CONSENSUAL AND CONTROVERSIAL ISSUES ON IFRS FOR SMEs

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Abstract:
The "IFRS for SMEs" is expressly designed to meet the financial reporting needs of private entities. In this paper, we present the arguments for undertaking this project by IASB, discussing priority issues like as the users' needs, the cost-benefit consideration, and the qualitative characteristics of accounting information. The adoption and applicability of the standard are further discussed considering some practical issues involved by converting to the SMEs standard. Our conclusion is that a common framework for financial reporting reduces the degree of differential reporting between public and private entities, thus being in the best interest of the users of financial information.

Key words: *financial reporting, SMEs, users' needs, cost-benefit of financial reporting, quality of accounting information*

JEL classification: *M 41, L25*

1. Introduction

The principal aim when developing accounting standards for small and medium-sized entities is to provide a framework that generates relevant, reliable and useful information, which should provide a high-quality and understandable set of accounting standards suitable for SMEs. Recently, IASB has focused its efforts in attempting to harmonize the financial reporting of non-listed firms by introducing the "International Financial Reporting Standard for Small and Medium-sized Entities" (IFRS for SMEs) in July 2009, as an alternative framework that can be applied by eligible entities in place of the full set of IFRSs. This is a self-contained standard, incorporating accounting principles based on existing IFRSs that were simplified to suit the entities that fall within its scope. Therefore:

- the standard does not address some topics, as some of accounting practices and disclosures may not provide useful information for the SMEs' financial statements users,
- there are certain accounting treatments that are not allowable under this standard,
- only the simpler option (or a modified version of the simpler option) is included in many areas where full IFRS has a choice of alternative accounting treatments.

According to IASB, the IFRS for SMEs is tailored for the needs and capabilities of smaller businesses (IASB, 2009c). The standard responds to strong international demand from both developed and emerging economies for a rigorous and common set of accounting standards for smaller and medium-sized businesses that is much simpler than full IFRSs.

2. Background of Undertaking the Project of IFRS for SMEs by IASB

Small companies pursue different strategies, and their goals are more likely to be survival and stability rather than growth and profit maximisation. The stewardship function is often absent in small companies, with the accounts playing an agency role between the owner-manager and the bank (Holt, 2009). Considering the above mentioned, we discuss a few arguments for introducing a separate SME accounting standard.

Different users' needs. The IASB makes it clear that the prime users of IFRS are the capital markets, IFRS being primarily designed to meet the needs of equity investors in companies in public capital markets, and not SMEs. The vast majority of the world's companies are small and privately owned, and it could be argued that full IFRSs are not relevant to their needs or to their users (Holt, 2009), as they are rather focused on assessing shorter-term cash flows, liquidity and solvency (IASB, 2009a). According to Holt, SMEs also use financial statements for a narrower range of decisions, as they have less complex transactions and therefore less need for a sophisticated analysis of financial statements (Holt, 2009).

Being a concise, complete set of simplified accounting principles organized by topic, the standard might better meet the needs of financial statement users. The complex and sometimes detailed accounting and reporting requirements of national GAAP or full IFRSs are not always relevant and can be costly to apply in practice.

Discussing the users' needs, we agree that an IFRS for SMEs has clear benefits for investors, lenders and those seeking to raise finance through the transparency afforded by a consistently applied global set of financial reporting standards. According to the training material for the IFRS for SMEs, published by IASC Foundation, the main groups of external users of SMEs financial statements include banks that make loans to SMEs and vendors that sell to SMEs and use SMEs' financial statements to make credit and pricing decisions (IASC Foundation, 2009). If generally the listed companies apply for financing to the potential share buyers, the unlisted entities do not choose the same path, as SMEs are not listed and do not have a market where to negotiate their shares (Neag et al., 2009). A bank loan is much more accessible from all points of view than looking for a person interested in the development of a small enterprise. In this context, IASB considers banks as the most important users of accounting information in case of SMEs.

A controversial issue is the IASB position concerning the shareholders of SMEs that are also the managers, which are mentioned after the clients and sellers as users of financial statement. The Board argues, in the Basis for Conclusions of the standard, that managers may get any information they need in order to run their business and subsequently explains that “SMEs often develop financial statements only for the use of sole proprietors or for the fiscal reporting or for other regulation goals that do not make reference to securities. The financial statements written only for these reasons are not necessarily financial statements with a general purpose” (IASB, 2009b). We conclude that providing information for the sole proprietors in order to help them make management decisions does not represent the primary goal of the IFRS for SMEs.

Cost-benefit considerations. It is often thought that small business managers perceive the cost of compliance with accounting standards to be greater than their benefit. As IFRS have gained greater acceptance around the world, many jurisdictions have adopted them or have developed national GAAP based on IFRS. According to IASB, at the date on which the standard was published, nearly 30 jurisdictions required full IFRSs for all unlisted (private) companies, another 20 jurisdictions required them for some, while another 36 jurisdictions permitted private entities to use full IFRSs; many other jurisdictions that did not require IFRS directly were increasingly converging their national standards with IFRS. These means that, de facto, IFRS are being ‘pushed down’ to private entities, which often do not have the expertise or ability to bear the costs of complying with full IFRSs (IASB, 2009a). In this context, many private entities denounce that full IFRSs impose a burden on small private entity preparers, a burden that has been growing as IFRSs have become more detailed and more countries have begun to use them.

Under these circumstances, the main argument for a separate SME accounting standard is the undue cost burden of reporting, which is proportionately heavier for smaller firms, as the cost of applying the full set of IFRS may not be justified comparing to users' needs. Thus, in developing the IFRS for SMEs, IASB twin goals were to meet users' needs while balancing costs and benefits from a preparer perspective. Application of this standard reduces the compliance costs for many smaller entities and helps make the financial statements of such entities less complex (Ernst & Young, 2009b).

Still, there is the opinion that the IFRS for SMEs is not suitable for internal management, and would increase the cost of preparation and audit of individual company accounts. As a result, the increased disclosure requirements could potentially put companies that adopted it at a competitive disadvantage to firms using less stringent accounting rules (Stokdyk, 2010).

Lower quality of accounting information. Every country across the globe has developed its own simplified generally accepted accounting principles (GAAP) for private entities. In most countries, many or even all entities have a statutory obligation to prepare financial statements that conform to the required set of GAAP. Those statutory financial statements are normally filed with a government agency or put on a website and thus are available to creditors, suppliers, employees, governments and others. Having one or more individual national GAAP for private entities in each jurisdiction, results in lower quality of accounting information.

Furthermore, IASB argues that the accounting standards for private entities in many countries have not been developed with the needs of lenders, vendors and other external users in mind. This has harmed private entities' access to capital or, at a minimum, raised the cost of capital, particularly in small and developing countries. In jurisdictions that require private entities to use full IFRSs, the quality of implementation often is problematic (IASB, 2009a).

The IFRS for SMEs provides improved comparability for users of accounts; it enhances the overall confidence in the accounts of SMEs, and reduces the significant costs involved of maintaining standards on a national basis. Additionally, IASB notes that the standard also provides a platform for growing businesses that are preparing to enter public capital markets, where application of full IFRSs is required.

Lack of comparability in global markets. The world's business markets are integrated, even for small private entities. The main issue is that the accounting practices developed for SMEs may not have been consistent and may have lacked comparability across national boundaries. Accounting differences reduce intelligibility, obscure comparisons and lead to sub-optimal decisions.

Introducing the IFRS for SMEs, Sir David Tweedie, IASB Chairman, said: «The publication of "IFRS for SMEs" is a major breakthrough for companies throughout the world. For the first time, SMEs will have a common high quality and internationally respected set of accounting requirements. We believe the benefits will be felt in both developed and emerging economies» (IASB, 2009c).

On the other hand, given that the requirements in the IFRS for SMEs are not as exhaustive as those in the full IFRSs, it is inevitable that entities reporting under the standard may use different accounting treatments. Despite that the wording of the IFRS for SMEs is 'short and simple', which makes it easier to read than the full IFRS, many of the explanatory paragraphs included in non-bold type in full IFRS have not been included in the IFRS for SMEs. This may complicate the standard's interpretation (Ernst &Young, 2009a). On a short-term, this may result in a lack of comparability of financial statements of entities reporting under the IFRS for SMEs with those of entities applying full IFRSs. This concern will most likely be reduced over time, as more entities adopt the standard and the interpretation of the requirements of the standard becomes more standardised.

Comparability may suffer also because IFRS for SMEs, like full IFRSs, has more flexibility, less-specific rules and more opportunities to apply professional judgment, therefore there is a possibility that the same type of transaction entered into different companies could be reported differently in their financial statements (Fitzpatrick & Frank, 2009). Moreover, IFRS for SMEs includes a number of references to requirements not having to be applied if they require undue cost or effort to determine. This is likely to require significant judgment by preparers of financial statements to ensure consistent and high quality application of the standard. In order to ensure the standard achieves international consistency and comparability of financial reporting, it is important that interpretations are not developed that are specific to particular jurisdictions (Ernst & Young, 2009b).

3. Decision-making Considerations regarding the Adoption of IFRS for SMEs

IFRS for SMEs is intended for use by "small and medium-sized entities" which are defined by the IASB as entities that do not have public accountability but do publish general purpose financial statements for external users. The breadth of the definition depends on the words 'public accountability'. Although developed with a focus on the needs of a typical mid-size company, IFRS for SMEs may be used by any non-publicly accountable entity regardless of size, but there are many issues to consider in determining whether to adopt the standard or not. Practically, these entities will have to evaluate how converting to IFRS for SMEs will affect their organization and the recipients of their financial statements (Munter et al., 2009).

From the perspective of the *entity's management*, the IFRS for SMEs may improve the quality of financial information and trigger improvements in management accounting systems (Ikäheimo, 2010), referring to the most useful methods for the internal decision-making and management purposes of the IFRS for SMEs, like as:

- the revaluation model for property, plant and equipment if a market price exists compared to the cost model,
- recognition of contract revenues based on the stage of completion of the contract activity compared to revenue recognition only after completion of the entire contract, and
- capitalization of development costs compared to the recognition of development costs as expenses.

Considering the simple truth that "simplification does not necessarily mean better" (Moss-Adams, 2009), the solutions to the following practical issues involved by converting to the SMEs standard are the arguments for decision-making (see Munter et al., 2009):

- Key financial-statement users' willingness to accept financial statements prepared in accordance with the new standard,
- The training the organization's personnel will need,
- The information needed for conversion,
- Whether systems changes are needed locally and across the entire entity,
- Communication plans to minimize surprises to stakeholders, such as investors, creditors, customers, and suppliers,
- The need to renegotiate current business contracts, such as debt agreements and covenants to reference IFRS for SMEs instead of national GAAP and the potential impact on covenants based on financial information,
- The effect on customer and supplier contracts, and
- The effect on management compensation metrics, and also on income-tax reporting, compliance, and planning.

Further, we will discuss some of the practical issues mentioned above.

The adoption of IFRS for SMEs depends on whether the standard fits in with local *financial reporting requirements*. Even if it does, prior the adoption, the individual entities still need:

- to determine whether they can claim compliance with the standard in their particular circumstances (KPMG, 2010; Ernst & Young, 2009b), and, particularly, to consider whether the IFRS for SMEs is widely accepted as financial reporting framework;

- to consider whether changes are required to information systems and financial statements processes;

- to consider the impact of not applying full IFRSs, as there is no short-cut approach if the entity later decides to adopt full IFRSs (Ernst & Young, 2009b).

Entities involved in cross-border trade or seeking foreign investment would benefit from adopting a standard developed by an independent international standard setter that is based on similar principles as the widely accepted full IFRSs, is simplified to fit for purpose of SMEs than full IFRSs, and is a more widely recognised framework than the local GAAP (KPMG, 2010). On the other hand, for companies operating in just one country that have no need for cross-border comparability, the extra burden the standard imposed would outweigh any potential benefits (Stokdyk, 2010). Furthermore, those who argue against different reporting requirements for SMEs say the system could lead to a two-tier system of reporting. Entities should not be subject to different rules, which could give rise to different 'true and fair views' (Holt, 2009).

Discussing the issue of *'fair value accounting'*, the adoption of the IFRS for SMEs may offer better access to financial markets and a potential to lower the cost of equity capital, to the extent that fair value accounting improves the transparency and timeliness of financial information. While the IFRS for SMEs has attempted to limit the use of fair value to situations where the benefits from its use outweigh the costs, the use of fair values may still be more widespread than under local GAAP. For example, the requirement to recognise an expense for share-based payments based on the fair value of the instruments provided is a new concept in many countries (Grant Thornton, 2009). The use of a valuation expert may be necessary in order to arrive at the fair value.

The opposite opinion is that the fair value accounting may increase the volatility of reported earnings, and, as a consequence, may lead to an increased cost of equity capital (Ikäheimo, 2010). The fair value requires an ongoing time assessment of the assets with major drawbacks. The financial performance is greatly influenced by changes in value that are driven by chance, which might not only completely consume the informative operational core profit, but also intensify cyclical swings. In particular, according to Haase et al. (2009), the calculation of current fair values creates great problems. In the context of the financial crises of 2008, they can only be continuously monitored in a small number of markets and, even then, they are not free from the risk of being seriously distorted.

Adopting the IFRS for SMEs may have various *cost implications* to consider.

- *Cost reductions*: IASB plans to update the SME standard approximately once every three years by issuing an omnibus amendment, therefore it may be a more stable platform than full IFRS (Munter et al., 2009); as a result, the ongoing training costs may be less than those incurred under a rapidly and constantly changing financial reporting framework; many complex accounting areas in full IFRSs are simplified in the IFRS for SMEs, potentially reducing the need for experts (valuation experts, actuaries etc.) in some areas; the extent of disclosures in financial statements prepared under the IFRS for SMEs is significantly less than in those prepared under full IFRSs, thereby resulting in lower costs to prepare financial statements under the new standard.

- *Cost increases*: businesses and their advisers have to learn new terminology and accounting techniques and make changes to their information systems and accounting software; system changes, reformatting the financial statements and training costs requires an upfront investment (Ikäheimo, 2010); the standard provides less guidance than the full IFRSs in some areas and does not address certain topics, those requiring additional consultation with experts (KPMG, 2010); the process of updating the standard may increase costs if the IFRS for SMEs reporter reports to an entity using full IFRSs.

Still, regardless of the modifications which were meant to create a simpler set of IFRS for smaller companies who do not trade publicly, some claims that the large costs which are incurred in the process of IFRS conversion are not counteracted with sufficient outcomes (Simon, 2010).

Entities should also consider their *long-term goals and plans* when determining whether to adopt the IFRS for SMEs. When an entity has growth ambitions or is planning to be listed in the future - this requiring the adoption of full IFRSs - an earlier adoption of the standard may be a useful step towards adopting full IFRSs when coming from a less detailed and less complex local GAAP. On the other hand, it could be considered an additional costly change if local GAAP is already similar to full IFRSs. Similarly, existing reporters under full IFRSs that are considering applying the IFRS for SMEs should contemplate future transactions or events that might require it to revert to full IFRSs.

4. Conclusions

Global financial reporting standards, applied consistently, enhance the comparability of financial information. Accounting differences can obscure the comparisons that investors, lenders and others make. By requiring the presentation of useful financial information (i.e. information that is relevant, reliable, comparable etc), high quality global financial reporting standards improve the efficiency of the allocation and pricing of capital. This benefits not only those who provide debt or equity capital; it also benefits those entities that seek capital because it reduces their compliance costs and removes uncertainties that affect their cost of capital (IASC Foundation, 2009). According to IASB, IFRS for SMEs is a response to international demand from developed and emerging economies for a rigorous and common set of accounting standards for smaller and medium-sized enterprises that is much easier to use than the full set of IFRSs.

Reviewing the potential benefits of adopting IFRS for SMEs, we note that the standard: improves access to capital; improves quality and comparability of reporting; focuses on the needs of users of SMEs' financial statements; offers the stability of accounting framework; eases burden where full IFRS has previously been required; stepping stone to full IFRSs for private entities aiming to become public. Still, adopting the new IFRS by private entities, in particular small and medium-sized entities, is highly controversial: orientation to the investors' financial information needs; no or little relation between financial and tax accounting; high degree of disclosure; increased costs, which outweigh any potential benefits.

We conclude that, despite the controversial issues, a common framework for financial reporting for public and private entities is in the best interest of the users of financial information and that the efforts of the IASB in these directions are welcomed. Our arguments is that the new standard reduces the degree of differential reporting between public and private entities, thus providing users and preparers with one single 'true and fair view' when describing their financial position and financial performance.

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