statements (2001).

The European Committee of Central Balance Sheet Offices (III Working Group on ECCBSO, 2004) suggests at least two difficulties for users of SME accounts when full IFRS are used as a reporting base. Firstly, too many alternatives in

standards impair comparability. Secondly, fair value methods which require models and hypotheses may result in valuation being applied in an inconsistent manner. Resulting variable information bases may not be well understood by SME users who have a stewardship rather than a value relevant approach. The Registered Association of Certified Accountants in Finland proposed SME users do not need to understand underlying concepts in financial statements. However, users “desire credible financial reports, which are reliable, and that they can use confidently in their planning, control and decision-making” (HTM-tilintarkastajat ry, 2004, p.2).

As the financial reporting environment evolves to emphasise informational concerns, the challenge is to assess users’ needs and devise appropriate reporting mechanisms that will enhance accountability and transparency. There are unique SME concerns and any effort to regulate for such accountability will require balancing of user needs with the costs borne by preparers.

4.2 Preparers: Top-down and Bottom-up

Within differential reporting there are two approaches. One is the “top-down” system which can be divided into integral and distinct approaches (Baskerville and Simpkins, 1997). The integral approach details exemptions from standards for entities designated as SMEs (as used in New Zealand and discussed in the following section). In addition there is a distinct approach where separate standards are issued to cover any issues in the main standard set that would apply to SMEs. This *ad hoc* approach may leave gaps when standards are revised in an arbitrary manner to suit political agendas (Devi, 2003).

This confirms the experiment by the Swedish Accounting Board (BFN, or Bokföringsämnden) which attempted to simplify financial reporting standards by using a top-down, distinct approach without success. They found simplification left

IFRS unclear and incomprehensible. Small entities were unable to apply the simplified IFRS to their accounts preparation. Further, stakeholders had no need for ensuing financial statements which lacked comparability. Consequently, the BFN is now generating four different sets of accounting standards on the basis entities elect one of the four categories for their financial statement preparation (Bokförlingsämnden, 2004).

This second approach to differential reporting, the “bottom-up” system, begins with a new conceptual framework for SMEs and builds a completely different set of standards for them to use. The bottom-up approach is the preferred method in Denmark where the Danish Institute of State Authorised Public Accountants (Foreningen af Statsautoriserede Revisorer) has issued separate standards for SMEs. These were developed after analysis of user needs and have been readily accepted by the users (Foreningen af Statsautoriserede Revisorer, 2004).

In the United Kingdom however, practitioners from small accounting firms opposed a second set of standards which the FRSSE represented, citing difficulties with maintaining currency with two sets of accounting standards and concerns that large companies may be tempted to depart from large GAAP to utilise the FRSSE alternative valuation principles (Perrin, 1997). Simplified accounting standards may erode the importance of financial reporting as reduced disclosure requirements diminish transparency, clarity and comparability (Council on Corporate Disclosure and Governance, 2004).

Certainly there are greater costs to the economy from having two sets of standards. Preparers also need to learn both sets of standards; there are further costs to the regulators themselves; and users may not experience enhanced benefits if both sets of standards are used concurrently. Therefore the alternative simplification of

financial reporting standards for SMEs, is to apply a top-down approach to differential reporting.

4.3 Top-down: The New Zealand experience

In New Zealand the public sector and SMEs, and thus the wider community as a whole, now derives benefits from financial reporting standards (Ministry of Economic Development, 2004b). It was not until 1993 that New Zealand could anticipate enforceable or mandatory standards for all entities with the passing of the Financial Reporting Act; which occurred considerably later than in the United Kingdom or United States. Prior to this date standards were binding on accounting professionals only by virtue of the *Code of Ethics*.

The Financial Reporting Act provides a legal mandate for standards covering both the private and public sectors and SMEs so that all sectors now have the same legal authoritative support in standard application. This has led to more reliable and comparable financial reporting (Baskerville and Bradbury, 2004). As a result of standard setters having to consider application of particular accounting treatments to public sector transactions, ownership structures, and purchase agreements; the standard setting process became more rigorous. Efficiencies (and enhanced employment opportunities) were also considered to have been generated through greater mobility of chartered accountants between sectors and entities of different sizes, which are working to one set of standards.

4.3.1 The Framework for Differential Reporting

As part of a group of Exposure Drafts issued in 1992 during the Conceptual Framework project, Exposure Draft (ED) 92 proposed establishing a Framework for Differential Reporting. The exemptions to be allowed were to be decided on the basis of qualitative and quantitative aspects as summarised in Table 2. The exemptions

were from complete standards (such as the Cash Flow statement requirement and financial instrument disclosures) or for parts of standards (such as reporting Income tax liabilities and assets, and related party disclosures) (Baskerville and Simpkins, 1997).

Constituents' responses to the first ED reflected a high level of interest relative to responses on other Exposure Drafts (Baskerville, 1996, Baskerville and Newby, 2002). Regulators focused on determining a cost-benefit criterion, deeming public accountability as one of three proxies for this. There was little debate on accountability per se; and much more focus on the issue of whether or not two different sets of GAAP could both result in a true and fair view.

TABLE 2 ABOUT HERE

Para 4.18 of ED-92 stated that the size criteria would be reviewed regularly and the Financial Reporting Standards Board (FRSB) committed to re-visit the size criteria regularly so that it captured at least 80% of all companies in New Zealand. In so doing, it would also capture a large number of incorporated societies, co-operatives and other entities that would otherwise be left with heavy compliance costs. Thus in 1997 the FRSB again invited constituency response, increasing the size limits (Baskerville and Simpkins, 1997).

From 1997, entities such as Local Authority Trading Enterprises wholly owned by publicly accountable Local Bodies, were not permitted to utilise exemptions provided by the Framework. Thus an entity which parent or ultimate controlling entity was publicly accountable was no longer permitted to use the Framework. There was one notable example of a very large company utilising the Framework. When the Government privatised the national rail network, the new

company TranzRail had all shareholders on the Board, and so claimed that by being closely held they were eligible for exemptions by virtue of the Framework.

4.3.2 Financial Reporting Act Review Discussion Document April 2004.

Subsequent to the revision of levels and eligibility in 1997, no further public discussion on the Framework for Differential Reporting occurred until 2004. Then, the decision by New Zealand regulators to adopt IAS from 2007⁵ required that SMEs be reconsidered. Further, the Ministry of Economic Development had released a Discussion Document in 2002 on small entities (Ministry of Economic Development, 2002) and sought to encapsulate feedback from this within a revised Financial Reporting Act. The Review document expanded the public accountability definition to include a majority of not-for-profit entities as well as foreign owned entities which would impose NZIFRS on a much greater catchment than the then prevailing Framework (Ministry of Economic Development, 2004b). The sector neutral approach of New Zealand's standard setters meant that, unlike Canada and United Kingdom, there were no separate standards for not-for-profit entities, which would face an extreme cost burden under this proposed IFRS regime.

There was a "significant degree of comment from submitters" on this proposal (Ministry of Economic Development, 2004c). Accordingly, in a second FRA Review Discussion Document in November 2004, references to not-for-profit entities were dropped and only economically significant companies were required to report under NZIFRS. This has also now been reduced to include publicly accountable large entities only (see Appendix One). The size limits to define an SME were increased but, given the delay in the IASB's SME project, no reference as to the relevant GAAP for SMEs was provided. A broad definition of public accountability had little traction in the New Zealand environment.

The New Zealand situation of a ready acceptance of IFRS without a differential reporting base is a significant move away from the broad principles which have enabled it to manage all sectors. The “top-down” approach now needs to be revisited within an IASB framework that is written primarily for publicly listed entities whose users require decision-useful financial reporting.

5. Discussion

Implementing accounting standards encourages comparable financial reporting and delivers information on the stewardship of delegated resources; as well as information useful for making decisions about providing resources to an entity in the future (Institute of Chartered Accountants, 1993). Improved standards therefore enhance information utility. The requirement to produce financial accounts disciplines all enterprises, aiding the economy. It also reduces business owners’ uncertainty and increases SME financiers’ confidence (Devi, 2003). Accordingly, as the Brazilian Independent Accountants Institute (IBRACON, 2004) noted, the SME question is both strategic and technical.

Although nation states may find it cost-efficient to allow the IASB to develop SME standards, new financial accounting standards imposition undoubtedly increases preparers’ costs as evidenced in Table 1. Agency theory predicates that preparers will always attempt to reduce the costs of the production of financial statements. Alternatively, the interpretive approach recognises the ability of financial reporting standards to enhance communication with stakeholders. Unique SME factors, including close-knot agency relationships, a tendency to aim for survival and stability over profit maximisation and growth (John and Heleas, 2000); suggest a distinctly different focus to the IASB conceptual framework is required (European Accounting

Association, 2004). Although the IASB originally aimed for a single set of conceptually robust SME standards, they must revisit the specific stewardship focus of SME reporting to gain traction in this project.

The overwhelming call by submitters to ensure that an IASB SME set of standards produces financial statements meeting ‘user needs’ (e.g. Small and Medium Enterprise Agency of the Ministry of Economy, Trade and Industry Japan, 2004) is complicated by a lack of definition of those needs. Strong support for the stewardship objective of financial reporting, combined with a requirement to tailor SME reporting standards to likely users, has prompted the IASB to call for user feedback on their requirements. When the Jenkins Committee undertook a similar survey in the early 1990s, it was found the great majority of users were not participating actively in standard setting processes (Larsen, 1994), and neither do the SMEs themselves. Therefore obtaining information from SME users as to how they use financial statements and how these statements can be made more useful has proven extremely difficult.

Combined with an IASB review, an acceptable differential reporting framework strategy is required. Current practice shows that different nations have utilised a bottom-up approach and introduced entirely new standards for SMEs, changing disclosure requirements as well as, in some cases, measurement and recognition criteria. Others have utilised a top-down approach from a single conceptual base and provided differential reporting exemptions. Agreement intra-country on differential SME frameworks is difficult (Malaysian Accounting Standards Board, 2004), foreshadowing much IASB negotiation. The IASB has responded to national standard setters’ calls to include a variety of users, standard setters and accounting firms to assist with decisions (International Accounting Standards Board,

2004), and its increased working group may provide the most representative way forward in this difficult debate which challenges all standard setters.

The prevalence of an unsubstantiated view that SMEs are ‘small entities on the way to becoming large entities’ overshadows the argument on whether and how SMEs should be offered relief from highly technical IAS. Accordingly, defining which entities fall within the spectrum of an SME programme is the third challenge. Some countries have regulation for SMEs already (e.g. the German commercial code HGB-Handelsgesetzbuch, New Zealand FDR) or are developing a Best Practice Guide for their SMEs (e.g. Institute of Chartered Accountants in Australia, 2004). Exemptions may be based on a public accountability test (as in Canada), but Finland finds the Canadian example ‘too vague’ (HTM-tilintarkastajat, 2004) and New Zealand’s sector neutral stance made the application of this definition too broad. Other national standard setters exempt SMEs on a cost-benefit analysis due to size. This may be a weak indicator of both preparers’ costs and users’ benefits (European Accounting Association, 2004; Korea Accounting Standards Board, 2004) and a useful worldwide set of quantitative criteria seems an impossible task. The IASB may limit definition to broad qualitative and quantitative SME boundaries in its struggle to provide a useful suite of SME accounting standards to nation states.

Managing different worldviews and the demands of both preparers and users who are unused to lobbying at a high level, will be challenging for the IASB.

6. Conclusion

Differential reporting for SMEs has increased worldwide in the last fifteen years. The recent imposition of IFRSs by many governments has created a predicament for the IASB. Despite a wave of support for its recent SME Discussion Document, the IASB

has been encouraged by submitters to re-visit its conceptual framework and also to reconsider technical pronouncements on measurement and disclosure specifically for SMEs.

The IASB has therefore been encouraged to learn from other standard setters so as not to undermine its credibility (BDO Netherlands, 2004). It must balance the real benefits of regulated accounting to users against the costs to preparers. Achieving a workable SME composition definition will only occur when the IASB involves practitioners and users of SME reports in the standard setting process. Furthermore, the IASB recognises the manner in which it responds to the challenge of differential reporting will signal commitment to future debate and negotiated harmonisation of accounting as a mediating language.

¹ The stewardship or accountability role is defined in the New Zealand Statement of Concepts as assisting users to assess the reporting entity's financial and service performance, financial position and cash flows (their reports); and the entity's compliance with legislation, regulations, common law and contractual arrangements, as these relate to the assessment of their reports.

The decision usefulness role is defined in the New Zealand Statement of Concepts as an ability to assist users to make decisions about providing resources to, or doing business with, the reporting entity.

² For example, John and Heleas (2000) for ACCA; Devi (2003) for CAPA.

³ See Appendix One for a comparison of definitions from five IASB members.

⁴ However Canada has separate accounting regulations for not-for-profit entities as well as the public sector and therefore, unlike New Zealand, does not seek sector neutrality.

⁵ Early adopters may use NZIFRS from 2005.

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Appendix One: Definitions of SMEs in specific countries

Country	Qualitative	Quantitative	Top-down or Bottom-up Approaches used?	Measurement/recognition exemptions?
New Zealand	<ul style="list-style-type: none"> • Not publicly accountable (including issuers and public sector) • Closely held AND 	<ul style="list-style-type: none"> • Total income >\$20m (US\$13.6m) • Total assets > \$10m (US\$6.8m) • > 50 employees 	Top-down with sector and entity neutral IFRS compliant standards (NZ IFRS). SMEs have a framework for Differential Reporting exempting SMEs from certain NZ IFRS.	Differential disclosure and some measurement exemptions.
Australia	<ul style="list-style-type: none"> • Have no public users 		No standards for non-reporting entities	Not applicable
Canada	<ul style="list-style-type: none"> • Have no public accountability (including issuers and public sector) • Approval of all owners to adopt differential reporting 	None	Top-down with optional application of exemptions from full Canadian Financial Reporting Standards.	Differential disclosure and some measurement exemptions.
United Kingdom (Based on EU legislation)	<ul style="list-style-type: none"> • 	<ul style="list-style-type: none"> • Turnover < £5.6m (US\$10m) • Net Assets < £2.8m (US\$5m) • Average number of employees < 50 	Bottom-up approach with FRSSE a complete set of reporting requirements.	Differential disclosure exemptions only.
The Philippines	<ul style="list-style-type: none"> • Not publicly accountable AND 	<ul style="list-style-type: none"> • Total assets > P250m (US\$4.7m) • Total liabilities > P150m (US\$2.8m) 	Top-down. SMEs are exempted from IFRS equivalents (PFRS). SMEs may apply a reduced set of old Philippine Financial Accounting Standards.	Differential disclosure exemptions only.

Standard/Regulation Impact:	Costs to preparers	Benefits to users
In a regulated market	<ol style="list-style-type: none"> 1. Collecting and processing information required to meet standards. 2. Audit costs. 3. Dissemination costs. 	<ol style="list-style-type: none"> 1. Credibility of financial reports increases lender confidence. 2. Results in lower capital costs and increased availability.
Where standards are changed	<ol style="list-style-type: none"> 1. Effort to analyse, understand and interpret new information requirements. 2. Processing excessive information and rejecting redundant information impacts entity. 	<ol style="list-style-type: none"> 1. Enhanced user utility of the information increasing benefits above. 2. More informed evaluations due to better accounting information may improve investment selection.
Unidentifiable (in strict dollar terms) consequences	<ol style="list-style-type: none"> 1. Decrease in availability of capital or increase in its cost due to changed user decisions. 2. Occurs when standard is dysfunctional with management's objectives. 3. Standard causes management to act in uneconomic ways. 4. Competitive advantage is lost. 	<ol style="list-style-type: none"> 1. Change in accounting standards may affect contractual arrangements with a wide range of stakeholders. 2. Knowledge base needs to expand in order to understand SME accounting reports. 3. Political, social and moral impact may be beneficial or harmful.

Table 1. Costs and Benefits in Accounting Regulation (extracted from Brown, 1990, p. 90-93)

Regulatory Event	Eligibility proposed on the basis of	Size limits: ‘Small’ if the entity met two of three of the following:
ED91 1992	Small Size or lack of public accountability or closely held	Revenue under \$1.5 million Assets under \$1 million Under 10 employees
1994 Framework for Differential Reporting	Small Size or lack of public accountability or closely held	Revenue under \$2.5 million Assets under \$1.5 million Under 20 employees
1997 Framework for Differential Reporting	Small Size or lack of public accountability or closely held or not being a subsidiary of a publicly accountable entity	Revenue under \$5 million Assets under \$2.5 million Under 20 employees

Table 2: Stages of New Zealand’s Framework for Differential Reporting