**Research Note**

# Small Enterprises and Convergence with International Financial Reporting Standards[1]

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## Abstract

*The purpose of this paper is to explore the intersection between financial reporting research and small business management. This is achieved by an examination of issues surrounding the differential reporting debate for small business financial reporting. In particular the impact on small business of a policy to adopt international financial reporting standards is examined. Data gathered from a survey of the preparers of small business financial reports are used. The data analysis shows that the concept of user dependency is accepted by financial report preparers as a valid discriminator for differential reporting purposes.*

## Introduction

When the International Accounting Standards Committee (IASC) was formed in 1973 it assumed responsibility for developing International Accounting Standards (IAS) suitable for use around the world. Although the IASC produced a considerable number of IAS many of the major developed nations continued to develop and use their own national accounting standards. In 2001 the IASC was reorganized into the International Accounting Standards Board (IASB) and has since revised many of the IAS. It has also produced five standards in a new series known as International Financial Reporting Standards (IFRS). It is clear that the prime users of the IAS and IFRS (IAS/IFRS) are participants in the capital markets (Jarvis 2003). That is, IAS/IFRS are primarily designed for companies that have securities traded on capital markets (*listed* companies). Companies that do not have securities traded on capital markets (*unlisted* companies) tend to not use the capital markets to raise finance. Therefore it is likely that both the users of the financial reports of listed and unlisted companies, and the needs of those users, will differ. Evidence from research suggests that while listed companies are large, unlisted companies tend to be small businesses. This suggests a case for differentiating between large and small businesses on the basis of their different users and needs.

The Australian Financial Reporting Council recently announced that it would be proceeding to converge with IAS/IFRS for Australian financial reporting entities from 1 January 2005 (Australian Financial Review 2004). In 2001 when Australia agreed to adopt the IAS/IFRS

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for financial reporting from January 2005, it appeared that it would be only one of many countries formally abandoning their national accounting standards in favour of a separately agreed, common, set of standards (Townsend 2004). However, Canada, Japan and the United States (US) have all since decided to retain their independence. New Zealand and the countries of the European Union have remained committed to convergence with IAS/IFRS.

Harmonisation of national accounting standards involves issuing and revising accounting standards to be consistent. Commonly, harmonisation has meant *bringing the standards of different countries more into line with each other"* (Haswell and McKinnon 2003:8). Convergence is *akin to the outright adoption* (Knapp and Kemp 2004:xviii) of IAS/IFRS. Concern about the need for harmonisation/convergence of financial reporting philosophies across national borders has been evident in the literature from the early 1960s (Watson 1962; Mahon 1965). More recently Sharpe (1999) saw convergence as a means to reduce the cost of capital in a global economy. Yong (2003) also identified the underlying drive towards international convergence of accounting standards as resulting from the globalisation of financial markets and the need to meet securities regulators concerns, while Haswell and McKinnon (2003:8) argued that the main reason for harmonisation is *to reduce the information costs of transporting capital around the world.* Research exists to suggest that financial markets are capable of reconciling financial reports prepared using national generally accepted accounting principles (GAAP) to reflect numbers that would be determined under another jurisdiction's GAAP or under IAS/IFRS (Lev and Sougiannis 1996), so clearly capital market efficiency provides the theoretical justification for convergence. The implication is that standardisation of accounting standards allows companies to avoid the cost of compliance with GAAP in different jurisdictions (*preparer* perspective); and security analysts to avoid the costly acquisition of specialised expertise in GAAP (*user* perspective).

## The Research Issue

The research in this study focuses on the preferred model of financial reporting for small business entities. Subsidiary matters centre on (1) the purpose; and (2) the users of small business financial reports. Financial reports are of limited relevance if the information they contain fails to satisfy the needs of the report users. If financial reports prepared in compliance with IAS/IFRS fail to meet the needs of small business report users a strong case for differentiating rather than standardising the financial reporting requirements of small business entities may exist. Therefore differential reporting is an important aspect of financial reporting for small business.

There are a number of complex issues that need to be addressed when considering differential reporting. Brailsford and Ramsey (1993:54-5) raised some of these issues including: (1) how is the decision to determine an entity's reporting status made; and in the Australian context (2) whether the reporting entity concept of the Australian Conceptual Framework for financial reporting (*conceptual framework*) adequately services the needs of users.

Additionally the cost/benefit considerations need to be addressed as cost/benefit provides a conceptual underpinning for differential reporting. Relevant costs for small business include the time needed to acquire and maintain the intellectual capital needed to comply with technically sophisticated financial reporting standards. The benefits to small business users are likely to be relatively low. The reporting implications for small business under the IAS/IFRS reporting regime could be quite onerous. The potential burden on small business if

IAS/IFRS are imposed on all profit seeking entities makes investigation of the issue important. Practitioner opinions that provide a direction to the vexing issues surrounding differential reporting are important so that submissions to the government and the IASB from the accounting profession are provided on an informed basis. Research in this particular area is both relevant and timely as the deadline for Australian convergence with IAS/IFRS is 2005.

## Literature Review

Differential reporting is a notion that some organisations should be permitted to depart from either all, or some, of the requirements of particular accounting standards when preparing their own financial reports (HKSA 2002). Nair and Rittenberg (1983) described differential reporting as a notion that certain reporting entities may be exempted from the application of specific accounting standards because of their size, legal structure, ownership, sector (public/private/industry), or the presence of a dependent user. The implication arising from these views is that distinct accounting and reporting rules should govern conceptually different organisations.

McCahey and Ramsey (1989) asserted that differential reporting is a response to the problem of accounting standards overload. This argument has been advanced in favour of exempting small businesses from the application of certain requirements on the basis that the costs of preparing reports, which comply with all financial reporting regulation, exceed the benefits that flow from such compliance. Mersereau (2003) argued that differential reporting does not necessarily mean fewer requirements for financial report preparers or less information for users. Rather, it should help preparers produce more useful and understandable information for the users of their financial reports.

While much of the discussion on the verbatim adoption of IAS/IFRS has focused on large organisations (Sharpe 1999; Brown and Clinch 1998; Howieson 1998), there are also a significant number of impacts on the small business sector. Parker (2003:65) warned that some small businesses will be more affected than others *but all will be impacted.*

In the face of mixed predictions and uncertainty as to the benefits or otherwise of convergence there is room for a fuller consideration of the impact of this policy change on small business. Small businesses have fewer resources available to deal with financial reporting compliance than do large organisations thus concerns regarding the financial reporting burden on small business are justified given the disproportionately higher compliance costs that this sector faces relative to larger organisations. Some evidence supporting this contention appears in the literature. For instance Haswell and McKinnon (2003) argued that a result of convergence will be that small companies which have no direct involvement with foreign ownership or enterprises will be faced with massive changeover costs with no obvious immediate benefit.

The differential reporting debate was an issue of considerable importance *particularly in the US* (Holmes Kent and Downer 1991:126) in the 1980s. It was also an important issue in Australia at that time as accounting regulators were engaged in development of a conceptual framework for financial reporting. The Australian regulators formed the view that the focus of financial reporting should be to provide general purpose information that is common to the needs of the broad range of users who are unable to command the preparation of reports tailored to their own particular needs. The regulators labelled the organisations that are required to prepare general purpose financial reports as *reporting entities*. Under this conceptual approach to financial reporting no exceptions were deemed appropriate on the basis of defining characteristics such as "size, ownership", (McCahey and Ramsey 1989:83) structure, sector, users or nature of operations although it has been acknowledged that size may act as a surrogate for the existence of dependent users (CAPA 2003; Mersereau 2003). Thus small and large organisations in Australia are, in principle, subject to the same theoretical framework for financial reporting.

Australia has to some extent embraced the concept of differential reporting through the Corporations Act 2001 (*Corporations Act*) and the conceptual framework. The Corporations Act contains a *Small/Large* test which directs whether or not a company must comply with the accounting and financial reporting requirements of the Corporations Act. The conceptual framework focuses on reporting entities which are required to provide general purpose financial reports to satisfy the common needs of a broad range of users who are unable to command specific purpose financial reports. If a company is not regarded as a reporting entity it need not comply with Australian accounting standards.

Recent comments by Dixon (2003:5) suggest that this situation may not continue after the adoption of IAS/IFRS in 2005.

> *In the immediate future, Australia will be retaining the Reporting Entity concept. However, the form of differential reporting in the future may move to a European proposal which differentiates between listed companies and other entities. A concept of differential reporting favoured by Sir David Tweedie, Chairman of the IASB.*

Alfredson (2003:6) supported this view when he suggested that the differential reporting issue should be dealt with in conjunction with the IASB's project on small business reporting (IASB 2004). Meanwhile, he argued, the existing regime based on the reporting entity concept should remain.

Under the Corporations Act, whether the accounting and financial reporting requirements of the Corporations Act are imposed on an unlisted company, depends on whether it is classified as small or large. An unlisted company is classified as small if it satisfies at least two of the following tests: (1) gross operating revenue of less than \$10 million for the year; (2) gross assets of less than \$5 million at the end of the year; and, (3) fewer than 50 employees at the end of the year. An unlisted company that does not satisfy at least two of these tests is classified as large (Corporations Act 2001:S10.1). The majority of unlisted companies in Australia are small under these tests. Small unlisted companies are obliged to prepare an annual financial report if shareholders controlling at least five per cent of the votes give the company the direction to do so, or, if it is controlled by a foreign company (Corporations Act 2001:S.10.3). If obliged to report, the small company annual financial report must be in accordance with applicable accounting standards. A large unlisted company must prepare annual financial reports and a directors' report, have the financial report audited and send both reports to shareholders (Corporations Act 2001:S10.3).

Although the Australian Accounting Standards Board (AASB) has decided that IAS/IFRS should be used as the foundation standards to which material, detailing scope and applicability of the standard in the Australian environment will be added (Chalmers and Shying 2003), it has also identified two sectors where differential financial reporting will apply. These are the *not-for-profit* sector including the *public* sector. While the AASB makes standards that are sector neutral, the IAS/IFRS are limited to *for-profit* entities (Knapp and Kemp 2004). Therefore the AASB will, where necessary, need to add text in order to adequately deal with issues in the not-for-profit and public sectors.

McCahey and Ramsey (1989) considered a number of differential reporting proposals including: (1) the simplification of accounting standards; and, (2) differential disclosure within accounting standards. While they regarded simplification as an appealing concept, they argued that this approach would not satisfy the need for guidance on emerging issues. They also asserted that reporting costs are generally associated with measurement requirements rather than disclosure requirements and so differential disclosure would be unlikely to solve the cost/benefit problem of financial reporting. Two other differential reporting models, the *integral* and the *distinct* models (Howieson [1998] refers to the distinct model as the *selective* model), were discussed in CAPA (2003). The *integral* model provides for exemptions to components within accounting standards specifically to suit the circumstances of small business and the needs of their financial report users. The *distinct* model requires the preparation of a separate accounting standard comprising all the issues that are addressed in the IAS/IFRS that are relevant to small business. The distinct approach has been criticised on the grounds that components could be selected arbitrarily, and if not updated on a timely basis it would suffer from incompleteness.

## Research Method

An internet survey of practitioners engaged in small business financial reporting was conducted to determine their attitudes to the introduction of IAS/IFRS. A survey was considered the most appropriate research method given that prior studies have mainly been limited to normative pronouncements. The practitioner survey method was also used by Holmes Kent and Downer (1991) in a similar investigation. They sought the opinions of practitioners regarding the appropriate application of a selection of national accounting standards to a range of different sized and legal business structures.

Survey participation was invited from members of a professional organization, CPA Australia, who were involved in financial reporting matters for small business. The invitation to participate was extended through *CPA Online*, a weekly electronic newsletter. A web address was provided and in anticipation of a low response rate, an incentive was offered by CPA Australia, the research sponsor, to members who responded promptly. 52 practitioners providing usable responses to the survey. The use of CPA Australia's database of members is heavily restricted in order to protect members' privacy and confidentiality and as a consequence the survey could only be administered once. This restriction on subsequent administration of the survey prevented the improvement of the response rate. Details of the size of the population, the awareness of the population of the internet survey, and the demographic representativeness of the population were not available to the researchers. The generalisability of the research outcomes must be viewed in this context.

## Presentation and Discussion of Data

The data presented in Tables 1 to 3 provide information on aspects of the financial report preparation process. Data was gathered on: (1) the reporting models used in this process; (2) the frequency of report preparation; and, (3) the type of report prepared by respondents.

The data presented in Table 1 indicates the financial reporting model identified as relevant to the small business financial reports prepared by the respondents. Respondents were able to identify their use of one or more of the models described in Table 1. A further response category was provided to identify any *Other* reporting models used however no responses were recorded in this category. Although this may be suggesting that *Other* reporting models have little relevance for small business financial reporting, it could also be indicating a lack of awareness of other models.

**Table 1**
**Financial reporting models employed in report preparation**

| Model categories | Frequency | Percentage |
|---|---|---|
| GAAP | 24 | 46.2 |
| National accounting standards | 31 | 59.6 |
| Australian conceptual framework | 11 | 21.2 |

Respondents were asked to indicate the frequency and type of small business reports prepared other than annual financial reports. The data presented in Table 2 indicates the frequency of *Other* report preparation and the data in Table 3 shows the type of *Other* report that is prepared. A large proportion of small business financial report preparers (82.7%, Table 2) have a regular commitment to the preparation of small business financial reports that are not annual financial reports. The type of *Other* small business financial reports prepared by respondents reflects both internal management reporting requirements (71.2%, Table 3) and the requirements of the Australian taxation regime.

**Table 2**
**Frequency of report preparation**

| Timing categories | Frequency | Percentage |
|---|---|---|
| Daily | 4 | 7.7 |
| Monthly | 27 | 51.9 |
| Quarterly | 12 | 23.1 |
| Not at all | 5 | 9.6 |

**Table 3**
**Type of *Other* reports prepared**

| Report type categories | Frequency | Percentage |
|---|---|---|
| Budgeted financial reports | 37 | 71.2 |
| Income tax returns | 26 | 50.0 |
| Goods & services tax returns | 34 | 65.4 |
| Business activity statements | 18 | 34.6 |

## Appropriateness of Differential Models

An aim of this research was to explore practitioners' perceptions of the appropriateness of the extant differential financial reporting models as specified in the conceptual framework and the Corporations Act. The key points and measures of the differential reporting models addressed in the survey were: (1) User dependency (conceptual framework); (2) Gross operating revenue < $10m for the year (Corporations Act); (3) Gross assets < less than $5m at year end (Corporations Act); and, (4) < 50 employees at year end (Corporations Act).

The existence of users who are dependent on general purpose financial reports was deemed by more than 71 percent of respondents (Table 4) to be an appropriate criterion for classifying businesses as small or large for the purposes of differential financial reporting. This outcome reflects the fact that Australian accounting practitioners have, since 1991, operated within a conceptual framework for financial reporting that determines the need for financial reporting solely on the basis of the existence of users reliant on general purpose financial reports.

Importantly, there is a significant lack of support amongst respondents for the criteria (Revenue, Assets, Employees) specified in the Corporations Act. The *Small/Large* test contained in the Corporations Act is not conceptually based, it is arbitrary. An implication of this research outcome is that there may be other measures that determine the difference between small and large entities more effectively.

**Table 4**
**Applicability of extant differential model to small business**

| Differential point | Small | Large |
|---|---|---|
| | Percentage | Percentage |
| User dependency | 73.1 | 71.2 |
| Gross revenue < $10m | 42.3 | 0.0 |
| Gross assets < $5m | 38.5 | 32.7 |
| Fewer than 50 employees | 30.8 | 25.0 |

Further differential points were added to explore whether (1) respondents perceived the arbitrary threshold of $10 million for revenue to be too low, and/or (2) whether other balance sheet indicators (liabilities; equity, other) were perceived as relevant to the classification of entities for the purposes of differential reporting. Perceptions as to the appropriateness of these differential points in categorising entities as small or large were determined by having respondents indicate the applicability of the measure for identifying a reporting entity. The additional differential points were: (1) Annual turnover (quantum requested); (2) Equity at reporting date (comments requested); (3) Financial liabilities at reporting date (comments requested); and (4) Other (as separately identified by respondents).

As shown in Table 5 respondents did not offer any views on Annual Turnover as an appropriate alternative to the Gross Revenue test contained within the Corporations Act.

**Table 5**
**Support for differential points including Annual Turnover**

| Differential points | Small | | Large | |
|---|---|---|---|---|
| | *n* | Percent | *n* | Percent |
| User dependency | 38 | 73.1 | 37 | 71.2 |
| Annual turnover <$50m | - | - | - | - |
| Gross revenue < $10m | 22 | 42.3 | - | - |
| Gross assets < $5m | 20 | 38.5 | 17 | 32.7 |
| Fewer than 50 employees | 16 | 30.8 | 13 | 25.0 |

Additional comments as to appropriate differential points for classification of entities as small or large for the purposes of differential financial reporting provided by respondents are summarised in Table 6.

**Table 6**
**Comments regarding additional/alternative differential points**

| Indicator | Number of comments received | Comments received regarding classification of small and large entities |
|---|---|---|
| Turnover | 6 | Suggested range of turnover for small entities \$5M -\$50M |
| Revenue | 0 | No additional comments made |
| Assets | 1 | For large entities assets greater than \$2M |
| Employees | 7 | Range for small entities 25 -75 and for large entities, greater than 50 |
| Equity | 15 | Range for small entities \$10,000 - \$20M and for large entities, greater than \$2M |
| Liabilities | 18 | Range for small entities \$0 -\$10M and for large entities, greater than \$100,000 |
| Other | 9 | Comments reflected extant differential points: additional comments included; larger size of entities; use of the income tax return; number of shareholders; customers; interest coverage ratio; societal impact |

The respondents provided a diverse set of comments that reflected dissatisfaction with the arbitrary nature of the *Small/Large* test provided in the Corporations Act. The number and scope of comments regarding equity and liabilities and the relatively low ranges suggests that the internal and external funding position of entities are perceived, by respondents, to be important measures. The *Other* indicator yielded nine comments and of particular interest were references to the number of shareholders, interest coverage ratio and societal impact as potential differential indicators.

### Users of Small Entity Financial Reports

The respondents were asked to rank groups they considered to be the main users of small business financial reports. The response data are summarised and presented in Table 7.

**Table 7**
**Users of small business financial reports**

| Question | Rank |
|---|---|
| Owners | 3 |
| Non-manager shareholders | 4 |
| Managers | 5 |
| Competitors | 9 |
| Trading banks | 2 |
| Finance companies | 1 |
| Trade creditors | 7 |
| Government | 8 |
| Industry/Trade associations | 10 |
| Employees/Unions | 11 |
| Public | 12 |
| Tax authorities | 6 |

Respondents identified two major groups as extensive users of the financial reports of small business. These are: (1) Finance companies and Trading banks; and (2) Owners/Non-manager shareholders/Managers. This result is consistent with other evidence that the primary users of small business financial reports are owners as managers, and banks that provide the main source of funding to small business. Those users considered by respondents to have little use for the financial reports of small business include: Competitors; Industry/Trade associations; Employees/Unions; and the public. This outcome gives cause to reconsider the real, as opposed to the theorised, relevance of small business financial reports to the user groups identified under the conceptual framework in SAC 2 (Accounting Standards Review Board 1990: Paras. 18, 19).

## Purpose of Small Entity Financial Reports

Respondents provided feedback on their perception of the purpose of small business financial reports. The data is summarised and presented in Table 8.

**Table 8**
**Perceptions of the purpose of small business financial reports**

| Question | Rank |
|---|---|
| Investment | 5 |
| Management | 2 |
| Accountability | 3 |
| Taxation | 1 |
| Stewardship | 4 |

The highest ranked use of small business financial reports reflects the need for compliance (taxation). Respondents also provided a strong view that small business financial reports were used for management purposes. Stewardship and Investment purposes ranked lowest. An implication of this research outcome is that small business financial reports are of limited relevance to capital market participants other than to those bank(er)s directly involved in venture capital loans to small business. The low ranking for Stewardship may be reflecting the low intensity (or absence) of the agency problem that, theory holds, is created when ownership is separated from management. This outcome has implications for the need to apply corporate governance regulation to small business particularly in light of the associated cost of application.

## Conclusions

This research contributes to a better understanding of the nature, frequency and users of small business financial reports. The overarching intention in this research was to identify practitioners' preferred model of financial reporting for small business. In the process an investigation of the appropriateness of the differential reporting models of the conceptual framework and the Corporations Act was also conducted. The existence of users who are dependent on general purpose financial reports as an appropriate discriminator for *Small/Large* entities for the purposes of financial reporting has practitioner support, and a lack of support for the criteria specified in the Corporations Act as relevant discriminators for the *Small/Large* entity test was noted. This outcome suggests that the arbitrary Revenue/Assets/Employee test contained within the Corporations Act is overdue for revision.

This presents an opportunity for both policymakers and academics to consider the theoretical and practical merits of replacement discriminators that are selected conceptually rather than arbitrarily.

The data used in this paper posed some limitations on the form of analysis that could be undertaken and the relationships that could be explored. In particular the survey instrument could only be delivered once to the population of interest. Therefore a relatively small sample size was obtained. Further the data is a single snapshot providing a preparer rather than a user perspective. However, the data obtained provides important indicators that the theoretical underpinnings of the conceptual framework may have relevance for small business financial reporting; but that the financial reports of small business are not relevant to the full range of users identified in that framework.

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