THE EFFECTS OF INTERNATIONAL FINANCIAL REPORTING STANDARDS DISCLOSURE FOR SMALL AND MEDIUM ENTERPRISES (IFRS FOR SMEs) ON PROFITABILITY UNDER THE RETAIL SECTOR

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ABSTRACT

At the dawn of the 21st century, businesses from all over the globe started crossing geographical boundaries to compete in the international market. Several breakthroughs impacted not only on the firms' ability to generate profits but also their ability to provide accounting information to various stakeholders. As business innovations continue to push through, globalization further necessitated transparency and comparability across entities regardless of geographical location. Hence, the IASB published international standards tailored for established and large corporations. This, however, posed burden to small and medium sized entities. As a proactive response, the IASB subsequently crafted a firm-specific standard now known as the IFRS for SMEs. This set of standards was later adopted by the Philippines and renamed it to PFRS for SMEs.

This study determined that on a general level, compliance level among entities in the retail trade industry had increased by adapting the PFRS for SMEs. However, further testing suggests that such increase was insignificant. After assessing the compliance level through testing the disclosure indices, this study tested whether there has been a significant difference on the financial performance of the entities before and after adapting the PFRS for SMEs as evidenced by the entities' financial ratios. The result of the test indicated that there is no significant difference.

Keywords: *International Financial Reporting Standard, Accounting Standards for Small and Medium Enterprises, Disclosure Index and Profitability.*

INTRODUCTION

The International Accounting Standards Board (IASB) established the International Financial Reporting Standards (IFRS) in April 2001 with the purpose of employing comparative financial reporting among countries. These accounting standards are principle-based rather than rule-based. Also, the IFRS removed certain discretions that were once present before its promulgation. In the Philippines, it was adopted in 2004 and was renamed to the Philippine Financial Reporting Standards (PFRSs) and the Philippine Accounting Standards (PASs). The Philippine Securities and Exchange Commission mandates publicly-listed companies to apply these standards in the financial statements that they submit. However, full compliance has presented problems to corporations, even the biggest ones. Besides the ever-increasing complexities, the cost of compliance cast significant doubt as to whether it is cost-beneficial to comply.

Considering the challenges of full compliance faced even by the well-established large corporations, it is certain that smaller-scale companies face the same dilemma. Perhaps, it is safe to assume that the degree of difficulty is greater for them because of the limited resources they have. Philippines, as a country, is dominated by small and medium-sized entities (SMEs). In fact, more than 99% of the businesses in the Philippines are classified as SMEs (DTI, 2011). Indeed, the importance of SMEs in nation building is unquestionable as they provide employment to a lot of Filipinos. This trend of being dominated by SMEs is apparent not just in the Philippines, but in the whole world as well. Hence, a set of accounting standards specifically tailored for these entities is of great necessity thereby giving birth to International Financial Reporting Standards for SMEs (IFRS for SMEs) and Philippine Financial Reporting Standards for SMEs (PFRS for SMEs).

Considering that most companies are relatively small to medium in size, complying with all of the provisions seems impractical and costly, and sometimes impossible due to certain circumstances present. The solution to this was the creation of a more simplified version of the IFRS, which is the International Financial Reporting Standard for SMEs. The IASB removed unnecessary requirements which bore little relevance to small and medium entities. This will make financial reporting for them easier and less costly while still maintaining the high quality of information reported. The Philippines welcomed the new standard and officially took effect last January 2010, renaming it to the Philippine Reporting Standard for SMEs (PFRS for SMEs).

Noting that the PFRS for SMEs is just a mere simplification of the Full PFRS, the nuts and bolts of the latter should still be intact to the former. However, the certain accounting treatments, one of which is accounting for provisions, may pose differences in the figures presented in the financial statement. Thus, this may result to variances on financial ratios calculated on both standards. According to Palka and Svitakova (2011) in the "Impact of IFRS for SMEs Adoption on Performance of Czech Companies", the conversion of statements from the Czech Accounting Standards to International Financial Reporting Standard for Small and Medium-sized-Entities showed that the results of the financial ratios were affected by the said conversion. However, it was proven that the overall effect on the financial ratios were insignificant since the average deviation of the financial ratios were too low, which are below 1.5% of the value of the indicators. This paper aims to answer the question, what was the extent of the effect of compliance with PFRS for SMEs on profitability of companies belong to retailing industry?

THEORETICAL FRAMEWORK

Agency Theory

In relation to stakeholder theory, the agency theory assumes that the interest of the principal (the stakeholder) and the agent (the manager) diverges (Hill & Jones, 1992). The conflict between the interests of the former and latter could produce an undesirable outcome for the company which could put one party at a disadvantage over the other through possible biased financial information. The stakeholders have no option but to trust the manager on handling the affairs of the company and in providing the right information, since they rely on the published documents that are available for the public to view from authorized and legal sites. The risk of conflict of interests with the manager can be reduced by offering incentives in order for him to have a motivation to consider alternatives that would benefit most, if not all, stakeholders. This study enables the management to see the benefit of abiding with the PFRS for SMEs through the determination of the relation of the new standard with the financial ratios. A positive relationship between compliance and ratios will encourage managers to present their information according to the standards because it is in their interest to display a good company performance to shareholders and potential business partners.

Stewardship Theory

In contrast, the stewardship theory sees the relationship between the principal and agent with confidence. Managers are believed to be stewards whose motives are aligned with the objective of company principles and are not motivated by their individual thoughts. Maximizing their authority as managers, they strive to protect both the shareholders' and stakeholders' wealth. They are trusted to deliver the right information to the owners and to others who have interest in the firm. This is the ideal situation for the stakeholders so that they would not have any doubts regarding the information presented to them.

The agency theory and the stewardship theory are the ideas which pertain to the perception of those who rely on another to do what is deemed appropriate. The relationship in the stewardship theory is the type of affiliation that the stakeholders would want to have with the management with regard to the information disclosed to the public. It is in contrast with the agency theory, which is characterized by the lack of trust between the stakeholders and the management. The management will only be able to release financial statements and reports that are free from material error and fraud if they are truly concerned not only with the owners' interest but also with the investors' and other users' interests. In order for it to be achieved, the prescribed standards of the Securities and Exchange Commission, which are unbiased, must be complied with by the companies. This also led to the concept of harmonization. Harmonization is achieved through the uniformity of the standards complied with by the companies. It is a growing trend due to the expansion of business transactions for company growth. Through harmonization, investors and other stakeholders all over the world would be able to easily compare business entities due to uniformity of the preparation of the financial statements on which the financial ratios are based from.

SIGNIFICANCE OF THE STUDY

Anchored on continuous development of Financial Reporting, this study aims to provide insights and useful information to various stakeholders, such as the firm itself, the users of financial information and the regulatory bodies.

It seeks to inform and assist the SMEs in the retail industry to improve their performance with regard to increased compliance with the standards. This serves as a motivational tool to use various discretionary privileges permitted by the standard to produce more appealing financial statements without violating the fundamentals of the conceptual framework for financial reporting.

External users of the financial statements may refer to the results of this study as a guiding tool in assessing the impact of adopting the standard to key profitability ratios. This, in turn, guarantees that they make proper decisions which directly affect the firm itself. The time span in which the data were gathered may provide useful information regarding the ability of the firm to sustain its operations in the long run.

Moreover, the study also aims to facilitate future local researches and scholarly studies alike on the topic PFRS for SMEs as the study rests in the Philippine setting.

In a broader context, the regulatory bodies can utilize and consider the findings of this study to determine whether the supposed benefits of applying the PFRS for SMEs have been attained. Specifically, it aims to respond to several issues, such as whether more stricter or relaxed compliance is needed, what further amendments, if there may be, can be adopted to fully optimize the promised advantage of the standards, or whether a new and complete set of standards should be crafted to best suit the needs of SMEs in the Philippines.

Lastly, accountants and auditors may be more aware and alert on the possible audit implications of conversion from adopting full IFRS to PFRS for SMEs. It may also provide them with factual data in helping firms correct errors in applying the standards which are already identified in this study.

PANEL ANALYSIS, EMPIRICAL FINDINGS AND FINAL LINEAR REGRESSION TABLE FOR FINACIAL RATIOS, FULL IFRS DISCLOSURE INDEX AND IFRS DISCLOSURE INDEX FOR SMEs

Table 1
TEST OF DIFFERENCE – DISCLOSURE COMPLIANCE

PERIOD	MEAN DIFFERENCE	P-value
Degree of Compliance with Full IFRS vs. Degree of Compliance with IFRS for SMEs	- 0.0693	0.1104

The Paired T-test is utilized to identify whether there is a significant change between the applications of the two standards. As shown in Table 1, the resulting mean of - 0.0693 and p-value of 0.1104 is considered not significant at the 95% level of confidence. As evidenced by the resulted p-value, it can be concluded that there is no significant change between the degree of compliance with the full PFRS and the PFRS for SMEs under the Other Retail Sale in Non-Specialized Stores – Department Stores class. With the outcome of statistical tests showing an insignificant difference in terms of the degree of disclosure compliance prior and subsequent to PFRS for SMEs implementation, a conclusion can be made in contrast to the expected effect of the implementation of PFRS for SMEs. The insignificant increase in compliance with the PFRS for SMEs suggests the non-achievement of the objectives of the said standard, which is to ease the burden and to address the needs of small and medium-sized entities. The provisions in the PFRS for SMEs are complied with due to the benefits it promised to those who adopt the standards.

Table 2
SUMMARY OF PAIRED T-TEST ON KEY FINANCIAL RATIOS

VARIABLES	BEFORE	AFTER	P-value
Return on Equity	.1326239	.1516534	0.6614
Return on Assets	.0430901	.0341789	0.0805
Gross Profit	.1131944	.0870462	0.1494
Net Profit	.0866552	.0797653	0.1225
Operating Profit	.0962538	.0865691	0.1696

Based on Table 2, all of the ratios used in Test of Difference have come up with p-values greater than the critical p-value of 0.05. This means that there is no significant difference in the ten key financial ratios prior and subsequent to the implementation of the new standard, the PFRS for SMEs. It can be inferred that the increases and decreases in the financial ratios are not substantial enough to acknowledge that the transition from full PFRS to PFRS for SMEs has influenced its movements. To sum it all up, it can be concluded that there is no significant change in the firm performance as measured by the financial ratios between the use of the full PFRS and the PFRS for SMEs.

These findings are supported by the study of Palka and Svitakova (2011), which performed a similar research to determine the impact of IFRS for SMEs adoption to company performance as opposed to the local Czech Republic standards. The study concludes that there is a change in the key financial ratios after PFRS for SMEs implementation; however, such changes are statistically insignificant.

Table 3
SUMMARY OF DISCLOSURE COMPLIANCE WITH FULL IFRS VS FINANCIAL RATIOS

	MODEL	P-value	INTERPRETATION
Return on Equity	Random Effects	0.2326	Not significant
Return on Assets	Random Effects	0.1480	Not significant
Gross Profit	OLS	0.0012	Significant
Net Profit	Random Effects	0.0618	Not significant
Operating Profit	Random Effects	0.5297	Not significant

With the exception of one ratio, namely the gross profit margin, the analysis with the use of different tests shows that financial ratios generally has not produced any significant effects as to the degree of compliance prior to the application of PFRS for SMEs as presented in Table 3. It can be construed that small and medium-sized entities merely used the standard for compliance purposes and not as a means to improve their financial performance. A study of Mutawaa and Hewaidy (2010), which determines the possible effects of disclosure compliance by listed companies on the full IFRS to financial performance, discover that leverage ratios are negatively correlated with the degree of disclosure compliance but are statistically insignificant. The profitability ratio, as measured by the Return on Equity is positively associated with the disclosure compliance level, but not significant. Their conclusion expounded on their selected indicators, which are independent variables, as to have both positive and negative effects in relation to the level of compliance, but these are statistically insignificant. The result of their study, although conducted on listed companies, supports the results obtained in this study wherein ratios are not significantly affected by the degree of compliance.

In relation to Philippine listed companies, the study of Ferrer and Ferrer (2011) entitled "The Relationship Between Profitability and the Level of Compliance to the International Financial Reporting Standards (IFRS): An Empirical Investigation on the Publicly Listed Corporations in the Philippines" proved that there was no significant relation between company profitability, as measured by the Return on Assets, Return on Equity, Basic Earnings per Share, Return on Sales, and Revenues, and the degree of compliance to PFRS. Another study by the same authors, Ferrer and Ferrer (2011), entitled "Liquidity and Financial Leverage Ratios: Their Impact on Compliance with International Financial Reporting Standards (IFRS)" concluded that there was no significant relationship between company liquidity and financial leverage ratios and the degree of compliance to PFRS. Longer periods were used in these studies so that irregularities in events may be minimized to observe the true outcome. Nevertheless, both studies resulted in an insignificant relationship even if they were conducted on Philippine listed companies and not on SMEs.

Table 4 SUMMARY OF DISCLOSURE COMPLIANCE WITH STANDARDS FOR SMEs VS FINANCIAL RATIOS			
	MODEL	p-value	INTERPRETATION
Return on Equity	Random Effects	0.8080	Not significant
Return on Assets	OLS	0.0011	Significant
Gross Profit	Random Effects	0.1752	Not significant
Net Profit	OLS	0.8677	Not significant
Operating Profit	Random Effects	0.1420	Not significant

For years 2010-2011, the applicability of PFRS for SME has been imposed. With the corresponding tests conducted, it is concluded that the degree of compliance has no significant effect on the key financial ratios with the exception of the return on assets. There were reported differences in the figures in the financial statements, especially during the year of transition; nonetheless, these fluctuations in amounts generally did not make way for a significant change to take effect. While there have been changes in the degree of compliance, it was not in connection with financial ratios.

A separate study conducted by Chyzhevska, Müllerová, Paseková, and Strouhal (2010) suggested that a substantial number of SMEs in the Czech Republic and Ukraine are not interested in reporting accurate and factual information for management purpose; rather, they merely produce reports to comply with tax regulations. The lack of significant impact resulted from the degree of disclosure compliance on financial ratios can also be supported by the intention of the PFRS objective and framework which is to provide transparent financial information and not to improve financial performance. However, one particular ratio exhibited a significant effect in relation to the degree of compliance to the PFRS for SMEs.

CONCLUSION

When the degree of compliance with full PFRS was related to the firm performance during 2008-2009, it was determined that there were no significant effects on the financial ratios due to the degree of compliance with the full PFRS with an exception to three ratio namely the Gross Profit Margin. With the given results, it cannot be ultimately assumed that a significant effect is present in relating the degree of compliance with the full PFRS to the key financial ratios. Therefore, the significant relationship between the three ratios mentioned as exceptions and the degree of compliance to the full PFRS could have been produced by other factors such as company specific characteristics and the internal behavior of the companies which are unique across the entities. On another hand, the assessment on whether there is a significant effect on the relationship between the degree of compliance and the PFRS for SMEs on firm performance has generally concluded that there is no significant effect, with an exception of one particular ratio, which is the Return on Assets. This is aligned with the initial objectives of the creation and implementation of PFRS for SMEs. The objectives of the PFRS for SMEs do not include the goal of improving company performance. The primary purpose of the PFRS for SMEs is to provide relevant and reliable information to users of the financial statements of small and medium-sized entities. Disclosing the necessary financial and non-financial information is for the benefit of the public, especially for those who would use this information to come up with vital business decisions. Lastly, the determination of the substantial relationship of the firm characteristics with the firm performance has been evaluated. The statistical results have produced an insignificant relationship between the variables. The asset size did not have any substantial relevance with the key financial ratios. It can be inferred that maintaining abundant resources for the company does not necessarily result to high or good and profitability ratios.

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