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Micro-Entity Financial Reporting: Perspectives of Preparers and Users

International Federation of Accountants

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MICRO-ENTITY FINANCIAL REPORTING:
PERSPECTIVES OF PREPARERS AND USERS

CONTENTS

Background

The IFAC Small and Medium Practices (SMP) Committee[*] is pleased to issue this Information Paper presenting the findings of research into the preparers, users, and user information needs of micro-entity financial reports.

The SMP Committee commissioned this research in early 2006 prompted by a concern that the International Accounting Standards Board's (IASB) proposed accounting standard for SMEs, International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs),[†] which is expected to be issued as an Exposure Draft (ED) in late December 2006 or January 2007, may not be suited to the smallest entities within the SME spectrum. The paper comprises a review of the existing research literature and an empirical analysis of the legal status of micro-entities across national jurisdictions and the nature and format of existing financial reports that these entities produce. The SMP Committee hopes the paper will inform the debate on whether the proposed standard will suit micro-entities.

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The authors conclude that:

> *The findings of this paper indicate that very little research has been previously conducted looking specifically at micro-entities as these tend to be subsumed in the term SME. Furthermore much of the published literature is restricted to studies conducted in developed countries and does not reflect the very different environment in which micro-entities operate in developing, emerging or transition economies. This gap in the literature indicates that this is an area that is ripe for further in-depth examination and research.*

This conclusion has prompted the SMP Committee to consider undertaking further research in this area, in particular investigating whether the proposed IFRS for SMEs is likely to meet the needs of users of financial reports of micro-entities. The SMP Committee hopes that others will contemplate conducting further research.

The views expressed in this paper are those of the authors and as such do not necessarily represent the views of the SMP Committee. While this paper does not explicitly request comments, the SMP Committee and the authors are keen to receive reaction from those that read

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* For more information see http://www.ifac.org/smp/

† For more information see http://www.iasb.org/Current+Projects/IASB+Projects/Small+and+Medium-sized+Entities/Small+and+Medium-sized+Entities.htm

it and to receive details of any relevant independent initiatives in this area of study. For this reason addresses for correspondence are set out below:

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Executive Summary

Introduction

This report presents the preliminary findings of an investigation into the preparers and users of micro-entity financial reports and their information needs. Micro-entities are the smallest entities within the spectrum of small-and medium-sized entities (SMEs) and for the purposes of this study are tentatively defined as less than 10 employees (including those that do not have any employees).

This study has two key objectives: first, a review of the extant academic literature; and second, an empirical analysis of the legal status of micro-entities across national jurisdictions and the nature and format of existing financial reports that these entities produce.

Principal findings

The literature review unearthed a variety of prior studies on SMEs, although studies specific to micro-entities were rare. Despite the general recognition of the economic significance of SMEs, attempts to define them have raised their own complications. Thus, although quantitative criteria have been the common mode of defining such entities (using either the number of employees, turnover or balance sheet total) in recent times more qualitative criteria, such as public accountability, have gained acceptance. Currently, in most jurisdictions SMEs are subject to relaxed regulation as determined at the national level, taking on board specific economic and local conditions. However, the increasing significance of SMEs in the global economy, the burden/inapplicability of full International Financial Reporting Standards (IFRS) and the potent arguments in favor of differential reporting have drawn the attention of international regulators and given rise to the proposed new regulatory regimes for SMEs generally and now, potentially, micro-entities too. The International Accounting Standards Board's (IASB) recent SME exposure draft, for example, applies to SMEs that have no public accountability and publish general purpose financial statements for external users (examples of which include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies). Despite this interest on the part of regulators, the literature indicates that there are mixed views on the cost/benefit balance of regulation and the production of such information by smaller entities.

Preparers

For the smallest entities financial information tends to be prepared either internally by owners-managers themselves or bookkeepers (using a computerized package) or externally by a hired accountant. While most small entities do maintain accounting records of some description, either manually or on a computer, there is some evidence supporting the claim that owners have limited financial expertise and some reliance is therefore placed upon external accountants to assist in the preparation of financial statements and offer advice. Balance sheets and income statements based upon accrual information are most commonly produced in more developed countries (although some of the smallest entities have statements based upon cash transactions). However, this almost certainly is not the case worldwide where, particularly in developing countries, levels of literacy, access to accounting education and computerized accounting systems may have a strong bearing on the ability to produce financial information.

As might be expected, the literature suggests that the main concerns of owners of SMEs include the cost of producing the statements followed closely by their ability to understand them, the costs of other services, the inconvenience and concerns about confidentiality. It should be noted that the literature does have a developed country focus and may not fully reflect the situation in developing and transition economies.

Users and user needs

The IASB's conceptual framework identifies key users of financial statements as investors, lenders, suppliers and other trade creditors, employees, customers, government (and their agencies) and the public. However, not all of these are likely to be important for small enterprises. The literature identifies the main users of the financial statements of small entities as banks, directors (or owner-managers and non-manager-owners) and tax authorities. More recent studies also identify venture capitalists, business angels and grant-awarding bodies as users of SME financial statements.

The literature suggests that the main uses for SME financial statements by banks are to determine capacity to repay and to assess profitability, security and liquidity. Owners utilize financial reports for a variety of functions including, to ascertain remuneration awards and dividend payouts, to monitor performance, capital expenditure, budgeting, planning, for loans and financing, as a confirmatory tool and in some countries as a means of minimizing tax liabilities. Tax authorities also tend to be key recipients of SME accounts and prior work shows that that major uses of SME financial statements by the tax authorities include: to determine gross profit, assess directors' fees, look at tax provisions, ensure that expenses are reasonable and check for a clean audit report.

Survey of legal status of micro-entities across national jurisdictions

Most countries employ quantified definitions of micro-entities for a variety of different purposes. Such categorizations are common not only for statistical or data collection but also important for state aid schemes, research and innovation support, loan guarantee schemes and regional economic development funds. For example, the European Union (EU) recommend a definition of less than 10 employees and/or turnover of €2m and/or a balance sheet total of €2m. However, not all EU member states have adopted a legal definition of micro-entities and several of those adopting a definition have used considerably more restrictive definitions.

When legal definitions do exist, they are not generally used for accounting purposes. Instead, where a differential system of accounting exists, the differentiation is based upon legal status, listing status, or, where size criteria are used, they instead are concerned to differentiate between large entities and other entities.

Conclusion

The findings of this paper indicate that very little research has been previously conducted looking specifically at micro-entities as these tend to be subsumed in the term SME. Furthermore much of the published literature is restricted to studies conducted in developed countries and does not reflect the very different environment in which micro-entities operate in developing, emerging or transition economies. This gap in the literature indicates that this is an area that is ripe for further in-depth examination and research.

Although differential reporting is prevalent in many jurisdictions, the exemptions awarded to SMEs from full IFRS compliance varies. The varying needs of users have underpinned the arguments supporting differential reporting for SMEs, although there is little evidence underpinning this and it remains unclear exactly what those user needs are as far as micro-entities are concerned.

With respect to the smallest entities this study does highlight several key issues. These include the common use of computerized packages by small entities to produce information already in a uniform fashion, the cost/burden implications for the smallest entities of new regulations, the issue of enforcing such guidance, the demands of users and finance-providers, issues of literacy and training in some developing countries and the fact that micro-entities are subject to varying definitions in different jurisdictions.

1. Introduction

1.1 In June 2004 the International Accounting Standards Board (IASB) issued a Discussion Paper entitled "Preliminary Views on Accounting Standards for Small and Medium-sized Entities" and draft Exposure Drafts (ED) of its International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) in August and November 2006. The final ED is expected in late December 2006 or early 2007. It is anticipated that this will provide guidance at a much simpler level than full IFRSs, for those SMEs which are required to produce general purpose financial statements that are made available to the general public. However, there is some concern that the final standard may not be appropriate for the smallest entities at the end of the SME spectrum, the micro-entities. Although some guidance for such entities already exists, in particular the Accounting and Financial Reporting Guidelines for Small and Medium-Sized Enterprises (SMEGA) – Level 3 Guidance issued by the United Nations Conference for Trade and Development's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (UNCTAD/ISAR) (see section 3.15), concerns have been aired regarding guidance emanating from a non-IASB source and, it is argued, that this will affect its uptake. However, such guidelines represent an appropriate starting point for any work by the International Federation of Accountants (IFAC) in this area.

1.2 At IFAC's SMP/SME and Developing Nations Consultative Conference in Prague in March 2005, delegates encouraged IFAC to play a role in helping to address the needs of users of micro-entity financial reports. This study was commissioned by IFAC's Small and Medium Practices (SMP) Committee in response to this interest in financial reporting for micro-entities. The study aims to provide IFAC with a basis for responding to the release of the IASB ED on IFRS for SMEs[1] and focuses on the preparers, users and user information needs of micro-entity financial reports.

1.3 The IASB expects its standard to be suitable for entities that (a) do not have public accountability[2] and (b) publish general purpose financial statements for external users.[3] Examples of such external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies (IASB, 2006, p.14). For the purpose of this project micro-entities are tentatively defined as enterprises with

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1 Originally, the IASB proposed a name change for its standard to Non-Publicly Accountable Entities (NPAEs) rather than SMEs as size is only one of the criteria for relevance of the proposed standard. Although the term NPAE was eventually dropped, the concept of the publicly accountable entity is still employed.

2 An entity has public accountability if: a) it has filed, or is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of financial instruments in a public market, or b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, an insurance entity, securities dealer/broker, pension fund, mutual fund or investment banking entity (IASB 2006, p,14).

3 General purpose financial statements are directed towards the common information needs of a wide range of users, for example, shareholders, creditors, employees and the public at large. The objective of financial statements is to provide information about the financial position, performance and cash flow of an entity that is useful to those users in making economic decisions (IASB, 2006, p.11).

less than 10 employees, including those entities that do not have any employees. It is also an objective of this study to consider the suitability of the IASB definition.

1.4 There exists a very small body of academic research on accounting and the SME sector and various authors have made calls for further work in this area, particularly to identify the user information needs of SME financial reports (Flower, 2004; Anacoreta and Silva, 2005; Evans et al., 2005; Baskerville and Cordery, 2006). Although this report focuses on the preparers and users of micro-entity financial statements, the prior literature relating to this specific sector is virtually non-existent as in most prior studies this sector has been subsumed within the larger group of all SME. It is hoped that further research will help to fill this significant literature gap for micro-entities. It may be speculated that this gap in the SME literature can be attributed to the difficulties incurred in gathering data on the smallest SMEs, in particular with respect to the participation of small business owners (Sian and Roberts, 2003).

1.5 The remainder of this preliminary report is structured as follows: section two reviews the background to the study and provides a critical analysis of the rationale for the IASB's involvement in the SME sector. The literature review in section three summarizes the findings of prior research into the accounting and reporting needs of SMEs in general, while paying particular attention to those studies or results of particular relevance to micro-entities. Section four is an empirical survey of legal status of micro-entities across national jurisdictions and the nature and format of existing financial reports that these entities produce. Finally, section five draws conclusions and makes a recommendation as to suitable definitions for micro-entities.

2. Background to the Current Study – An Analysis of the IASB's Involvement in the Accounting Regulation of SMEs

2.1 The IASB is an organization more commonly associated with promulgation of International Financial Reporting Standards (IFRSs) with the aim of achieving global accounting harmonization of publicly accountable entities. Therefore, it may come as somewhat of a surprise that it has been drawn into considering financial reporting regulations for SMEs. However, there exists a number of reasons for the IASB's involvement in SME regulation:

- The IASB is alert to the fact that their extant standards are not always appropriate for SMEs. IFRSs are aimed at meeting the needs of financial reporting by companies listed on global capital markets. While this results in the production of general purpose reports aimed at a variety of users, the IFRSs have been developed from the viewpoint that capital markets are the most important group. This means that they do not necessarily meet the information needs of the users of SME accounts. Neither do IFRSs necessarily take on board the needs of developing and transitional economies which tend to have a greater abundance of SMEs (House, 2006), but who adopt IASB standards as a means of attracting foreign investment (Flower, 2004). In addition, full IFRSs are complex and costly to implement while many SMEs have very limited accounting capabilities (Flower, 2004).

- There is the alignment and international comparability argument. European Union (EU) member states were required to adopt IFRSs in 2005 for the consolidated financial statements of listed companies and most are currently in the process of aligning national generally accepted accounting principles (GAAP) with IFRSs. Very few member states will make IFRSs compulsory for SMEs and most will instead permit SMEs to follow either IFRSs or national GAAP. Since most countries already have various exemptions and relaxations for SMEs in their national GAAP, "there is a real possibility, in Europe alone, that there could be two dozen or more sets of national standards that purport to be adaptations of IFRSs suitable for SMEs. This is true not only in Europe, of course, but also elsewhere in the world" (Pacter, 2004a, p.74). The EU has already indicated that it will support the SME standards if they are an improvement on the Fourth and Seventh Directives (House, 2006).
- There is the transition argument which suggests that IFRSs for SMEs would ease the transition for growing small entities wishing to seek a listing at some future date, although this does rather assume that a significant number of small entities have a growth objective, which is not always the case[4] (Baskerville and Cordery, 2006).

2.2 The IASB's involvement with SME regulation is not without its critics and arguments casting aspersions upon the project have also been voiced.

- One of the key issues is the "top-down approach" (Baskerville and Cordery, 2006). Originally, the starting point of the project was full IFRSs and the IASB proposed that disclosure rules would be relaxed[5] and that there would be minimal modifications to the recognition and measurements rules. In a survey conducted by the IASB canvassing opinions of national standard-setters, the majority (24 out of 30) felt that simplifications of recognition and measurements rules were required too (Pacter, 2004b) and the IASB position changed to reflect this.
- There is some debate as to whether the IASB's plan to base the SME standards on its present conceptual framework, which was developed to cater for the needs of large listed entities, is entirely appropriate[6] (Evans et al., 2005; Kormaier, 2005). Observers have commented that "unique SME factors, including close-knit agency relationships and a tendency to aim for survival and stability over profit maximization and growth suggest a distinctly different focus to the IASB conceptual framework is required" (Baskerville and Cordery, 2006, p.2). It is also worth noting that the IASB Framework does not explicitly recognize cost/benefit implications of implementation of standards, something that is a key consideration for SMEs.

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4 Demartini argues that IFRS based standards may be suitable for those with a high growth rate because "an effective communication process can help them to establish trusting and co-operative long-term relationships, especially with stakeholders providing key resources in order to reach strategic goals" (Demartini, 2005, p.6).

5 This is similar to the approach adopted by the UK's Financial Reporting Standard for Small Entities (FRSSE). Research has shown that there was poor uptake of the FRSSE because the relaxation of disclosure requirements was not considered to be beneficial to SMEs (John and Healeas, 2000).

6 "The question arises as to whether a regulatory framework developed for firms reporting within an Anglo-American governance and capital market context, such as that developed by the IASB, can usefully be adapted to the needs of SMEs in EU member states (and elsewhere)," (Evans et al., 2005, p.25).

- As the IASB is planning to issue two sets of standards it expects to recommend which companies can use the SME standards. It has been argued that "the IASB has neither the power nor the authority to do this. This authority lies with the national regulatory authority….the IASB has no power or authority to prevent an enterprise using its standards if so permitted by national law" (Flower, 2004, p.18).
- It is questionable whether the IASB is the most appropriate body to set such standards given that "only a handful of the present members have any experience with SMEs" (Flower, 2004) and some have commented that the IASB has "underestimated the complexity of the whole project" (Kormaier, 2005, p.551).

2.3 Despite these reservations there has been general support for the IASB's plans. At a meeting in September 2003, the IASB hosted 40 of the world's standards-setters and a survey prior to the meeting suggested that responses from 30 standard-setters supported the IASB's proposal to develop standards for SMEs (Pacter, 2004a). A recent study conducted on the responses to the IASB's discussion paper "Preliminary Views on Accounting Standards for Small and Medium-sized Entities" (2004) similarly suggests that most respondents, some 77%, agreed that the IASB should develop accounting standards for SMEs (Anacoreta and Silva, 2005). Of these a high proportion also supported the suggestion the SME standards should follow, loosely, full IFRSs.[7]

3. Literature Review

What is a small enterprise?

3.1 Many researchers have struggled with the question of defining relevant criteria (Stanworth and Gray, 1991). In the UK, for example, an early qualitative definition was offered by the Bolton Report (1971) which required the enterprise to have a "relatively small share of the market," while being "managed by its owners," and to be "independent in the sense that it does not form part of a larger enterprise."

3.2 Until recently, quantitative criteria have been common, using the number of employees, turnover or balance sheet totals[8]. While these definitions may be easier to apply, they are not problem-free. For instance, employee numbers can be distorted by the increasing use of part-time employees, casual workers and outsourcing while balance sheet figures depend upon the specific rules used. Even turnover figures are sometimes difficult to ascertain for unincorporated enterprises which are not required to make such information publicly available and, indeed, may not even have accurate accrual based turnover information themselves (Curran and Blackburn, 2001).

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7 The IASB received 116 comment letters from professional bodies, practitioners, government departments, academics and others. The largest group of respondents was standard setters, while no groups exclusively representing SMEs responded.

8 Most definitions use more than one criterion given the large differences across industries. For example, providers of personal services, international product or raw materials traders and heavy industry would vary enormously in terms of the relationship between numbers of employees, turnover or balance sheet totals.

3.3 There has been increasing criticism of this quantitative approach and the use of more qualitative criteria has been advocated (Paoloni et al., 2000) or a mix of both quantitative and qualitative. One suggestion is that alternative definitions focusing on ownership or organizational structure are far more useful (Chittenden et al., 1990).

3.4 The IASB have also refrained from adopting quantitative size criteria to define SMEs and have focused instead on public accountability, following comments received from respondents to its 2004 Discussion Paper. Public accountability is defined by the IASB in terms of two criteria (see footnote two) and if an entity meets either of them it must use the complete set of IFRSs. The IASB recognizes that economic significance in a home country could create the presumption that an entity was publicly accountable. It will be left to individual countries to develop quantitative or other measures of economic significance.[9]

3.5 Research has suggested that SMEs are not a homogeneous group and that they can be further differentiated as micro-entities, small entities or medium-sized entities and further still into growing SMEs and non-growing SMEs. It is acknowledged that disaggregating the sector further would come with its own associated problems and any cut-off criteria would be arbitrary (Barker and Noonan, 1995; Demartini, 2005).

The significance of small enterprises

3.6 Small firms are economically significant in all countries. It was estimated that in 1997, there were approximately 6.3 million SMEs in the USA[10] and 9.3 million in the EU. In the EU, the countries with the most SMEs were Germany, followed by Italy, the UK, France and Spain (Karmel and Byron, 2002). This sector accounts for most of the enterprises in each of these countries. For example, estimates suggest that 99.1% of all UK businesses were classified as small (less than 50 employees), accounting for 43.3% of private sector employment and 31% of total private sector turnover in 2001.[11]

3.7 The importance of micro-entities varies greatly across different sectors of any economy. For example, in the EU-15 countries in 2001, micro-entities (defined as entities with less than 10 employees) accounted for only 1.9% of all employment in the electricity, gas and water supply industry and 4.6% in mining and quarrying. In contrast, they accounted for 45.7% of employment in hotels and restaurants and 39.6% in distributive trades (Eurostat, 2005). Micro-enterprises are rather less significant in new EU-countries than they are in the earlier member countries. Thus, they accounted for 20% of employment in

9 Economic significance will be defined in individual jurisdictions and be based on size criteria such as total assets, total income, number of employees, degree of market dominance and nature and extent of external borrowings (IASB, 2006, p.7).

10 In the United States, most micro-enterprise development programs target their services to low-income people. Many programs are tailored to meet the needs of specific target groups such as welfare recipients, minorities, women, the working poor, and individuals or business sectors that, for these and other reasons, lack access to credit (Source: http://www.microenterpriseworks.org/about/whatis.htm).

11 Data source: Small Business Service, http://www.sbs.gov.uk. However, such statistics are estimates only as they are compiled using a variety of sources and accurate statistics are often difficult to find (Page, 1984).

the EU-15 countries but only 17% in the newer members (Eurostat, 2002). However, extensive privatization has flamed the rapid growth of the SME sector in the newer members (Jaruga and Fijalkowska, 2004).

3.8 In developing countries small entities play a particularly important role as larger, listed companies have less of a presence and in some countries many larger enterprises are partly or wholly state-owned. In such countries, the formal employment sector is often unable to absorb the workforce and there is a need to promote entrepreneurship in order to create sustainable livelihoods. Guidance has, therefore, been a key issue in many developing countries, for example the Eastern, Central and Southern African Federation of Accountants (ECSAFA) has developed an interim guide for SME financial reporting (ECSAFA, 2005) and Sri Lanka, Vietnam, Malaysia and the Philippines, too, have developed guidance for small entities (see section four).

3.9 In addition, the global reach of the internet has meant that many smaller enterprises are now able to access the international market. We believe that the IASB's and IFAC's interest in regulatory guidelines recognizes the global importance of such enterprises and the need for information for decision making and control by owners, for raising finance, for equitable taxation and the need for a framework within which small and micro-entities can grow.[12] It is this increasing significance of SMEs in the global economy that has drawn the attention of international regulators and given rise to the proposed new regulatory regimes for such entities.

The need for differential reporting

3.10 Most accounting regulatory regimes recognize differences between larger and smaller enterprises and between those that are listed and unlisted and/or non-publicly accountable[13] (Devi, 2003). Recognizing the burdens placed upon smaller enterprises by financial reporting, many countries exempt smaller enterprises from statutory audit and subject them to differential reporting requirements. For instance, as a result of EU accounting directives, small and medium-sized companies throughout Europe have the option of filing abbreviated reports with reduced levels of disclosure and all private companies in the US are exempted from the need for GAAP financial statements and audit.

3.11 There are some incisive arguments supporting the need for differential reporting and relaxing requirements for smaller entities. Looking, first, at the benefits of reporting, there is the issue of user needs. Much of the disclosures and information required by full financial statements are seen as not relevant to smaller businesses. There is general

[12] "SMEs are the economic engine that fuels growth, jobs, and ultimately individual prosperity and security, in countries of all sizes in all parts of the world. Heightened regulations, together with increased and more complex standards, resulting in part from corporate and accounting scandals over the past decade, have placed increased burdens on SMEs. Recognizing that such burdens can potentially inhibit innovation and growth in this important sector, IFAC has made it a priority to represent the interests of SMEs in its interactions with regulators, standard setters, and other international organizations whose actions potentially could affect SMEs," (Speech on July 13, 2006 by Graham Ward, IFAC President, http://www.ifac.org/MediaCenter).

[13] For more on the specific rules in place, see section four.

agreement that the users and user needs of SME financial reports are not the same as for larger entities (see section 3.28 below) and the purpose for which financial reports are produced is related to the size and complexity of the entity. Collis (2001) suggests that larger companies use their financial statements for a wider range of decisions and that they undertake more complex transactions than smaller enterprises, providing aggregated information that requires more sophisticated analysis.

3.12 However, it is not only the benefits that must be considered, but also the costs of compliance. Financial reporting requirements can impose a significant burden upon smaller enterprises and in particular costs associated with compliance (Page, 1984; Keasey and Short, 1990; Barker and Noonan, 1995; Collis et al., 2001; AICPA, 2005; Kormaier, 2005).[14] These can be identified as follows:

- The cost of producing financial accounting information, including the direct costs of preparing the information (either from within the business or by hiring an accountant), printing and publishing the information and possibly attesting or auditing the information;
- Opportunity costs as managers divert limited resources to prepare such information;
- The potential cost of disclosing information to a competitor; and
- The costs of complying with legal requirements (Paoloni and Demartini, 1999).

Many of these costs are either fixed or do not vary directly with size, but instead are significantly more important for smaller entities.

3.13 Equally, the literature presents a case against differential reporting for larger and smaller entities:

- There is the universality argument (i.e., companies should not be subject to different rules giving rise to different "true and fair views") (Barker and Noonan, 1995; Collis et al., 2001; Evans et al., 2005);
- The need for comparability and reliability derives from the universal application of accounting regulations;
- There is the argument that, regardless of size, published accounts are "the price to pay for limited liability" of ownership and management;
- There is concern amongst the profession that such a reduction in regulations for smaller entities may portray small companies as second class citizens and may even risk bifurcation within the profession (Barker and Noonan, 1995);

[14] However in an earlier study, Carsberg (1985) suggested that the cost of compliance was not perceived to be a burden by small entities. Barker and Noonan (1995) suggest that 15% of their respondents found general bookkeeping to be a burden, 20% nominated stocktaking and 19% cited specific financial reporting requirements.

- It has been argued that it is practitioners and academics that are pushing for differential reporting rather than SME owners and users, who may not even be aware of the pros and cons;
- There is also the argument that more than one set of rules may undermine the credibility of accounts in the minds of users since different rules may result in different results and, in particular, profit figures; and
- Botosan et al., (2006) argue that "if private companies have the business acumen to enter into complex transactions, then it is reasonable to expect them to have or be able to obtain the accounting expertise to account for such transactions. Therefore, the Committee recommends the IASB respond cautiously to requests for GAAP exceptions supported primarily by complexity arguments," (p.180).

3.14 On balance, the arguments for differential reporting seem to be stronger. Indeed, as discussed in section four, countries are increasingly adopting differential reporting requirements (or big GAAP and little GAAP rules). Thus, the important argument now appears to be not whether this is an appropriate approach, but rather how the two should differ. For instance, should they be based upon the same conceptual framework or measurement and recognition criteria, with little GAAP being simplified and easier to apply and offering certain exemptions from the full set of regulation? Alternatively, should there be two distinct sets of rules developed separately, despite the possibility that they may not necessarily articulate well with each other?

3.15 In its recommendations for SMEs, ISAR advocates differential accounting and reporting requirements for the three levels of enterprises with the aim of allowing businesses to grow within a consistent accounting framework and being cost effective with respect to the targeted users and preparers[15] (UNCTAD, 2004). The objective of the Level 3 statements (aimed at the smallest entities) is to make them as consistent as practicable with IASB-observant Level 1 and 2 enterprises, while still recognizing the differences between these types of enterprises. These guidelines do not provide a detailed definition of Level 3 enterprises,[16] as it is recognized that these will vary internationally, depending upon the size and stage of economic development of countries (UNCTAD, 2000). Recommendations for Level 3 entities, suggest that they should "follow a simple accruals-based accounting system that is closely linked to cash transactions, and with a

15 The UNCTAD/ISAR Accounting and Financial Reporting Guidelines for Small and Medium-Sized Enterprises (SMEGA) identify three levels of regulation. Level 1: Listed entities whose securities are publicly traded and those with significant public interest should follow IFRSs. Level 2: Significant commercial, industrial and business entities that issue neither public securities nor financial reports to the general public may follow a single set of requirements derived from IFRSs and consistent with them, but embodying only the simplest and most regularly encountered transactions. Level 3: The smallest entities that are owner-managed should follow a simple accruals based accounting system (producing a simple balance sheet, a profit and loss account and reduced notes), closely linked to cash transactions, and with a derogation for businesses to use cash accounting for a limited time when establishing their accounting systems. Such a system should be consistent with the requirements of IFRSs, although not fully compliant (UNCTAD, 2004, p.27).

16 It instead describes them as small owner managed enterprises that are likely to have few employees. It would also normally include new entrants.

derogation for businesses to use cash accounting for a limited time when establishing their accounting systems" (UNCTAD, 2002). This system should be consistent with the requirements of IFRSs, although not fully compliant. It is recognized that the usefulness of any specific set of guidelines is also dependent upon the education, taxation, financing and regulatory systems in different jurisdictions, given that the small enterprise sector is not homogeneous either in any country or internationally (Blackburn and Jennings, 1996). For example, the importance of distributable profit definitions tend to vary across common law and code law countries making it significantly more difficult for countries like Italy to introduce fair value accounting than countries such as the UK.

3.16 While it may initially appear obvious that all entities should employ an accrual based system, this does not have universal support. ISAR recommends that the newest entities might be allowed to adopt cash based accounting and others also support this arguing that the smallest entities be relieved from the burden of applying double entry altogether (Haller, 2003, quoted in Evans et al., 2005; Paoloni, 1999). However, there are also calls for more research to be conducted on the benefits and costs of such cash-based systems (Paoloni et al., 2000).

The usefulness of financial information for SMEs

3.17 Despite the belief that differential reporting is useful, the literature indicates that owners of small entities have mixed views on the cost/benefit balance of regulation and producing such information. For example, recent questionnaire-based research (involving owners and financial managers, practitioners and external stakeholders) in the USA suggests that "respondents rated the benefits of preparing or using GAAP financial statements when compared with the cost of preparing them as medium to moderately high" (AICPA, 2005, p.6).[17] However, most respondents were also in favor of a simplified set of GAAP for unlisted corporate entities. Several reasons were given to support the regulations for SMEs namely that GAAP based statements:

- For use as a decision tool;
- Because they provide useful information;
- Because they provide a standardized language;
- Because they allow for comparability between reporting periods and with other companies; and
- Users prefer an outside accountant's report (AICPA, 2005, p.13).

3.18 In contrast, in the Netherlands, evidence suggests that many small firm managers do not consider financial reporting and its regulation to be a key issue for them nor do they "expect to gain much by disclosing financial accounting information or appreciate the usefulness of the financial statements to third parties" (Bollen, 1996, p.180).

17 In their recent commentary, Botosan et al. (2006), voice grave concerns over the methodology employed by this survey.

3.19 Usefulness will vary across different types of SMEs. For example, Barker and Noonan (1995) conducted research in Ireland, questioning accountants with SME clients. Their findings suggest that owners of growing small entities were much more likely to accept regulation as a means of generating interest, and therefore potential outside investment, in the company. Other smaller entities in a start-up situation "may be a better target for a more relaxed regulatory regime" (p.18).

3.20 Absolute size and not just growth potential or intention will also be important, as might be country of origin. UNCTAD, which has been mainly concerned with African and transition economies, suggests that many of the smallest SMEs do not actually keep proper financial records or accounts. This is either because they are not convinced of their usefulness for decision making and control or they lack the business knowledge, skilled accounting personnel or infrastructure required to implement existing accounting regulations (UNCTAD, 2002). One issue here may be the price of professional accountancy services and the relative lack of accounting technicians rather than the more highly qualified and expensive certified or chartered accountant, particularly in developing countries. As ISAR put it "the services of such an expert would be cheaper and better adapted to the needs of small enterprises" (UNCTAD, 2001, p.6).

Preparers of SME financial reports

3.21 The prior literature addressing issues surrounding the preparation of financial information by smaller entities is somewhat limited and has a country-specific focus. While it is not possible to extrapolate such findings to other regulatory jurisdictions, this work does provide some interesting insights into who produces this information and the type of financial information prepared and maintained by small entities (Sian and Roberts, 2003). Within the smallest entities financial information tends to be prepared either internally by owner-managers themselves or bookkeepers or externally by a hired accountant.

3.22 Research focusing on internal preparation seems to suggest that financial awareness amongst owner-managers of the smallest entities is quite low and that there is inadequate record-keeping (UNCTAD, 2002). For instance, in the UK, a survey of 200 businesses with fewer than ten employees found that while most respondents maintained business records, only 34% used any form of budgeting (Nayak and Greenfield, 1994). They also noted that small enterprises that monitored their profits and undertook some form of budgeting also maintained the best records, while enterprises with more than one owner-manager were more likely to keep better records (either on paper or on computer).

3.23 Other studies have found important differences in the financial awareness and skills in small businesses (Sian and Roberts, 2003; Collis and Jarvis, 2002; Deakins et al., 2001). The evidence suggests that significant numbers of small businesses use fully or partially computerized accounting systems (Sian and Roberts, 2003, Collis and Jarvis 2002). However, this does not mean that the level of understanding is necessarily also high. Indeed, there are indications that generally few owner-managers are able to understand the contents of statutory accounts and that they tend to rely upon their accountant to explain the details to them (John and Healeas, 2000). The level of understanding of management accounts seems little higher. For example, Marriot and Marriot (1999) looked partly at financial awareness among owner-managers in enterprises with a turnover of less than £350,000. They found that while many of these businesses were using computers to produce management accounts, the figures produced were often "erroneous and incomplete" (p.vii). Often this arose because the owner-managers had established their systems without the advice or help of their accountant. The study also found that while levels of financial awareness varied greatly, all of those in the sample had paid for statutory information provided by their accountants that they did not use or understand. While many accountants were found to be proactive in their clients' financial education, more often than not small clients viewed their accountants "as an extension of the tax system" (Marriot and Marriot, 1999, p.45).

3.24 A study by the Professional Oversight Board (POB) in the UK found that the limited financial expertise available in many small business caused such businesses to turn to external accountants for assistance[18] (POB, 2006). In a recent UK survey, for instance, the majority of small owner-managed entities used the services of an external accountant to produce financial statements (57.2%), and less commonly tax or VAT information or even to run the accounting system. Most respondents (86.3%) stated that their accountants provided additional information, commonly a verbal explanation or analysis of the accounts (Sian and Roberts, 2003). Because accountants often prepare (and audit) these financial statements they are in a privileged position when it comes to advising small enterprises on internal management planning, decision making, control and future strategy (Chittenden et al., 1990; Deakins et al., 2001). Accountants are the advisors that most small businesses have regular contact with and in their study Chittenden et al. (1990) noted that 74% of small business respondents were in contact with their accountants at least once every quarter. Services commonly provided by accountants include the provision of annual reports, management accounts and routine tax work (Chittenden et al., 1990). Other research has found that small business owner-managers primarily see their accountants as providers of statutory services[19] or as a source of advice in an emergency (Kirby et al., 1998) and cost is seen as a key factor when it comes to requesting non-statutory work from their accountants. In the UK, at least, it is the case that when small entities receive their statutory accounts from their accountants, they also receive other information at the same time, such as management advice and/or a more detailed set of statements (Collis and Jarvis, 2002, p.100).

3.25 Despite the lack of current SME regulations there is evidence that some accountants are already making financial information more accessible and relevant to SME clients. For example, Marriot and Marriot (1999) found that many accountants were already "customizing the financial reports for clients through the provision of ratios and many were providing additional interpretations" (Marriot and Marriot, 1999, p.45) and that this increased the clients' understanding and hence the utility of the accounts. However, much

[18] The POB (2006) survey found that 85% of small and medium-sized companies used some form of external support for accountancy work.

[19] Kirby et al. (1998) classify statutory services as tax compliance, statutory audits, statutory accounts and company secretarial work. Non-statutory work includes management accounting, tax consultancy, payroll, accounts preparation and general financial advice.

of this customization comes at a cost and is often a conduit to offering other services to the client.

3.26 An issue related to the preparation of financial statements is that of the audit of such statements. While the audit requirement is non-existent for small businesses in many countries there is still evidence that many smaller incorporated enterprises would have their accounts audited even if not legally required to do so. In their UK study, Collis and Jarvis (2000) quote figures of 62.6% of their sample as falling within this category and suggest that the reason for this is the perception that audits provide an independent verification of the figures in the accounts, so playing a confirmatory role. More recently, evidence has been presented that suggests that approximately 180,000 small non-dormant companies in the UK, that would qualify for an exemption, undertook a voluntary audit in the year 2004/5 (POBA, 2006, p.33). Similar conclusions are presented by Page (1984) who found that small companies obliged to produce financial reports felt that “the overt cost of an audit did not rank as the main disadvantage so frequently as the hidden cost of disclosure” (Page, 1984, p.275).

3.27 While many small enterprises have access to professional advice, the picture is not a homogenous one. For example, Dunkelberg et al (1987, quoted in Storey, 1994) showed that growing firms were much more likely to have been provided with important information by their accountants than were declining firms. Similarly, a study conducted by the Cambridge Small Business Research Centre (1992) showed that “69% of fast-growth firms had sought taxation and financial management advice, compared with only 59% of stable or declining firms” (quoted in Storey (1994, p13)) While these studies do not suggest that access to good accounting information is a cause of small firm growth, they do suggest that rapidly-growing small firms are more likely to seek out and use such information.

Users of SME financial reports

3.28 The IASB’s conceptual framework identifies the key users of financial statements as investors, lenders, suppliers and other trade creditors, employees, customers, government (and their agencies) and the public. In contrast, the IASB states that users of general purpose financial statements of SMEs would include owners not involved in the business, existing and potential creditors and credit rating agencies. It would see reports compiled solely for owner-managers or taxation as being outside the definition of general purpose financial statements.

3.29 Others writers have identified that the main users of the financial statements as banks, directors (or owner-managers and non-manager-owners) and tax authorities (Page, 1984; Pratten, 1998; Collis and Jarvis, 2000; Jarvis et al., 2000; Collis et al., 2001; Sian and Roberts, 2003; Riistama and Vehmanen, 2004).[20] It has been argued that in the absence of other market data (available for larger listed companies), SME financial statements are even more important sources of information for such users (Jarvis, 1996). For example,

[20] Pratten (1998) identifies the most important users, in order, as bankers, executive directors, other shareholders and the Inland Revenue.

Collis et al. (2001) surveyed 198 companies in the UK with the objective of: first determining who the recipients of small company accounts were; second, ascertaining whether owner-managers read the annual reports of other businesses; and third to investigate the usefulness of their own annual reports. They find that the main non-statutory recipients of the annual reports are (in this order) bank managers, the directors and finally other major lenders[21] and customers. Furthermore, 51% of small companies claim to read the annual statutory reports of their competitors.[22] For the smallest companies the most important sources of information for management purposes were: the periodic management accounts, the annual statutory reports and cash flow information (in that order).

3.30 While it is generally agreed that owner-managers are an important user group, this does not mean that they universally find the financial statements useful. For example, in his UK study, Page (1984), questioning directors of small independent companies, found that only 41% of directors considered the annual reports to be useful for providing management information. Collis and Jarvis (2000) confirmed in a wide-ranging interview and questionnaire based study that UK statutory accounts were not considered useful to owner-managers, although they do appear to play a "confirmatory" role. Smaller enterprises also tend to more readily adopt alternative indicators and in one study "the owner-managers took a specific standard of living as a reasonable indicator of business success" (Jarvis et al., 1996). This supports the earlier arguments of the Bolton Report (1971) which commented that money was not always a prime motivator for owner-managers and factors such as the quality of life, independence and involvement in the ownership and running of their own business resulted in greater satisfaction (Stanworth and Gray, 1991). While profit and profitability measures are still important, research shows that "owner-managers juggle a range of objectives continually arranging and rearranging them within what they perceive as changing constraints internal and external to the business" (Jarvis et al., 2000). For example, various additional financial indicators such as cash, liquidity and cost levels, and non-financial indicators such as the "number of times the telephone rings," the general level of "busyness" and the "speed with which buyers settle debts" were also used (Jarvis et al., 2000).

3.31 The finding that owner-managers use, albeit perhaps infrequently, financial statements does not necessarily imply that statements and the rules behind them should be designed with this user group in mind. For example, the IASB argues that general purpose financial statements are designed only for external users and not owner-managers. Obviously, owners who are not also managers would always be a significant user group.

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[21] These can include family members, venture capitalists, business angels (individuals who provide capital for a business start-up, usually in exchange for ownership equity, and who, unlike venture capitalists, typically do not manage the pooled money of others in a professionally-managed fund), trade creditors and factoring companies. The authors suggest that although the Inland Revenue is an important recipient, it is likely that the reports are sent by the companies' accountants.

[22] The IASB states that general purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their particular information needs. General purpose financial statements include those that are presented separately or within another public document such as an annual report or a prospectus (IASB, 2006, preface paragraph 8).

For SMEs these owners are likely to be very important in that often they gain a significant amount of their wealth from this single investment and they do not gain from the diversification advantages open to investors in the stock market.

3.32 One of the main aims of small businesses run by owner-directors and their families is to minimize tax liabilities. Paoloni et al. suggest that in small Italian firms accounting information systems are "developed to comply with legal requirements and not as a tool to communicate with external readers or for management needs" (Paoloni et al., 2000, p.17).[23] This contrasts with evidence from the UK which suggests that small firms themselves do not appear to make use of accounting information for tax purposes as they do not undertake sophisticated tax planning (Poutziouris et al., 1999). Empirical evidence from UK studies suggests that tax authorities are a key user of SME accounting information and Collis and Jarvis (2000) found that 45.2% of their sample sent a copy of the financial statements to the Inland Revenue. Similarly, Sian and Roberts (2003) found that tax authorities are the main external recipients of small owner-managed entities (SoME) accounts (55%), although in contrast other studies suggest that only a very small proportion of small companies do this (Dugdale et al., 1997). In their study Barker and Noonan (1995) comment that major uses of SME financial statements by the Inland Revenue include: to determine gross profit, assess directors' fees, look at tax provisions, ensure that expenses are reasonable and check for a clean audit report (in that order).

3.33 Accepting the importance of tax authorities as a major user of financial statements implies significant problems for any international regulation of financial statements. Tax authorities in most countries have their own accounting rules which differ across countries. This means that one set of GAAP will never satisfy each and every tax authority. This is probably the reason why the IASB explicitly states that their standards, including the SME standards, are not intended to meet the needs of tax authorities.

3.34 Finance providers are undoubtedly important users and sources of finance will vary across countries. For example, venture capital investors (VCIs) have also been identified as key users of SME financial reports in research conducted in Italy (Demartini, 2005). VCIs play a constructive role in the development of management accounting systems in investee firms and their information demands have a direct influence on supply. There is also evidence that the information needs of VCIs are much broader than those satisfied by traditional external financial accounting methods (Paoloni et al., 2003). More recently,

[23] In their study, Paoloni et al. (2000) used a questionnaire based survey to analyze the benefits and costs related to small business financial reports in Italy and Spain, comparing their results to similar studies conducted in the UK. In particular they analyze the characteristics of small company accounts and the burdens associated with financial reporting in Italy and Spain and also the information needs of users of small business annual reports. In both Italy and Spain small firms find the maintenance of accounting records to be less onerous than tax requirements and the production of accounts is heavily influenced by tax law. In Italy, they find that much of the cost burden upon smaller entities is associated with payments to expert accountants for the production of accounts as accounts are heavily influenced by tax law. In Spain three types of companies are recognized in legislation: small, medium and large, while in Italy there are only small and large companies. Also there are differences in the level of financial reporting requirements for non-limited liability companies. In Spain, all businesses have to present similar annual accounts and in Italy smaller entities only have to meet valuation criteria used by limited companies.

business angels have also been identified as key investors in some smaller businesses in the UK (Harrison and Mason, 1995) and although hard evidence is not available, it is "generally assumed that business angels are significant users of the statements" (Jarvis, 1996, p.20).

3.35 In most countries, the most important source of finance for small enterprises are banks (Chittenden et al., 1990; Storey, 1994) and financial statements play an important role in their lending decisions (Berry et al., 1987; Berry et al., 1993). Collis and Jarvis (2000) found significant numbers of enterprises (69.1% of their sample) sent annual accounts to their bankers. Sian and Roberts (2003) focused on smaller owner-managed entities and found that 36.8% of respondents sent their accounts to their banks for the purpose of monitoring existing loans and 36.6% sent their accounts to banks for the purpose of applying for new loans in the UK. The literature shows that information contained in the profit and loss account and the notes to the accounts is used by bankers in their analysis (Berry et al., 1987) and banks additionally often demand "expanded financial statement information such as forecasts" (Berry and Waring, 1995, p.150). Berry and Waring (1995) found that in making lending decisions bank lending officers may use the profit and loss account to produce "crude cash flow measures," examine the current value of assets on the balance sheet, utilize profitability measures and demand budgeted financial forecasts to aid their lending decisions. They comment, however, that there is no direct relationship between information demanded by the banks and its use. In contrast, Barker and Noonan (1995) suggest that the main uses for SME financial statements by banks are: to determine capacity to repay and to assess profitability, security and liquidity. Referring to prior work on the use of private company accounts by banks in the USA, Botosan et al., (2006) conclude that external lenders lending to small businesses generally "perceive their needs to be similar to decision makers dealing primarily with larger companies" (p.186), want more not less disclosure, and perceive GAAP-based financial statements to be useful.

3.36 SMEs in some countries will also gain finance from other sources. Particularly important may be Government agencies, in particular SME and regional development agencies. In some countries credit unions may also be important as may be NGOs in developing countries.

3.37 There is little evidence that the financial statements of small enterprises are used by many of the other users identified by the IASB. For instance, drawing on evidence collected in the UK, Jarvis (1996) notes that "no reference is made to the use of financial statements in determining the credit worthiness of companies by trade creditors in determining trade credit" (p.26). In contrast, other authors have found that 51% of small companies claim to read the annual reports of major competitors, 44% read the reports of major customers and 26% read the reports of major suppliers (Dugdale et al., 1997). Similarly, research conducted in Italy suggests that while owner-managers, tax authorities and banks are the main users of accounts produced by small entities, other users, such as non-owner managers,[24] trade creditors and employees[25] make little use of SME annual accounts (Paoloni and Demartini, 1998; Demartini, 2005).

Uses of SME financial reports

3.38 Studies have found that owner-managers use financial statement information for a variety of purposes. Important results include:

- Collis and Jarvis (2000), in a study of incorporated entities in the UK, found that the annual accounts of small companies are commonly used to ascertain remuneration awards made to directors, to compare company performance with previous periods and for purposes associated with loans and financing. Sian and Roberts (2003) also highlights the confirmation and verification roles of financial reports in the UK, finding that annual data plays a confirmatory role rather than being a useful tool for forward planning in the opinion of owner-managers. The most commonly cited use of such statements was to compare income and costs with past periods.
- In Ireland, Barker and Noonan (1995) asked about benefits attached to the financial statements of small entities. Their results showed that they were useful for: planning and decisions (including future planning and decisions re directors' emoluments and dividends) (35%), tax purposes (21%), bank purposes (19%) and review of performance (11%). Furthermore, although most directors and shareholders did not understand formal financial statements, they were seen as providing "confidence in the calculation of value and performance and they lend transparency" particularly for use by the Revenue, banks and other potential lenders (p.19).
- Studies in Italy confirm that owner-managers, in particular, are important users of accounting information, although delays in the production of accounting information means that its use as a decision making tool is limited (Demartini, 2005).

However, this does not mean that financial statements are the most important source of information for managers. For example:

- In Ireland, Barker & Noonan (1995) found that owners felt that periodic (weekly/monthly) management information was more useful than formal annual statements;
- In the UK, Sian and Roberts (2003) found that the most important sources of information for owner-managers are bank statements and annual reports, with quarterly or monthly management accounts either being ranked as very useful (30.0%) or not useful (30.9%). While owner-managers do use financial information, the results would indicate that they do not use it very frequently. The reasons cited include that the financial statements were too complex and not easy to understand, or that they were too long term or that they were just not relevant;

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[24] In most cases, owners who are not involved in management are family members and can obtain information about the firm's financial situation through informal channels (Paoloni et al., 1998).

[25] "Directors of small firms do not usually consider employees as users of the annual report. Indeed, one of the arguments against disclosure of information to employees is the suggestion that disclosure is undesirable because intrudes into the private affairs of owners" (Paoloni et al., 1998, p.17).

- In some small businesses computerized (or partly computerized) systems of record keeping allow the generation of regular internal financial information. Collis and Jarvis (2002) noted that in the UK, larger small companies found the periodic management accounts, cash flow information generated internally and bank statements generated externally more useful than the annual financial statements and 80% of their sample claimed to use these three sources of information to manage their business. These findings are reiterated in other studies, for instance John and Healeas (2000) and Jarvis et al. (1996).

In contrast, referring to the case of continental Europe, Demartini (2005) notes that many small companies do not have elaborate internal control systems and that financial statements should be "more useful for management control purposes and for banks' credit decisions but, to date, compulsory financial reporting is not aimed at these purposes, given that in most cases it is only prepared to comply with legal requirements" (Demartini, 2005, p.4).

3.39 There has been very little research on the ways in which other users use financial statements from SMEs. However, there is some evidence of differing perceptions. For example, although owner-managers may use accounts in a confirmatory role, accountants viewed financial statements as being useful forward-looking tools with their role in assessing risk for making new loan decisions being seen as more important than their role as a monitoring device (Sian and Roberts, 2003). Meanwhile in the Netherlands, research suggests that user needs are not necessarily being met (Bollen, 1996). In 1990, six years after the introduction of accounting regulations, up to 15% of small Dutch firms continued to not disclose financial statements, and of those that did a significant number failed to file their reports within the time allowed by law. This implies that publicly available financial information is delayed and this raises doubts about the usefulness of such information for users.

3.40 This suggests that while the typical accrual-based set of financial statements may be demanded by external users they are of little use to many, if not most, owner-managers. This appears to validate the need for specific guidance for smaller entities.[26] Much of the research on differential reporting has ignored cultural influences. Research focusing on the perceptions of small business managers in Singapore and Australia, found culture-based differences in disclosure preferences of small business entities (Williams and Tower, 1998). Studies in Italy instead conclude that small entities are unwilling to disclose information to other external users (the exception perhaps being communication with venture capitalists and major foreign shareholders) (Demartini, 2005). Owner-managers regard disclosure to external stakeholders as a breach of privacy and Demartini notes that most small entities do not view web pages as a means of circulating financial

[26] In the UK this exists in the form of the FRSSE, but there appears to be "a general rejection of the FRSSE and even the use of accounting standards for the smaller companies, i.e., a rejection of the general purpose model" (Marriot and Marriot, 1999). John and Healeas (2000) concur with these findings and note that the FRSSE has had no fundamental effect on the content of financial statements, not least because the FRSSE often simply exempts small enterprises from disclosure rules for complex transactions that are not of relevance to them and because of the Companies Act requirement to produce full accounts for shareholders.

information. This may be an important consideration for international organizations attempting to establish uniform regulations for SMEs. As some have argued, it may be a task better left to national standard-setters who have a clearer insight into specific local conditions for smaller entities not seeking internationalization.

Extending IFRSs to SMEs

3.41 There seems to be general support for differential reporting rules. For instance research conducted in Australia, questioning practitioners, suggested that 97% of those questioned supported the need for differential reporting (Holmes et al., 1991). Similarly, the AICPA's research into private company reporting suggested that "GAAP for private companies should be developed" and that "fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private companies are met" (AICPA, 2005, p.6). However, there is far less consensus on how the standards for SMEs should be set and exactly which entities fall into this category.

3.42 The IASB is writing its SME standard using the same conceptual framework as used for IFRS but reducing the financial reporting burden. Initially this 'top-down' approach meant that the standard would maintain the measurement and recognition criteria, though in certain cases in a simplified form, while reducing disclosure differences (although eventually the IASB abandoned this position and recognized the need for measurement and recognition modifications too). However, this approach was not without its critics, many of whom cited the significant differences between larger and smaller entities (Paoloni et al., 2000; Riistama and Vehmanen, 2004; Demartini, 2005).

3.43 There are several factors that may differentiate small enterprises from larger enterprises:

- Many small entities are owner-managed (family interests) and as there is no separation of ownership and management the stewardship purpose of financial statements based on accounting standards is not the same and so perhaps does not have the same significance;
- Because of the small size, managers have few business skills, the business is tight-knit and the values of owner are shared by employees (Baskerville and Cordery, 2006);
- Small entities tend to operate in a unique and uncertain environment. SMEs are not able to operate in the financial market like conglomerates, mainly because of their small size and limited resources and they operate, almost without exception, locally (Riistama and Vehmanen, 2004). They have small numbers of customers and suppliers, an inability to drive prices and some owners do not always have the objective of maximizing profits. Evidence from New Zealand suggests that SMEs tend to be differentiated on the basis of "innovation" and many started spontaneously with an innovative product (Baskerville and Cordery, 2006), although this is debatable particularly in the case of developing countries; and
- They do not have the same sort of obligations and responsibility to their investors as larger entities and mainly rely upon debt rather than equity finance. Since SMEs are

not seeking a public listing, their value is of less significance than their capacity to generate positive cash flow and the users of financial statements of SMEs are limited to the owners and the management as well as to the financing institutions that have financed the SME in question (Baskerville and Cordery, 2006).

3.44 There are certain arguments in favor of and against an international standard for SMEs. Arguments in favor of an international standard for SMEs include the following:

- It would mitigate the cost/benefit argument used against full IFRSs and create a defined and consistent regulatory framework for those small enterprises maturing to a capital market listing;
- It would be beneficial for SMEs in some transitional economies, especially those required to apply full IFRSs as a result of World Bank directions;
- It would be beneficial to any SME that has users located in different jurisdictions or that wish to use the financial statements of other SMEs;
- Accounting is about reporting economic events and if the event is the same across countries then the reporting should be the same across countries. Differences in users, or legislative, political or cultural differences do not imply that the accounting for the same transactions or items should differ across countries; and
- Having an SME standard means that the cost of regulation is reduced and having a larger group of standard-setters improves the quality of the final product. In particular this is an advantage for developing countries that lack the infrastructure or money to develop their own standards.

The first two arguments apply only if a "top-down" approach is taken to developing such a standard (i.e., that full set of IFRS for large companies is simplified for smaller entities, (Baskerville and Cordery, 2006) as opposed to the "bottom-up" approach where a new standard would be developed with simplified measurement and disclosure requirements specifically for SMEs).[27] The first three arguments apply in particular to SMEs that are larger and that are intending to grow further and who are involved in activities internationally. The advantages to the smallest entities center almost exclusively around the last two arguments.

3.45 The main counter arguments to a single set of recommendations or rules internationally center around the issue that users do differ across countries, as does the culture and the type of legal system and stage of economic development. This suggests that the importance of many items will differ across countries, implying that it may be appropriate to have different rules in different countries. However, this argument would seem to apply in particular to social or environmental concerns and disclosures in the review of operations rather than the financial statements and associated notes. While it is easy to argue that certain types of transactions vary in importance across different countries (e.g., leased assets, final benefit pensions, share options) it is more difficult to

[27] The alternative is the "bottom-up approach" which is based on a new relevant conceptual framework and focuses on developing a specific SME standard.

sustain the argument that the appropriate accounting method for these transactions also differs across countries.

3.46 A second argument against international standards for SMEs is the additional costs that these may involve. This might be an issue if they cannot be used for taxation purposes and if SMEs are then required to produce additional information for taxation authorities. In this case it might be difficult to argue in favor of an international standard for the smallest SMEs, or those that are not interested in growing or taking part in international activities of any sort if they then also have to incur additional costs to produce tax accounts. However, if they can be used for taxation purposes, international standards could replace national standards or current practice and the financial impact might be expected to be neutral on average.

3.47 Furthermore, a recent commentary authored by the American Accounting Association's Financial Accounting Standards Committee (AAA's FASC) notes that "survey evidence indicates that external users of small business financial statements do not perceive their needs to be substantially different from decision makers who deal with larger companies" (Botosan et al., 2006, p.180), which mitigates the differing user needs argument.

3.48 Even if it is accepted that an international standard for SMEs is useful, there can be several problems with applying the "top-down" approach.

- First, there are issues of practicality and although the IASB has suggested that SME GAAP can be derived from full IFRSs, some writers have expressed concern that it is not easy to imagine "how mere simplifications of more than 1700 pages of standards and their interpretations and alike could meet the materially different financial accounting information needs of SMEs" (Riistama and Vehmanen, 2004, p.4).
- Second, there is the issue of the full IFRSs being based on a conceptual framework that is oriented to the needs of large enterprises, while the needs of small enterprises are not necessarily the same.[28] For example, the IASB in its discussion paper argues that smaller entities may need to disclose much more related parties' information. Small companies often have different objectives, for instance they aim for survival and stability, also shareholders are not necessarily the primary users of accounts, but rather banks are. "The experience of some national standards-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 (Baskerville and Cordery, 2006, p.11).

[28] The counter-argument is cited in Evans et al. (2005). Studies conducted in Italy contributing to this theoretical debate have concluded that the objectives for financial reporting should be similar for all entities, there exist commonalities in users of such information and therefore the same accounting principles should be applicable to all financial statements, although they comment that "it is, however, questionable whether the IASB's *Framework* is such a *universally suitable* framework." Evans et al. comment that the IASB's framework is geared towards large companies with international listings and either needs amendment before application to SMEs or a new framework be developed for SMEs.

- Third, when full standards are used as the base point for the development for SMEs, it is argued that a potentially ad-hoc approach to this may result in gaps in regulation and may well be the subject of a political agenda, although the "top-down approach" has already been adopted with some success in countries such as Sweden and New Zealand (the latter adopts a sector neutral approach) (Baskerville and Cordery, 2006).

3.49 For micro-entities the arguments for a top-down approach are very much less convincing as these entities are even less like large entities and are less likely to grow into large entities. Indeed, UNCTAD suggests that they "follow a simple accruals-based accounting system that is closely linked to cash transactions" with recourse to cash accounting at the early stages of establishment (UNCTAD, 2002). Similarly, others have argued that "an accounting theory based on realization and matching principles is more suitable for financial accounting of SMEs than a static balance sheet and fair value based approach applied in IASs" (Riistama and Vehmanen, 2004, p.17).

3.50 Irrespective of who sets the standard for SMEs, having two or even three sets of standards gives rise to greater costs to the economy and to the regulators and preparers who need to learn both sets[29]. Although it may be easier and less costly for nation states to leave it to the IASB to set SME standards, any new tier of regulation adds to the cost burden for preparers and SMEs are not themselves involved in the process. Furthermore standards for preparing financial statements must meet user needs, but in the case of SMEs such needs have not really been defined. It is also debatable whether the top-down approach, which views SMEs as small companies growing into larger ones, is appropriate. Again, the point needs to be made that we believe similar concerns and limitations may apply to IFAC's involvement in developing guidance for the micro-entity sector.

4. Survey of Legal Status of Micro-Entities Across National Jurisdictions

4.1 This section sets out to ascertain the current legal status of micro-entities across national jurisdictions. Probably the most prominent definition of SMEs is found in EU Commission recommendations. The initial recommendations came into force in 1996 (96/280/EC, 1996) as part of the logic of a single market to improve the consistency and effectiveness of policies targeting SMEs. These definitions were important not only for accounting, but also in a wide range of other areas, such as national state-aid schemes, research and innovation support, Regional Funds, venture capital funds and loan guarantee schemes. The definitions were updated in 2003 (OJEU 2003/361/EC) and, in addition, a new definition of micro-entities was also introduced. Also introduced was a definition of an autonomous entity. These definitions came into effect on January 1, 2005. However, it must be noted that these are recommendations only, and Member States, the European Investment Bank and the European Investment Fund may all, if they wish, apply lower ceilings, or may choose only to apply the criterion of number of employees, except in any areas governed by State Aid rules. The definitions apply to all

[29] The IASB has recognized some of these concerns in that it has announced that it will not be changing its standard every time a new IFRS is introduced, but instead it will issue a new standard no more then once every two years.

types of entities engaged in economic activity including sole traders and partnerships. The relevant size criteria both now and with respect to the earlier recommendations are shown in figure one.

Figure 1: EU recommendations on the size criteria for micro, small and medium enterprises

		Employees AND	Turnover AND/OR	Balance Sheet
2005	Medium	250	€50m	€43m
	Small	50	€10m	€10m
	Micro	10	€2m	€2m
1996	Medium	250	€40m	€27m
	Small	50	€7m	€5m

4.2 These size criteria only apply if the entity can also be considered autonomous. In this specific context, this is interpreted as meaning any entity that has less than 25% of its capital or voting rights owned by another enterprise or public body. It is worth quoting the European Commission on why they have used both a head count and financial ceilings:

> *The criterion of staff numbers … remains undoubtedly one of the most important, and must be observed as the main criterion; introducing a financial criterion is nonetheless a necessary adjunct in order to grasp the real scale and performance of an enterprise and its position compared to its competitors. However, it would not be desirable to use turnover as the sole financial criterion, in particular because enterprises in the trade and distribution sector have by their nature higher turnover figures than those in the manufacturing sector. Thus the turnover criterion should be combined with that of the balance sheet total, a criterion which reflects the overall wealth of a business, with the possibility of either of these two criteria being exceeded. (OJEU, 2003, paragraph 4).*

4.3 EU countries have implemented these recommendations in different ways. Not all countries have introduced all three size criteria into national legislation. For example, as shown in Figure 2, Belgium, Finland, Ireland, Italy, Norway and the UK have not introduced the new micro-entity definitions into national legislation. In all cases where size criteria have been adopted in national laws, the EU recommendations with respect to the number of employees have been used. In contrast, there is considerable difference of opinion with regard to the relevant financial cut-off points for each of the types of entities, including micro-entities. For example, while Czech Republic, Germany, Hungary and Poland are all happy to go with the EU recommendations for micro-entities, Denmark uses lower cut-offs with 10m DKK (US$1.7m) turnover, but only 4m DKK (US$0.7m) Balance Sheet total while Estonia uses even lower cut-offs of €639,000 (US$0.8m) and €319,500 (US$0.4m) respectively.

Figure 2: **Size criteria used in national legislation in various EU countries**

	Medium **Employees / Turnover/Balance Sheet Total**[30]	**Small** **Employees / Turnover/Balance Sheet Total**	**Micro** **Employees / Turnover/Balance Sheet Total**
Belgium	N/A	50 $4.7m $9.4m	N/A
Czech	250/ $64.2m/ $55.2m	50 $12.8 $12.8	10 $2.6m $2.6m
Denmark	250 $40.9m $20.5m	50 $10m $5.0m	10 $1.7m $0.7m
Estonia	N/A	N/A	10 $0.8m $0.4m
Finland	N/A	50 $9.4m $4.7m	N/A
Germany	250 $64.2m $55.2 m	50 $12.8m $12.8m	10 $2.6m $2.6m
Hungary	250 $55.2m $55.2m	50 $12.8m $12.8m	10 $2.6m $2.6m
Ireland	250 $19.6m $9.8m	50 $4.9m $2.4m	N/A
Italy	250 $64.2m $55.2m	50 $8.0m $4.0m	N/A
Malta	N/A	50 $6.4m $3.2m	N/A
Norway	N/A	50 $9.6m $4.8m	N/A
Poland	250 $64.2m $55.2m	50 $12.8m $12.8m	10 $2.6m $2.6m
Romania	N/A	50 $8.0m $5.0m	10
Sweden	N/A	50 $6.4m $3.2m	N/A
UK	250 $42.3m $21.2m	50 $10.6m $5.3m	N/A

4.4 A number of other countries also use quantitative cut-offs in various regulations concerned with accounting and financial statement production. The actual criteria used

[30] All local currency amounts have been converted into US$ equivalents at the exchange rate ruling at November 1, 2006 to facilitate comparison.

vary considerably across non-EU countries as shown in Figure 3, with only Switzerland using the three criteria of employees, turnover and balance sheet totals. Particularly interesting are the criteria employed in Korea and Russia both of which recognize that different types of activities or industries may warrant different definitions of medium or small entities and that a single quantified definition of number of employees is unlikely to be equally appropriate in manufacturing, service and financial industries.

Figure 3: **Examples of size criteria used in non-EU countries**

	Medium Employees/ Turnover/Balance Sheet Total[31]	**Small** Employees/ Turnover/Balance Sheet Total	**Micro** Employees/ Turnover/Balance Sheet Total
Brazil	N/A	$1.1m turnover	$0.1m turnover
China	300 employees	N/A	N/A
Korea: manufacturing	300 $8.4m N/A	N/A	N/A
Malaysia	N/A	50 $6.3m $3.1m – both gross	N/A
Russia manufacturing or construction	N/A	100 employees & less than 25% held by larger entity	N/A
Sri Lanka	N/A	N/A $4.8m $1m	N/A $0.5m $0.1m
Switzerland	200 $32m $16m	100 $16m $8m	10 N/A N/A

4.5 Exactly how the size criteria play out in the EU is rather complex. All EU countries require their listed entities to comply with full IFRSs when preparing their consolidated financial statements. Other corporate entities may generally choose to follow either IFRS or domestic GAAP. The exceptions to this are Poland, Latvia and Lithuania where national GAAP must be used by unlisted companies, while Cyprus and Malta require all companies to follow IFRS. Countries like Belgium, Portugal, Spain and France have a high standardization of financial reporting with legal status not being the determining factor. This means that all large entities must follow local GAAP or IFRS, including businesses other than companies with limited shareholder liability. There is far less harmonization of the accounting regulations for small entities because the Fourth Directive includes optional exemptions for SMEs, creating "competitive disadvantage and lack of comparability between annual accounts" (Demartini, 2005, p.3). For instance, in Denmark, the Republic of Ireland and the United Kingdom Company Law allows

[31] All local currency amounts have been converted into US$ equivalents at the exchange rate ruling at November 1, 2006 to facilitate comparison.

fewer exemptions for small businesses than in other European member States. The legal systems in the Netherlands and Luxembourg, on the other hand, have implemented many options allowed by the Fourth Directive. Between these two extremes there are countries such as Germany, Italy and Greece (Paoloni and Demartini, 1999, p.21). Jaruga and Fijalowska (2004) comment that in Poland, government policies promoting SMEs have conferred significant financial reporting exemptions and "even accounting requirements for the purposes of taxation are differentiated according to an entity's size and business sector."

4.6 Other countries which adopt a dual approach of public accountability and size include Hong Kong, Japan, New Zealand, the Philippines and Singapore. Public accountability is defined in various ways. All agree that it includes entities that issue public debt or equity or intend to do so. In addition, Hong Kong and the Philippines include all entities with a fiduciary responsibility to a broad range of outsiders. This would typically include banks, insurance companies, pension funds, securities and futures traders and similar. New Zealand instead, reflecting the fact that public sector organizations are required to adopt GAAP, also includes any entities that have a coercive power to tax, rate or levy to acquire public funds while the Philippines similarly includes public utilities or entities that provide essential services.

4.7 Very few countries base definitions of different types of entities only on the criteria of public accountability. For instance, Australia has two sets of requirements. The Corporations Act defines small companies in terms of size criteria (there is a requirement to fulfill at least two of the following: 50 employees; gross assets US$3.7m; and gross revenue US$7.4m). Small companies need not prepare financial statements unless they are controlled by a foreign company, or at least 5% of shareholders require the statements or it is required by the Australian Securities and Exchange Commission (ASIC). In contrast, accounting standards differentiate between reporting and non-reporting entities. Three criteria defining the existence of dependent users should be considered: separation of management and ownership; economic or political influence (with fiduciary responsibility to a wide range of outsiders being prima facia evidence of dependent users); and financial characteristics including size and indebtedness. If no dependent users exist then the entity must either follow ASIC reporting requirements or, if not relevant, it need not follow GAAP. Canada has similar but much simpler rules: here public accountability is defined to include enterprises with listed debt or equity plus co-operatives, regulated financial or rate-regulated institutions and public sector enterprises. In all these cases, entities must produce fully compliant financial statements, while other incorporated entities need only follow a set of simplified standards as contained in Canadian Institute of Chartered Accountants (CICA) standards (Section 1300: Differential Reporting), providing all users unanimously agree to this.

4.8 Probably the simplest basis of differentiation between types of entities is found in the USA. Entities that fall within the jurisdiction of the SEC, as they list public debt or equity, must comply with full US GAAP requirements in the form of FASB pronouncements. Other entities need not produce such statements, although many especially of the larger entities do produce GAAP statements as these are demanded by various users.

4.9 Two approaches are found to the development of specific rules or standards for SMEs. In the UK, for example, smaller incorporated enterprises, excluding financial institutions, are governed by the Financial Reporting Standard for Small Entities (FRSSE), a simpler and less onerous set of reporting rules. This recognizes that compliance with full GAAP burdens the small business with costs that are not offset by the benefits that owner-managers or other users gain from the production of such information (Dugdale et al., 1997). It also recognizes that disclosure requirements in financial statements pose particular problems for owner-managers who are often concerned with revealing information to competitors or making public what they consider to be their private financial affairs (Page, 1984). This approach has also been followed by a number of other countries such as Hong Kong and Malaysia as well as the IASB.

4.10 Some countries such as Canada, Malaysia and Hong Kong have instead adopted the "integral approach" whereby individual accounting standards offer exemptions to SMEs, while other countries have adopted the "distinct approach" which involves the development of a single standard applicable to and addressing the needs of SMEs (such as the FRSSE in the UK and the Sri Lankan Accounting Standard for Small Entities (SLASSE) in Sri Lanka) (Devi, 2003).

4.11 The IASB has undoubtedly succeeded in developing a draft standard that considerably reduces the amount or volume of regulations. The final standard is likely to be less than 250 pages, rather than the 2,400 or so pages of the full IFRSs. However, it is still a longer document than many other accounting standards for small entities. For example the UK 2005 FRSSE is a document of 274 pages, but only 106 pages of actual standard, the South Asian Federation of Accountants' Financial Reporting Standard for SMEs ED is 76 pages while the Hong Kong FRSSE is only 62 pages (HKICPA, 2005; SAFA, 2006). Some of the differences are due to the extent to which these are all stand alone documents. For example, the Hong Kong standard simply offers definitions of such items as financial instruments and then says that, if an entity has any, it must apply the full standard. Another reason for the differences is the extent to which the standards offer simplifications in disclosure or alternative recognition and measurement rules. For example, the UK standard does not contain any requirements to use fair values for financial instruments instead simply requiring that they are broken down into constituent parts on the basis of economic substance, so that the requirements are very simple, while the IASB standard attempts instead to maintain the measurement and recognition criteria of the full standards, albeit in a much simplified form.

4.12 One interesting example that has taken the Hong Kong approach even further is ECSAFA in their guidelines for SMEs (ECSAFA, 2005). At first glance this is an extremely simple statement that requires entities to apply the IASB Framework, IAS 7 *Cash Flow Statements*, IAS 1 *Presentation of Financial Statements* and IAS 8, *Accounting Policies*. Thus, the eight pages of standard plus five pages of specimen financial statements, define the elements, suggest that historical costs are normally sufficient and list those items that should be disclosed in financial statements including cash flow statements and notes to the accounts. However, while this appears to be a very simple statement suitable for the smallest entities it does not explain the specific rules that should be adopted and it cannot be used by itself. Instead it states that entities should refer to, in descending order of importance: standards and interpretations of the IASB; most recent pronouncements of other standard-setters who use a conceptual framework similar to the IASB Framework; other accounting literature and accepted industry practices.

5. Conclusions

5.1 In anticipation of the issue of the IFRS for SMEs ED, IFAC have commissioned research to investigate the need for regulation of financial reporting by micro-entities and if so their involvement in this regulation. This study investigates the information needs of preparers and users of micro-entity financial reports and key to this is the comprehensive review of the extant literature set out in section three. The review indicates that very little research has been previously conducted looking specifically at micro-entities as these tend to subsumed in the term SME. Furthermore much of the published literature is restricted to studies conducted in developed countries and does not reflect the very different environment in which micro-entities operate in developing, emerging or transition economies.[32] This gap in the literature indicates that this is an area that is ripe for further in-depth examination and research.

5.2 Recognition of the burden placed upon the smallest entities and the perceived irrelevance of full IFRSs for small entities has resulted in many jurisdictions providing reporting exemptions and general support for differential reporting. Although variant user needs have also been promulgated as an argument in favor of differential reporting for SMEs, there is little empirical evidence to support this and it remains unclear exactly what those user needs are far as micro-entities are concerned. Further, much of the research on differential reporting to date has ignored cultural differences, despite emerging evidence recognizing their importance. This may be an important consideration for international organizations, such as the IASB and IFAC, attempting to establish guidance for SMEs. Indeed some authors have commented that "it may be the case that the needs of the smallest SMEs are best served by a system developed by national regulators, taking into account their specific economic environment" (Evans et al., 2005, p.39).

5.3 Section three has shown that in the case of the smallest entities, financial information is generally prepared either by the owners or by an accounting practitioner (either internally or externally). It seems to be the case that owners are not always particularly financially literate and in developed countries often rely upon computerized systems to produce basic accounts. This is an area that may need to be addressed by bodies such as the IASB and IFAC as they seek to issue guidance for small entities. Many such packages are already geared to producing financial information in particular formats and it may not be cost effective for small entities to dispense with such packages. On the other hand it

[32] For instance, in Poland, there are over 5.5 million people working in SMEs and the average in each company "slightly exceeds 4 people" (Jaruga and Fijalkowska, 2004) the majority being employed in industries such as trade and repairs, construction and hotels and restaurants.

could be the case that companies producing packages for use by the smallest entities follow the lead of the international regulators and customize packages accordingly. Development of a regulatory regime in tandem with computerized packages for micro-entities may also assist in alleviating the cost burden for this sector to some extent. This, of course, is not the situation in all countries. Work previously conducted by the authors suggests that in developing countries micro-entities enjoy a lesser degree of permanence and stability (Sian, 1998). Here, the evidence suggests that owners of micro-businesses, who sometimes suffer from poor literacy, often maintain financial statements for the sole purpose of supporting claims for lower tax assessments. Either way, further research to ascertain the type of information owners of micro-entities regularly utilize to run their businesses effectively. Prior studies indicate that accountants who prepare financial information for small entities are also key business and tax advisors and their views, too, will be valuable in any further research.

5.4 Although the literature suggests that small entities use financial reports for a variety of purposes, such as raising capital, obtaining credit from suppliers, budgeting, monitoring profits for tax and for distribution purposes, qualifying for bidding on contracts, planning and forecasting for the business and validation purposes, it is not at all clear the extent to which all of these apply to micro-entities. Furthermore there is evidence that there is considerable variation in record-keeping, ranging from full computerized accounts to some small entities not maintaining adequate records partly because of cost issues and partly because owners do not always understand them or recognize the value of such information. On one hand this may be a hurdle, as any new international guidance to encourage record-keeping and accounts preparation may be ineffective without national enforcement but on the other hand there is also recognition of a need for some simplified, authoritative guidance in this area.

5.5 The main users of the financial statements of smallest entities constitute a much narrower grouping than those identified for larger entities and have been identified in the literature as: banks and other finance providers; directors (owner-managers and owner non-managers); and tax authorities. The literature suggests that venture capitalists, in particular, have much broader information needs than more traditional finance providers, such as banks, and may take a more prominent role in directing the production of financial information. However, in the case of almost all providers of finance, although prior work has attempted to ascertain the uses of SME financial statements (capacity to repay and to assess profitability, security and liquidity), very little research has been conducted to ascertain whether their needs are being met. Further research might address this issue and determine whether the new IASB guidance would suffice in the role. In addition, while some financiers do have access to periodic management accounts and cash flow information, given the comparative absence of other sources of market data on these small entities, the production of general purpose financial reports becomes an even more important source of information for external users. Such elevated significance would lend support to the argument advocating greater regulatory guidance for the smallest entities.

5.6 One of the key concerns associated with heightened guidance for small entities is the imposition of a higher cost burden. This involves not only gathering the data necessary to produce the information, but also the costs of accounting advice and possibly accountant's fees for services rendered. However, the fact that many accountants gear their services to focus on statutory work for larger businesses (Kirby et al., 1998), provides support for the suggestion that the use of accounting technicians (or equivalent) in conjunction with computerized packages may be of benefit to many small entities in assisting cost reductions.

5.7 The issue of heightened guidance for small entities is also related to the issue of enforcement and compliance. Statutory and voluntary audits and other assurance processes can assist in enforcing the application of IFRSs by larger and medium-sized entities. However, for the smallest entities this is not necessarily the case and enforcement remains an unresolved issue, particularly as many such entities prepare information for tax purposes only.

5.8 As seen in section four, it is increasingly common for countries to introduce a two tier accounting system of big GAAP and little GAAP. In all countries, those entities that offer equity or debt to the general public must apply big GAAP. While in the USA other entities do not have to apply GAAP, the USA is an exception. In other countries non-listed corporate entities often may instead apply a simplified set of rules or little GAAP. In nearly the whole of the EU, non-listed corporate entities may follow local GAAP rather than IASB rules, while in addition, if they are also "small", they may be exempt from certain reporting regulations. In countries where accounting rules for specific types of events or transactions are contained in accounting standards, two approaches to little GAAP exist, namely top-down or bottom-up approaches. The former starts with big GAAP rules and offers various exemptions to specific rules, while the alternative approach instead starts with the small enterprise and develops a separate standard or set of standards specifically for the smaller enterprise. In the latter approach some or all of the recognition and measurement criteria and methods may be different from big GAAP principles or rules. In contrast, the top-down approach tends to concentrate upon simplifying disclosure rules. While recognition and measurement rules may also be simplified, they will always be congruent with big GAAP rules. A separate standard for corporate entities that does not meet the requirements for the full accounting rules are found in a variety of countries such as Denmark, the Netherlands, Norway and the UK in the EU, as well as Hong Kong and Sri Lanka. Malaysia and South Africa are both also well on the way to introducing such a standard. This is also the approach being adopted by the IASB. The alternative approach of a list of exemptions from individual rules or standards is instead found in Finland and Sweden in the EU as well as Australia, Canada, New Zealand, India and Korea.

5.9 As also discussed in section four, the specific rules as to which entities may apply little GAAP differ across countries, however in all cases the definition attempts to describe "public accountability." For example in both the UK and Hong Kong, corporate entities would not be allowed to follow Little-GAAP if they are listed, hold assets in a fiduciary capacity for a significant number of outsiders (i.e., banks, insurance companies, securities traders and similar) or are above a certain specified size. Canada, New Zealand and the Philippines would add to this list of exclusions any entities that operate in the public sector or provide essential public utilities. A similar approach is being adopted by the IASB. While they cannot specify which entities must adopt their proposed standard, they have designed it explicitly for entities that do not have public accountability but that publish general purpose financial statements for external users.

Defining a micro-entity

5.10 The literature shows that there exists varying defining criteria for SMEs, both qualitative and quantitative. The IASB expects its SME standard to be suitable for entities that do not have public accountability and publish general purpose financial statements for external users. Many of the national jurisdictions surveyed in section four instead employ quantitative financial criteria.

5.11 Some writers have advocated the need to encompass factors such as industry and sector when determining size criteria for SMEs (Bollen, 1996). Bollen (1996) also introduces the concept of "degree of separation between ownership and control" and notes that "criteria based on the degree of separation between the ownership and management of a firm may therefore provide a much more articulate basis for differential financial reporting regulations. Such criteria relate to the difference between private and public companies and may be indicated by the number of stockholders, the fee transfer of stock or the degree of owner's equity held by management" (Bollen, 1996, p.181). It has also been suggested that small entities (and by extension also micro-entities) can be further subdivided into growing, non-growing and start-ups.

5.12 The EU has adopted the criteria of 10 or less employees as an appropriate definition for SMEs. While it is possible to argue about whether or not this is appropriate, it is sufficiently small to suggest that the appropriate accounting is likely to be much simpler than that envisaged by the IASB SME standard while capturing many entities that are significant in the context of a local economy. As argued in section four, it is far more difficult to define turnover or balance sheet totals that capture economic significance as this will depend upon local price levels. Thus a suitable definition of a micro-entity would be one that:

- Has an average of 10 or less full-time equivalent employees; or
- Is economically significant in its local economy as measured by turnover or balance sheet total.

5.13 The IASB SME standard is designed to apply to entities that produce general purpose financial statements. However, this definition is based upon what entities currently do, rather than what they intend to do, or what they should do. Thus, it seems more useful to define micro-entities in terms of those who might find the standards useful, even if they do not currently produce general purpose statements. Usefulness depends more upon the purposes to which financial statements are put, or the users and uses of the statements. It is generally accepted that in an international context, tax authorities should be ignored. Likewise, owner-managers should be ignored as while management may find these reports useful, management really needs more timely information. This implies that micro-entities who might benefit from a standard for financial statements are those entities that meet any one of the following criteria:

- There is at least one owner who is not also a manager; or
- They do, or intend to, raise external credit; or
- They do, or intend to, seek support from the government or public sector sources.

It is important to note that this definition says nothing about legal status. While legal status is undoubtedly important, especially in lending and credit granting decisions, it is not a significant determinant of most users and user needs. It is felt that all entities that meet these criteria, irrespective of their legal form, might benefit from international guidance or standards.

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