Small and
Medium
Practices
Committee

Information Paper
January 2008

Micro-Entity Financial Reporting: Some Empirical Evidence on the Perspectives of Preparers and Users

International Federation
of Accountants

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545 Fifth Avenue, 14th Floor
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ISBN: 978-1-934779-02-6

MICRO-ENTITY FINANCIAL REPORTING: SOME EMPIRICAL EVIDENCE ON THE 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 was duly issued as an exposure draft (ED) in February 2007, may not be suited to the smallest entities within the SME spectrum. The objective is to help inform the debate on whether the proposed standard would suit micro-entities.

The first phase of the research comprised 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 findings were published in an Information Paper entitled *Micro-Entity Financial Reporting: Perspectives of Preparers and Users*. The authors concluded 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 prompted the SMP Committee to initiate a second phase of research to investigate whether the proposed IFRS for SMEs is likely to meet the needs of users of financial reports of micro-entities and whether it can be easily applied by preparers.

This entailed assembling and obtaining the views of the three key stakeholder groups – owners, financiers and preparers - by way of focus group interviews. The findings are summarized in this Information Paper. It should be noted that the focus group interviews were undertaken in five countries. Furthermore, this paper primarily focuses on the fieldwork undertaken in two of these countries. A consequence of these limitations is that the findings are not globally representative.

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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

Acknowledgements

This paper has been authored by Dr. Suki Sian and Professor Clare Roberts. The SMP Committee appreciates the considerable amount of time and effort that the authors have invested in drafting this paper. The SMP Committee would also like to thank the following individuals for their contribution to the project:

- Professor Robin Jarvis, Association of Chartered Certified Accountants (ACCA)
- Caroline Kigen, Institute of Certified Public Accountants of Kenya (ICPAK)
- Zbigniew Luty, Accountants Association in Poland (AAP)
- Gladys Martinez, Colegio de Contadores Economistas y Administradores del Uruguay (CCEAU)
- Matteo Pozzoli, Consiglio Nazionale Dottori Commercialisti (CNDC)

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Executive Summary

Introduction

This report presents the 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 SME (small- and medium-sized entities) spectrum and for the purposes of this study are tentatively defined as less than 10 employees (including those that do not have any employees).

This report documents the second phase of this study, the objective of which was to ascertain the views of stakeholders on the issue of the suitability of the IASB's proposed SME standard, "International Financial Reporting Standard for Small and Medium-sized Entities" (IFRS for SMEs). Drawing from prior literature, stakeholders are identified as: owners of micro enterprises; lenders who provide finance to micro entities and preparers of financial reports for micro entities. In order to meet this objective, this phase of the study involved assembling and obtaining the views of the three key stakeholder groups. In order to permit comparison within different economic, political and social environments focus groups were conducted initially in both London and Nairobi. The UK is a country that has already adopted IFRSs for listed companies only, has a standard of its own that may be used by SMEs (the Financial Reporting Standard for Smaller Entities or FRSSE) and still has extant local accounting standards applicable to all non-listed companies. Kenya, by contrast is a country that has adopted IFRSs in full and these have been applicable to all listed and non-listed entities since 1999. In addition, focus groups were also conducted in Italy, Poland and Uruguay and the responses were made available to the authors of this report.

Principal findings

Preparers

- In all countries financial statements are generally prepared on an accruals basis, although *"there might be the odd one that's cash based, for the tiny, sole trader"* or certain businesses, such as taxis, that are cash based.
- Other communications occur between preparers and micro entities – meetings or phone conversations with the directors/owners and management letters.
- The processes involved in the production of financial statements for the smallest entities are dependent upon the sophistication of the client. Although the preparers and many of their clients utilize computerized accounting packages, the end product does not necessarily meet regulatory requirements and therefore requires tailoring.
- The most useful outputs of computerized packages are: debtors and creditors listings; quarterly value added tax (VAT) results; payroll and information on stock levels. Low levels of financial literacy mean that few small business owners are able to utilize much of the output offered by packages.
- In the UK, the constitution of the annual financial statement is guided by accounting standards (including the FRSSE) and company law with respondents often relying upon national professional bodies' publications and recommendations to interpret these. In

Kenya, the main sources of guidance are the IFRSs and the national professional body's recommendations. In Italy, in contrast, unlimited liability companies are common and for these entities, only the tax rules are important.

- Areas that cause difficulties for smaller clients include: deferred tax and VAT; the difference between leasing and hire purchase; reporting related party transactions; valuation of stock and work in progress; and specifically in Kenya, where IFRSs are applicable, fair value measurements and contingent liabilities. In Poland, transactions with entities or individuals located in other countries also posed significant problems.
- In the UK any new regulations would only be used by preparers if they were obligatory and recommended by the local regulator (accountancy bodies/Accounting Standards Board). In Poland and Italy it was thought important that the taxation authorities accepted them. In Kenya, there was greater acceptance of potential international guidance for SMEs including micro entities.
- Educating users and preparers about any new regulations was an issue raised by Kenyan participants, given their personal experience with the adoption of full IFRSs. This would make users and preparers more aware.
- Definition of a micro entity – the number of employees are not a suitable criteria for assessing whether an entity is medium, small or micro as these vary across different countries and industries. An alternative measure is ownership or connection to the entity and an assessment of the need for external information and creditor protection.
- Generally the UK and Kenyan groups called for a disclosure checklist with fixed format statements and a statement of principles to support the disclosures required. This approach was far less popular in other countries where rules for the most common transactions were generally preferred.
- Participants suggested that a two format approach might be more appropriate, a shorter document with practical guidance for owners of small entities and another longer, technical version suitable for preparers (no more than 100 pages).
- In general the UK respondents felt that existing national regulations were adequate for SMEs and micro entities. However, in Kenya, there was general support for international regulation, perhaps because there is no local SME guidance and IFRSs are already subject to local enforcement.
- There was general support for attesting the statements of micro entities. This should ideally take the form of a short report by an accountant rather than a statement by the owners as many small business owners are not financially literate. In Poland there were concerns about bureaucracy and a simple sign-off of the accounts by the preparer was thought sufficient.

Lenders

- Lenders rely upon the financial statements of small enterprises, in addition to other sources of information, mainly to make judgments about the entities to which they may or may not extend credit.

- The most useful components of the financial statements, for lenders, are the cash flow statement, the balance sheet and the income statement. In addition, where available, the presentation of audited accounts, creditors and debtors listings and credit searches, key ratios and management information are also useful. In Poland and Italy tax returns are also often requested.
- Lenders do not have specific requirements regarding the presentation of financial statements although the information provided is not always in a format that the lenders find useful. There was general support for standardization and fixed format statements at the micro level.
- Lenders support the use of computerized packages to ensure some form of consistency of presentation of information.
- Financial statements are a source of intelligence when conducting due diligence tests to assess credit risks. They are used to calculate key ratio indicators as a means of assessing future performance.
- Financial statements are used to assess the application in relation to its peer group and in some cases to assess collateral, although for many of the smallest entities there is very little available in terms of business assets.
- A “good set” of statements are seen to be a good indicator of the control that the owner has over their business.
- Problems experienced by lenders with respect to micro-entity financial statements and their contents include: obtaining financial statements for the smallest clients; time taken in gathering information necessary to make a decision; timeliness of any information that is produced; often small entities do not even produce accounts and those that do “bear little resemblance” to what is actually happening in the business; and the exclusion of items from the financial statements for the purposes of suppressing profit for taxation and the reliability of the contents.
- Different lenders had different notions of what they perceived a micro entity to be.
- In the UK some lenders supported national regulations whilst others supported international regulations for micro entities. In Kenya, there was overwhelming support for international regulations for all micro entities whether incorporated or not. In contrast, in Italy and Poland there was general support for local or national regulations so that they met national taxation requirements and took account of the local economic environment.
- Assurance and attestation of micro-entity financial statements is important to lenders but there is little consensus on whether this should be by the owner or an accountant.

Owners

- Generally, accrual-based financial statements are prepared to meet the requirements of tax authorities and other users, such as banks.
- In many cases business owners are not financially literate and rely entirely upon their accountant to determine the form of financial statements.

- Key determinants of the form of financial regulations are local pronouncements by accounting regulatory bodies and legislation or national taxation rules.
- Useful computer outputs are: aged debtors listings; VAT reports; and sales information.
- Areas that provide challenges for micro-entity owners include: bad debts; deferred tax and VAT; stocks and valuing finished products; and depreciation. In Poland transactions across national borders were also a particular concern.
- Owners would use new guidance if recommended by professional accountants, accepted by the tax authorities and credit granters and supported by computer software.
- UK participants supported the idea of national standards and regulation for micro entities, although Kenyan participants supported the idea of international regulations/guidance for micro entities.
- Owners that supported regulations for micros favored a disclosure checklist plus fixed formats for statements and a set of rules on how to account for the most common types of transactions.
- It is appropriate for the accountant, who has produced them, to accept responsibility for the financial statements as most business owners did not understand the contents.

Conclusion

This study has sought to ascertain the views of interested stakeholders on the suitability of the proposed IFRS for SMEs for micro entities and considers the need for new international guidance aimed specifically at these entities. In this study, significant differences emerged between the two different business environments: the UK and Kenya. In the UK the existence of the FRSSE means that guidance is already available for the preparation of the financial statements of small limited companies. In Kenya, IFRSs have been the main source of accounting regulation for all entities since 1999 and there is no specific financial reporting guidance available for smaller entities. Thus whilst the groups in the UK were generally reluctant to support the introduction of what they felt would be another tier of regulation adding little of value over the existing FRSSE, the respondents in Kenya were more convinced of the need for a new international standard. In the other countries, support would seem to depend crucially upon the extent to which any standard was also accepted by the taxation authorities.

Participants were asked to make “suggestions to regulators intending to issue financial reporting guidance” and their responses highlight some of the key issues raised in these discussions:

- Keep it simple with clear and practical guidance.
- Don’t start from big GAAP - start from a clean sheet.
- Consider the definition of a micro or small entity.
- Consider the cost - regulation is a great burden on micro entities.
- The IASB ED is too detailed for micro entities.
- Take on board the views of the people who are actually preparing the accounts and using the accounts.

- Consultation. How much do international regulators actually know about these tiny businesses?
- Education or training programs for preparers and users are important.
- Provide two versions for the different levels of sophistication of owners and accountants.
- Consider compatibility with existing computer packages.
- Need to look at the enforcement of regulations to facilitate comparison.

Despite some reluctance amongst the UK groups to support new guidance, both sets of groups were asked about the suitability of the proposed IFRS for SMEs for micro entities and the characteristics of new guidance should it be issued. Here there was overwhelming agreement that the Exposure Draft (ED) was far too complex and long (at over 200 pages) to be useful to micro entities. The groups were emphatic that the characteristics of any new guidance should include: simplicity; as few rules as possible; infrequent updates; web based and hard copy; as short as possible; and to be applicable to all businesses (not dependent on industry or legal status).

In terms of outline content, there was general support for fixed format statements, a simple disclosure checklist supported by a statement of principles. It was argued that if such a principles-based approach was adopted, updates would not need to be frequent. As regards publication, any such guidance should be available both on the Internet and in hard copy, as not all small business owners have access to computers (particularly those in rural areas in developing countries).

This study set out to canvas the views of interested stakeholders and has raised issues that an international financial reporting regulator might wish to consider as part of its due process in issuing guidance to small and micro entities. Finally, tentative conclusions may also be drawn in response to the questions raised in the introduction:

1. The ED appears to be too complex for micro entities.
2. It seems unlikely that simply making relatively minor changes to the current proposals will make them better suited to users and preparers of micro-entity financial reports.
3. The case for a separate tier of accounting guidance for micro entities - whilst there is support for new guidance for micro entities in Kenya, there was much less so in the other four countries. If such guidance was to be issued, there was support for two levels: a simple précis version that would be easy for business owners to follow and understand and a more technical version for preparers.
4. There was general support for some form of attestation to be attached to the financial reports of micro entities. It has been suggested that this perhaps should take the form of a statement made by the accountant, rather than the owner who may not always appreciate or understand the contents.

1. Introduction

1.0. In November 2006 the IASB (International Accounting Standards Board) issued the draft version of its "International Financial Reporting Standard for Small and Medium-sized Entities" (IFRS for SMEs). The Exposure Draft (ED) was issued in February 2007 for comments by 1st October 2007[1]. This ED provides 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.

1.1. However, there is some concern that the final standard may not be appropriate for the smallest SMEs, the micro entities[2]. It is anticipated that this lacuna in the provision of regulatory guidance may be addressed by IFAC. This interest in the financial reporting activities of SMEs and micro entities arises partly from the argument that small businesses may grow into larger ones that are expected to comply with full international financial reporting standards and partly because they make such a significant contribution to the economy of most countries[3]. 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 certain aspects of the IASB ED on IFRS for SMEs[4] and focuses on the preparers, users and user information needs of micro-entity financial reports.

1.2. The IASB expects its standard to be suitable for entities that: (a) do not have public accountability[5]; and (b) publish general purpose financial statements for external users[6]. Examples of such external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies (IASB, 2007, para 1.1). The IASB is not intending to quantify any size criteria and it will be left to national

1 At its Board meeting on September 19, 2007 the IASB agreed to extend the deadline for comments on the proposed IFRS for SMEs to November 30, 2007. The deadline for submitting field test results was also extended to November 30, 2007. The Board decided to extend the comment deadline primarily to allow entities participating in field testing the ED and those assisting such entities more time to prepare their comments. The Board strongly encouraged entities and organizations that were not involved in the field testing to submit their comments on the ED by the original October 1, 2007 deadline.

2 For example, the EC Commission has begun a project to reduce the administrative burden on companies. This includes a proposal to exclude micro-entities from all accounting directives including audit and publication so meaning that normally they would only have to follow the rules set by national taxation authorities (EC Commission 10/07/07)

3 It is estimated for example that there were 17.8 m micro entities in the EU employing 55.0 m people and 20.0 m in the USA employing 27.8 m in 2003 (EC 2003)

4 Originally, the IASB proposed a name change for its standard to "Not 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.

5 An entity has public accountability if: a) it files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; or b) it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity (IASB 2007, para 1.2).

6 "The objective of financial statements of SMEs is to provide information about the financial position, performance and cash flow of an entity that is useful to a broad range of users that are not in a position to demand reports tailored to meet their particular information needs" (IASB, 2007, para 2.1).

regulatory authorities and standard setters to decide "which entities are required or permitted to use the IASB's standards" (IASB, 2007, para 13). However, the issue of defining a micro entity is also touched upon in this report.

1.3. Phase 1 of this study[7] found evidence to suggest the existence of a very small body of academic research on accounting and the SME sector and in most prior studies micro entities have been subsumed within the larger group of SMEs (Sian and Roberts, 2006). It may be speculated that this gap in the SME literature can be attributed to the difficulties faced in gathering data on the smallest SMEs, in particular with respect to the participation of small business owners (Sian and Roberts, 2003).

1.4. The key objective of this part of the study, Phase 2, is to ascertain the views of stakeholders on a variety of issues concerned with financial reporting by small entities and, in particular, the suitability of the IASB's SME standard. To satisfy this objective, three key stakeholder focus groups (owners of micro enterprises, lenders who provide finance to micro-entities and preparers of financial reports for micro-entities) were established and interrogated. In order to permit comparison within variant economic, political and social environments the focus groups were conducted in both London and Nairobi in January 2007[8]. The objectives of the discussion groups were:

- to consider whether the guidance proposed for SMEs by international regulators are likely to meet the needs of users of financial reports of micro-entities;
- to consider whether changes could be made to the current proposals for SMEs to make them better suited to the users and preparers of micro-entity financial reports;
- if the current proposals for SMEs are considered wholly unsuitable for micro-entities, to determine the case for a separate tier of accounting guidance/standards (Third Tier) for micro-entities and to consider the nature of such guidance/standards, including their key characteristics and outline content; and
- to determine the appropriate level of assurance, if any, for micro-entity financial reports.

1.5. The remainder of this report is structured as follows. Section two documents the methodology underpinning this study and, in particular, considers the rationale for adopting such an approach and the associated limitations. Sections three, four and five are the empirical sections presenting an analysis of the data gathered from the focus group meetings held in Kenya and the UK, including relevant quotes from the participants. This is supplemented by a discussion of the main findings from similar focus groups held in Uruguay, Italy and Poland in early 2007 and a discussion of the answers given to a short post-focus group questionnaire. Section six draws conclusions and summarizes the findings of the study.

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[7] This study comprises three distinct phases. Phase 1 – Literature review and research design. Phase 2 – Preliminary focus groups conducted in UK and Kenya with some insights from three other countries. A further phase, Phase 3, would involve a survey instrument and further focus groups, extending the research to incorporate other countries.

[8] While the actual ED was not published until February a draft was available to the public at this time, and, for the purposes of this study, there were no significant differences between this draft ED and the final ED.

2. Method

2.1 Focus groups are a useful tool for gathering primary data in research. They involve a group setting where the group has common shared experiences and allow stimulation of interaction among group participants. As a research tool, focus groups afford the research process several key advantages. Firstly, they can provide a great deal of very rich data often at a lower cost than individual interviews. Secondly, groups allow for interaction between moderator and members, for instance to seek clarification or redirect discussions. Thirdly, they offer an opportunity to observe the interactions between members and may create a synergistic effect whereby new ideas or data emerges. For these reasons in addition to the geographical distances involved, in this study focus groups were the chosen method for ascertaining the views of various interested stakeholders on the issue of financial reporting by small and micro entities.

2.2. The literature suggests that the optimum size for focus groups should ideally be between six and eight members (Krueger and Casey, 2000) and no more than twelve (Stewart et al., 2007). Here, groups were segmented along the lines of preparers, owners and lenders and recruitment intermediaries, Association of Chartered Certified Accountants, ACCA, (in the UK) and Institute of Certified Public Accountants, ICPAK, (in Kenya), were asked to recruit between six and eight members for each group. For both locations the preparers were generally members of the hosting organization (although the UK group did also include Institute of Chartered Accountants in England and Wales, ICAEW, and Association of Accounting Technicians, AAT, members) and the lenders and owners were drawn from contact organizations of both accounting associations. The obvious advantage of using such an approach was the simplification of the labor-intensive recruitment process, although this is countered by the loss of control over group selection and reliance on a third party for the creation of the group. There is also the concern that use of intermediary may also "act as an unwanted 'screening device' selecting out certain members of the group from participating" (Bloor et al., 2002, p.32).

2.3 A key concern in focus group-based research is the attendance of participants, once selected and invited. Conducting the groups at the premises of the ICAEW, ACCA and ICPAK added a degree of credibility and possibly encouraged attendance by preparers and lenders. In the UK, in the case of the preparers, there was a worry that attendance at the focus groups might be affected by the timing of the group discussions, as they fell in January and coincided with Inland Revenue deadlines for filing personal assessments forms. In reality this proved to be less of a concern than attendance by owners, many of whom when approached suggested that as a single person operation it would be difficult to create the time required. In Kenya, it was the also owners group that was poorly attended. When approached, here, many owners were reluctant to attend and even suspicious of an event organized and hosted by the local accounting association and fearful that there may be some connection with the KRA (Kenya Revenue Authority), the national taxation authority.

2.4 The UK focus groups were recorded using equipment supplied by the host professional accountancy bodies and the researcher's own digital voice recorder. In Kenya a video recording was made of the groups in addition to the use of the digital voice recorder. In this study, predetermined sequenced questions were used, moving from the general to the specific as indicated by good practice guides. The interaction between participants makes focus group data different from other qualitative methods such as interviews (Morgan, 1997) and means that a large quantity of data can be collected in a relatively short space of time[9]. In both countries rich primary data was gathered, recorded and transcribed.

2.5 Focus group meetings were also conducted in Italy, Poland and Uruguay. It proved impossible to arrange a focus group meeting of owners in Uruguay, although group meetings of lenders and preparers were both carried out. The writers of this report were sent summaries of the responses from each of these focus group meetings plus details of the most common response of each focus group to each item in the accompanying questionnaires. These responses are also discussed in the following analysis especially where they suggest that the responses found in UK or Kenya may not apply in other countries.

2.6 Despite the various advantages associated with focus groups, there are also limitations. Firstly, the small number of participants and the convenience factor of recruiting groups restrict the ability to generalize the results. Secondly, the interaction between members means that the responses are not independent of each other and there can be issues in groups where there are overly dominant members. Thirdly, the moderator may unknowingly bias results by over-directing the discussion and finally, the open ended nature of the discussions can make interpretation and analysis difficult. However, such limitations do not invalidate this as a research method when it is used to draw attention to and highlight key issues in the field. Given this, a summary and analysis of the empirical data gathered, supported by exemplary quotations, form the basis of the next three sections of this report.

2.7 At the close of the focus groups the participants were asked to fill in a short questionnaire about various items that are commonly found in annual reports. Preparers were initially asked for their views on the key concerns of their SME clients. Preparers and owners were asked if they, or their clients, undertook a range of transactions and if so, whether or not guidance would be useful. The items covered are shown in Exhibit 1. All three groups were asked whether, if a range of possible accounting measurement or disclosure requirements were introduced, they think they would be relevant and whether either compliance with or use of the information would provide a challenge. These items are shown in Exhibit 2.

9 Morgan (1997) comments that the strengths of focus groups as a methodology include: the ability to produce concentrated amounts of data on the topic of interest; the group interaction provides an insight into the participant's opinions and experiences; and they are more time-efficient and practical than individual interviews. This is countered by the perceived problems associated with focus groups, which include: the researcher creates and directs the group so they less natural than participant observation; the group interaction may not always be successful and the existence of a group dynamic may affect what participants say; and with a group there is real potential for strong disagreement which can affect the conclusions drawn (p.14 -16).

Exhibit 1: Transactions and events that micro-entities may be involved in

Provide any defined contribution pensions schemes
Provide any other employee benefits that you do have to pay for until future years e.g. holiday entitlement that employees carry forward, future insurance or medical aid or profit sharing
Conduct any transactions in foreign currencies
Conduct any operations in foreign currencies
Obtain Government grants
Conduct any research activities
Use leased assets
Sell and leaseback assets
Carry out hedging activities, e.g. buying forward currency contracts
Have any purchased intangible assets
Have entered into long-term contracts
Provide any provisions
Have contingent assets or liabilities
Make share-based payments
Hold shares in subsidiary companies
Hold shares in associated companies
Operate any joint ventures
Recognize deferred taxation, e.g. providing for long term tax liabilities
Produce an annual cash flow statement
Get annual statements audited or attested

Exhibit 2: Possible accounting measurement and disclosure rules

Cash-based statements (i.e., include cash transactions only)
Accruals-based statements (i.e., include depreciation and other non-cash based adjustments)
Cash flow statements
Write down stock or inventory if selling price falls below cost
Breakdown of plant, property and equipment into major types
Impairment of fixed tangible assets i.e. write down if market value falls below cost less depreciation to date
Impairment of intangible assets or goodwill

Revaluation of fixed assets i.e. write-up if market value is above cost less depreciation to date
Revaluation of intangible assets or goodwill
Deferred taxation i.e. show known future tax liabilities
Capitalization of finance leases i.e. show as an asset and liability on the balance sheet based upon cost over life of lease
Splitting profit into profit from continuing and discontinued operations
Disclosing disposal of and profit from disposal of assets and investments
Disclosure of comprehensive income – i.e. profit and all gains or losses made and excluded from income statement
Disclosure of expenses by nature e.g. labor, materials
Disclosure of expenses by function e.g. production, selling & distribution
Contingent asset & liabilities e.g. disclose any that will only exist if a specific event occurs first
Disclosure of any guarantees given
Disclosure of significant accounting policies
Disclosure or any judgments made (except estimates) that have significant effect on amounts recognized
Disclosure of any key assumptions made about future or estimation uncertainty that may cause material adjustments to assets & liabilities in next 12 months
Loan defaults
Financial assets pledged as collateral
Total of key management personnel compensation, benefits & share-based payments
Related party relationships & transactions – (with parents / joint venture partners / subsidiaries / associates / key officers / other)

3. Findings: Preparers

3.1. The UK preparers group constituted accountants providing accounting services to small and micro entities in addition to an observer from the ICAEW and an independent commentator on SME matters. Those offering accounting services dealt with mostly small- and medium-sized enterprises, limited companies, sole traders and partnerships. Clients were very diverse and included charities, solicitors and insurance brokers. Services ranged from audit, tax, accountancy, business development, financial services, payroll, bookkeeping and management consultancy. Participants stated that they prepare annual financial statements (both statutory and non-statutory) for virtually all clients. For the smallest clients, such as sole traders, these would take the form of general income and expenditure accounts or a simple profit and loss account and sometimes a balance sheet. In the case of limited companies, accounts were produced (in the majority of cases) in accordance with FRSSE and filed at Companies House[10], often in abbreviated format wherever possible. In the UK the accounts of limited companies accounts are, therefore, publicly available[11].

3.2. The participants in the Kenya group all represented local accounting firms based in Nairobi with the exception of the representative from PwC (PricewaterhouseCoopers) who attended on behalf of the Institute's Professional Standards Committee. Mostly the clients of these firms ranged from micro- to small- and medium-sized entities for which financial statements were prepared and in the case of limited companies audited too. For most of the smallest profit-orientated entities, the financial statements were prepared for the owners themselves, or banks, or for income tax purposes[12], although there did not appear to be specific requirements to make such statements publicly available:

> *Are these reports made publicly available? Basically that depends largely on the client or on the institution itself, the owners of that organization, so they are the ones who decide where to circulate but we basically just give them the reports and then they decide what to do with them.*

3.3. The Kenyan participants suggested that some form of attestation was already provided, even for the smallest clients, although the nature of the report was dependent on whether the client is a limited company, a non-government organization (NGO) (who often have to meet donor requirements) or a partnership/sole trader:

> *I mean now we're required to sign the standard IFRS recommended report for all the clients who are limited liability companies and then when it comes to requirements for partnership we follow the Auditor General in the Income Tax Act. I suppose the Income Tax Act is what we usually follow.*
>
> *Some of them really don't totally care about the International Financial Reporting Standards. They have their own requirements or something they want from those particular set of accounts or financial statements. So that is a bit of a problem there, yes. So you find a lot of differences between because* [sic] *some of the small people really don't care about what the financial reporting standards say. They're looking at things from their own point of view, so we find it hard to actually get them to work with financial reporting standards.*

3.4. In contrast to all the other countries, attestation statements of any sort were seldom provided by the Italian respondents.

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10 Accounts for charities are submitted to the Charities Commission and some participants were also required to file accounts with the Financial Services Authority for clients involved in the financial services sector.

11 Most preparers were also involved in attesting the accounts of small clients, taking the form of an audit for those companies meeting the audit threshold levels in the UK. Others conducted grant work and income verification, voluntary independent examinations, or produced an Accountants Report for all non statutory statements that include a balance sheet.

12 For the NGO sector public availability is instead generally dependent upon the policy of the funding donors. For instance some SMEs are audited by the Controller Auditor-General and their financial statements are required to be publicly available.

The form of financial statements

3.5 Participants in the UK group produced virtually all accounts on an accruals basis, even income and expenditure accounts. Although, it was suggested that: *"There might be the odd one that's cash based, you know, for the tiny, sole trader that has always done their own thing or the bookkeeper has for them"*. The group indicated that required statements included an income statement, balance sheet, cash flow statement (for the larger companies only), notes, auditor's report (if thresholds are met) and directors' report. Depending on the size of the client, some participants also provided additional reports, such as the statement of recognized gains and losses, although this did depend on: *"the personal requirements of the client, their circumstances, the actual size of the client, that type of thing"*.

3.6 In addition to financial reports, UK preparers/accountants also furnished clients with verbal explanations, which might include a meeting with the client either on the telephone or face to face to discuss the accounts before they sign, or a general meeting with the directors (for limited companies). In addition, dividend certificates and management letters also are generally provided by service providers along with a letter explaining what the "figures mean" to non-financially literate clients. The latter was of particular concern to preparers, as one participant put it:

> *If I think the client will understand and needs an explanation I'll probably provide it in a written form with the accounts or in a telephone conversation, but most of the clients as far as I can see simply wouldn't be interested in it. It's really an annual chore that they have to go through or have to pay me to go through and that's about the limit of their interest in a lot of cases.*

3.7 A similar picture emerged in the case of the Kenya group. Most participants suggested that financial statements were generally prepared on an accruals basis, for limited companies these included an income statement, balance sheet, cash flow statement, notes, auditor's report, directors' report. In addition most provided verbal explanations to clients and prepared management letters. For the micros and NGOs[13] participants indicated there were specific issues:

> *For micros in the private sector - they deal in cash. They hardly get credit and they don't need credit. As to whether we produce an income statement, balance sheet, cash flow, notes, auditor's report, directors' report – yes, we do that. Cash flow is a question mark. If there's hardly anything in the balance sheet, how do you prepare the cash flow statement? Notes, very few. Over and above that we do have a management letter.*
>
> *When it comes to these NGO accounts normally they are in the cash based [sic] as they insist on the fund accounting and that is where we give the funds statement where we just list the income and the expenditure, so they do not take the form of an income statement. OK, the Income Statement is in the form of the fund accountability where it provides both the income, the expenditure and then the balance is whatever cash there is either in the bank or wherever that equates to the final balance that is carried forward. So you will not find a lot of balance sheets in those NGOs and the same for cash flows. But we try to include notes to support the fund accountability statement. We also include the auditor's report.*

[13] For several of the participants NGOs contributed to between 30 and 50% of their fee income.

3.8 In Kenya, too, the provision of verbal explanations seemed to be of particular importance for smaller clients who are not financially literate:

> *So some of the clients we try to run them through the accounts before they actually sign them as well so that we make them understand because we might find that some of them are not too aware. They know how their business performs, but the small, little detail they really are not aware of, so you have to explain to them some of these things. They keep their tax as little as possible, so you have to try and explain to them because again their intentions are different from what the standards are.*

3.9 A very similar picture emerges in Italy and Poland, with most statements being accruals based and including a balance sheet, income statement and associated notes. Cash flow statements, directors' reports and an auditor's statement were all less commonly provided. Verbal explanations were also regularly provided.

3.10 Further information was provided in the questionnaire responses. Reflecting the requirement that all entities in Kenya follow IFRS, the Kenyan respondents thought that interim statements, annual cash flow statements and audit reports were all commonly produced. In contrast, all three were thought to be provided in less than one-third of cases in the UK and Uruguay, while audited statements were thought to be relatively common in Italy and cash flow statements were thought to be relatively common in Poland.

The processes of preparing financial statements

3.11 UK participants suggested that the processes involved in the production of financial statements for the smallest entities was dependent upon the sophistication of the client and involved either a manual process starting with primary data or, more commonly, a computerized package:

> *It seems to imply that the use of a computer package means complete records….not according to my clients. We use a software package to produce statutory financial statements and non-statutory. Some are prepared from clients who use accounting systems, accounting software. I would say probably about one third. Two thirds are prepared from incomplete records.*

3.12 In some cases the clients used a standard accounting package to produce an annual trial balance and presented this to the accountant to prepare final accounts and produce a tax computation. Several of the participants represented UK firms with both small and larger clients and informed the group that they were also Sage trainers:[14]

> *So if we do have clients like that we offer Sage training and we are a Sage retailer. So we try to promote the use of accounting packages anyway and then on-going training. As has been said here, even though it's on a computer package it doesn't necessarily mean that the computer is correct it's only as good as the input that's given. So, a whole range of things and different people use different computer packages obviously and we can't have them all, so we have to probably go to clients' premises to do some of the accounts preparation if they've got, say, QuickBooks or Sage Line 100.*

3.13 Kenyan participants indicated that although some clients still present their accountants with boxes of receipts and bank statements, here too, there appears to be a marked trend towards

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[14] Sage is one of the most popular accounts software packages in the UK. QuickBooks is another popular accounts software package.

clients generally producing computerized accounts in some form, even if only to trail balance:

> *Most of my clients they do prepare the accounts and they come to us. Maybe sometimes they are not done correctly and we have to do the correction entries. A set of, but the only thing maybe they came up to trial balance because the knowledge you need to prepare your financial statement is still not in 60% of our clients. So they come with up to trial balance. I think 70% now are computerized of my clientele. 30% come with manual.*

3.14 Most of the preparers stated that they encourage clients to computerize if possible, although most are not themselves large enough to be able to offer training to their clients as it has an associated cost. From the trial balance, the accountant is able to prepare IFRS compliant financial statements. In other larger practices, some training is on offer and some of the accountants visit the client's premises to produce monthly statements:

> *Where we produce the accounts or where we are the accountant of such organizations, what usually happens is we send a guy there so that we prepare the accounts for them on a monthly basis. We don't leave it to them for the year, so we don't get a big box of receipts. We actually send someone there every month so that they are pretty current. And then where we do the audits, those are brought to us more or less complete ….. Only about six or seven years ago we used to get a lot of boxes – people bringing boxes with receipts – but we took some time and invested it to try to train our clients and to show them the advantages of going towards computer packages and a lot of them adopted, so you'll find like now probably maybe 90% of our clients … We'll rarely get the guys who do not have them now unless they are new. So we find most are computerized.*

3.15 Some country differences appear to exist here and the UK and Kenya may not be representative of all countries. Thus, while the Italian responses appear to be similar with computerized packages being employed in most cases, the use of incomplete records was reported to be far more common in Poland.

Why financial statements are in their current form

3.16 There was general agreement amongst UK participants that the constitution of annual financial statements is broadly guided by the Institute's recommendations, accounting standards (including the FRSSE) and company law. Although the preparers, and many of their clients, utilize computerized accounting packages, the end product does not necessarily meet regulatory requirements and therefore requires tailoring. The majority of participants felt that such regulatory guidance and the requirements for filing at Companies House[15] (in the case of smaller limited companies) superseded all other requirements, for instance those of the tax authorities and the banks. If these primary requirements could be satisfied, the group felt that the needs of other users would also be met. One participant commented that:

> *Banks and other users, they don't really play that much of an important role anymore. I mean from our experience, even as far as the limited company accounts are concerned, in the past there used to be quite a lot of requests from the banks, but it doesn't seem to be the case anymore.*

[15] All limited companies in the UK must register with and file accounts at Companies House.

3.17 In Kenya, the main source of financial reporting guidance is the Institute (ICPAK). They require that all financial statements of limited liability companies comply with IFRS so that determines the current format. In addition there is no differentiation on the basis of size, so all companies must comply irrespective of size. In the case of smaller un-audited entities, the main sources of guidance for financial reporting are income tax requirements and in the case of NGOs it is often the funding body that determines the form and content of the financial statements:

> *Well, principally there are two areas. One is the end user, why we prepare the financial statement, and two, the benchmark is basically the IFRS. We try to ensure that whatever we produce complies with IFRSs. Like I mentioned before, a problem area is specifically the NGO sector. Where the donor insists that these reports are specifically for them and their use and they want this report in a specific format. So the end user determines what should be done.*

Although IFRSs were adopted in 1999 in Kenya, it seems to be the case that the transition from Kenyan Standards to IFRSs was not (and is not) a particularly smooth one for all users:

> *My observation is that there is definitely a lack of understanding from the income tax department or from the Kenyan tax authority of understanding the IFRS accounts. And the level of tax officers who we are dealing with sometimes, they don't understand the accounts properly, especially the provisions and the operating rentals. I don't know whether you're recommending to the Institute, but I suggest that if the Institute can take some steps to educate KRA (Kenya Revenue Authority) in respect of IFRS and also when the SME standards comes.[i.e. when it comes into force]*

3.18 The Italian and Polish respondents also argued that, where they are applicable the most important source of guidance is the national accounting laws. In Italy, only limited liability entities most follow the accounting laws. Unlimited liability entities, which are common in the SME sector, only have to meet the taxation requirements and they do not have to produce or provide any financial statements beyond those required for taxation computation.

Useful components of computerized accounts

3.19 The UK group generally agreed that for those clients that prepared their own records on a computer, the debtors and the creditors listings were used more often than anything else. Although some clients were able to understand a profit and loss account, in many instances it was the case that: "the balance sheet tends to go over their head". Perhaps surprisingly, although clients were aware of the need to monitor cash flows, the cash flow forecast option offered by packages was rarely used. Thus, it was apparent from the discussion that, whilst a variety of facilities and reports are available from the commonly used computerized accounting packages, very few clients are sufficiently financially literate to take advantage of these:

> *The bulk who use Sage really just use it as a bookkeeping tool and until they have some training they rarely do bank reconciliations or things like that. They do use the VAT options. The fact that they don't use all of the options, all the reports within packages, can cause problems for us because it means things aren't reconciled.*

3.20 Some small clients, often those with greater levels of financial literacy, used the package to produce monthly or quarterly results (VAT, profit and loss and balance sheet). Such an approach was encouraged, where possible, by UK preparers on the grounds that: *"they get a better picture so that the twelve months result isn't a shock"*. This was particularly prevalent amongst preparers representing firms which offered Sage training to clients:

> *I think they find it pretty useful. It gives the larger end of our clients a better understanding of how their businesses are running. I agree with the others which is debtors, creditors, VAT. These are obviously useful exercises, but as far as I can see most of the time it's really meaningful management accounts which have helped them.*

3.21 Similarly, in Kenya, those clients that used a computerized system found that reports produced by the system, allowing them to monitor analysis of the debtors, cash flow, payroll, VAT and stock levels most useful. The most commonly used system by smaller enterprises in Kenya is QuickBooks, although Tally is also popular. Some preparers do direct clients to the use of other financial reports used by the systems, but not all are able to take advantage of this, often because of financial literacy levels:

> *The clients they mainly use data statements, but we also try now to get them to use profit and loss and balance sheet because most of the packages or all of them usually create reports and clients are mainly stuck with the trial balance. We also tell them how to use profit and loss and balance sheet and we discuss this with them and in addition to that we also mention the sales reports or the VAT, you know. I think they benefit, especially the ones who understand.*

Key areas presenting a challenge for micro clients

3.22 Key concerns for the smallest clients of UK preparers included:

- UITF40[16] and in particular the recognition of income and: *making the client understand why there's a change is difficult.*
- Deferred tax: *Other items that cause headaches – deferred tax. Nobody understands deferred tax. They don't really need it. They're not interested*.
- The difference between leasing and hire purchase.
- The reporting of related party transactions, why some things have to be disclosed and other things do not.
- Evaluation of stock and work in progress, depending on the nature of the business. For those involved in manufacturing there are costing issues: *You know, they don't seem to be able to understand value-added to certain raw materials as they go through the system and valuation in that respect can make quite a difference to the bottom line*. Another commented: *Yes, you know part of the overheads – Why should we take this in if we haven't done the job yet? All those sort of arguments come and to add insult to injury of course we, as accountants, are charging for all the time. That doesn't help the situation either.*
- Taxation - corporation tax for limited companies: *They don't tend to understand why certain items are disallowed for tax relief….what is and what isn't vat-able and what they should and shouldn't charge VAT on*.

[16] Urgent Issues Task Force Abstract 'Revenue recognition and service contracts'

3.23 UK participants commented that much of the concern arose from a *"lack of understanding and lack of education, I think, and communication from various authorities to the people, to the businesses"*. For instance various branches of the Inland Revenue send information and leaflets to clients, who invariably ignore them. One participant suggested: *"If VAT rules are simplified, if dreams came true and instead of a booklet dropping on the client it was just one page"*. However, for those dealing with the smallest entities, there were strongly held views that clients relied almost absolutely on the preparer, who was himself inundated with a variety of regulations:

> *Clients are quite happy to go along with what I produce. They don't have any particular views. What is a problem from my point of view is that with a relatively small number of clients in total, you have only one from various different sectors, so when you consider the regulations and requirements for a particular business, it's twelve months since you probably came across the problem before. There's too much regulation. You've got to stop … You know, unless you're dealing with it all the time when it becomes much easier, but there's so much regulation that if you're dealing with a broad base and you've got one case in each different category, it is a problem because it obviously increases the time, time increases the fees and the clients tend not to like that.*

3.24 Participants in Kenya also faced similar challenges:

> *I think the biggest challenge I face is on the **fair value measurements**. Some entrepreneurs can invest in properties and not expect to value their properties on an annual basis as it is costly. They cannot provide us with current or market values. At times you need to ask them: "What is the current value?" They do not understand their role, their responsibility for financial statements. They sign page two the financial statements on their responsibility, but they don't understand about it.*
>
> *Another area is **contingent liabilities**. They have to depend on their lawyers. I think the lawyers are beginning to charge their clients for that. There are also cases where lawyers take a long time to respond.*
>
> *It's especially about **fair values, e**specially when you are trying to bring into the accounts the fair value, especially for investments and also for monetary liabilities. When it comes to NGOs it's also the question of assets, how they should be treated, whether they should be capitalized. There is also the issue of donated assets how they should be treated, should they be expensed as they mentioned, and for provisions. These are some of the challenges.*
>
> *I think the biggest problem we experience I would say would be measuring their income taxes, especially regarding **deferred taxation**… That's given us a lot of nightmares and quite a lot of time we've spent some time trying to work out what deferred taxation is and then explaining it to the clients also is pretty difficult because they have problems just understanding the tax laws. So bringing in deferred taxation, you just loose them. So it takes a lot of time just explaining to them. A lot of times I suspect they don't fully understand, but they trust us, so they just sign our check.*
>
> *But very few large clients understand **deferred tax** even if they can do the calculations themselves, let alone smaller clients. And then I'll just add fair value and biological assets. Well, if you've got a small farmer who's expecting to value his crops it's silly.*

3.25 Only in Italy was taxation not a major concern. Instead, respondents were mainly concerned about inventory, leases, grants and the valuation of properties. In contrast, while tax, both deferred tax and VAT featured highly in the concerns of the Polish respondents, the issue appearing to give them the most problems was transactions occurring across borders, although most of these concerns appear to centre around the production of the necessary paperwork rather than the accounting issues per se.

3.26 The questionnaires provided more information on this issue as respondents were asked which transactions were seldom or never encountered and which were relatively common. The only item that was very seldom seen in all five of the countries was share-based payments. Joint ventures and associated companies were seldom or never seen in all countries except Kenya, while defined contribution pension schemes, research, hedging, and subsidiary companies were seldom or never seen in three of the five countries.

3.27 UK and Kenyan questionnaire responses indicated that there was general agreement that the areas that were particularly challenging were: the impairment of both tangible and intangible assets; contingent assts and liabilities; management compensation; and related parties information. In addition, Kenyan respondents thought the following were also particularly challenging: write-down of inventory; revaluation of intangible and tangible assets; deferred taxation; splitting results into continuing and discontinued operations; categorizing expenses by function; and reporting on key judgments and assumptions.

Using new guidance for micro entities and SMEs

3.28 The preparers group in the UK agreed that any new regulations for either small or micro entities would only be used if they were obligatory and recommended by the local regulator (accountancy bodies/Accounting Standards Board (ASB)) or accepted by the tax authorities as a basis for the preparation of financial statements. Although some conceded that international regulation would aid increasing comparability within Europe, not all participants were convinced of the need for a third tier of regulation:

> *I think with more global markets there is a lot more small businesses are going to be trading with Europe or America and you've got to be able to compare for buy-outs and so on, combinations of businesses, you know, they have to work together and you've got to be able to compare one with the other and if we're all working to different standards you just can't do it.*

> *One thing I suppose on micro-micro entities, is there any requirement? Does it serve any purpose to be able to compare a micro entity operating up at John O'Groats or somewhere with something operating out in the middle of Borneo? I mean who's interested?*

3.29 Some of the UK discussion involved comments on the perceived approach of the IASB to the SME issue, the need for SME regulations and identification of simple regulations (such as recoverable historic cost accounting) for the smallest entities:

> *The IASB [have] got themselves into a cul-de-sac, not thinking. They're effectively saying "Big GAAP is too hard for small companies. Let's give them small GAAP. The small GAAP's got to start from where Big GAAP came from," but I think that's just fundamentally wrong.*

> *At the bottom end there are the micro entities, but talking about size is the wrong way to discuss this issue. What you should be saying is that those micro entities are usually private companies in the sense of every single shareholder bar none is a director of the company or connected to a director of the company. So if you approach this on the basis of ownership rather than size you can apply some logic to it. So down at that small end where every shareholder is a director or connected to a director you don't need any investor protection*

> *whatsoever. So, the purpose of accounts for these small private companies is only to do with creditor protection. Is it okay to trade with these companies? For those you can just do the recoverable historic cost accounting – and the one rule that says little GAAP is recoverable historical cost and there are no other rules. You don't need any rules to say how it's done.*
>
> *The rules would say ... The first rule is who has to use little GAAP? Companies may use little GAAP if there is unanimous vote by all the shareholders to do so and no subsequent dissent. That's rule one. Rule two is little GAAP is nothing more than recoverable historic cost accounting and try very hard to write no more rules; you might have to write one or two, but try very hard not to do any more. And then the normal creditor protection rules of all companies who prepare annual accounts and file them and so on. And that means that the guidance that has been produced so far by the IASB, by their staff, the draft basically, the thing that's coming at the moment is still 243 pages……it can be reduced to half a side of A4.*

3.30 Other participants, while agreeing that the IASB draft in its current form may not appropriate for the smallest entities, argued that something more than this was required even for those entities which did not need to consider investor protection because there were other interested parties, such as employees:

> *I think the problem is really trying to make micro-micro entities use the smaller GAAP which is designed for SMEs. When you've got a larger number of employees, right, you don't want investor protection because you've got no investors – all your investors are all involved in the management – but I do think you've got to bear in mind responsibility, for instance, to the employees and if you're employing 50 or 100 people I think that company must be made to produce a proper set of accounts every year, you know, in order to give some to protect the employees to a certain extent, but I don't think they should be made to follow big GAAP.*

3.31 The issues raised in the Kenya discussion were different mainly due to the fact that Kenya has already adopted IFRSs for all companies, whereas the UK has only done so for listed companies and that in Kenya IFRSs are the only applicable standards, unlike the UK which has its own FRSSE. Therefore, there appeared to be a greater acceptance of potential international guidance for SMEs and also for micro entities in Kenya. Participants expressed a general feeling that, in fact, there was a need for an SME standard as a stepping stone for small- and medium-sized entities before they grow and are required to adopt full IFRSs. Here, the issue of education was also raised by several participants, given their prior experience with the adoption of full IFRSs:

> *Yes, there's a really big need of a step-by-step guide on how to produce information because this is an area which I strongly feel it has not been taken care of by ICPAK when it came to application of IFRS in the country. You know that step-by-step guide because when also we go to the clients and we say "Now we can regard it as per IFRS," and then there's a need for more efforts by auditors and they will appreciate it. Because they were not told by any outside body that now the requirement has changed to IFRS. So I think it is more important that whatever change comes in is widely discussed within the business community and not within the accounting community because we have to deal with the business community and if they're not aware of what we are trying to do for them it is very difficult.*

3.32 Most participants in the Kenya group anticipated standardized formats for financial reports alongside any SME standard, suggesting that this might also help to train less financially literate clients, to alleviate the cost burden faced by the smallest entities and therefore may persuade them to be more transparent with income tax returns:

> *I think it will probably mean a simpler format, yeah, for these accounts, especially for the smaller organizations. Yeah, in that, for example, a simple income statement where we can get it as close as possible to a cash based kind of system of accounting. And then one thing we need to bring into this particular environment is honesty. Because we find that … I'm not too sure about the rest of the members in the forum, but we find that a lot of clients are seeking to pay as little tax as possible. Now a lot of them you'll find will be so willing to cheat, to make that tax as little as possible. So if there is a way we could bring in something close to the ETR [Electronic Tax Register] whereby you find it becomes a level playing field whereby nobody can cheat, I think that is what might be more required in this environment.*

> *Okay, maybe they could be small in size, but you find that these entrepreneurs, once trained, they adopt stuff pretty well. Yeah. So like if you tell them "This is the routine we'd like you to prepare," you'll find they'll kind of follow this train so that they understand why they're doing it. So that 20 page document you can make it simple so that they are aware that this is basically how a basic income statement looks like.*

3.33 Here the issue of voluntary adoption did not arise, as if accepted it would be compulsory for SMEs. If ICPAK approved SME guidance, then any financial statements prepared on this basis would have to be acceptable to the tax authorities and credit organizations. It does not seem that there has been a wider SME/micro debate in this country, but participants emphasized the need for simplicity if such guidance is to be applicable to the smallest entities:

> *Well, the Institute certainly recognizes the problems of IFRS and there's a strong need for a simpler version for a different tier or a tiered structure. Yes, in fact it's just waiting. But when it comes I think it will be useful to be defined. It will be compulsory. If you don't comply with IFRS you must comply with the SME standard. (On the issue of micros) To my knowledge it hasn't really identified that as a burning issue. I think, as we've talked here, I mean the small and medium enterprises are pretty small anyway and maybe where the pressure's coming from is actually the micros at the moment. So yeah, we haven't really discussed it, but I haven't heard of a great sort of debate about the difference between micros and SMEs. The SME standard does need to be simple so that it can apply to micros. The first draft … I saw the staff draft and, you know, they're still pretty complicated and 250 pages.*

3.34 As in many of the other groups, participants in Kenya were keen to point out that if guidance is to be issued for micro entities, then some consideration needs to be given to the definition of an SME and how it varies within different jurisdictions:

> *What's an SME? In developed countries if you're talking about a million dollars … Here in Kenya perhaps a million dollars would be going towards a large company. Now we need to have specific size criteria in developing countries and developed countries. I think that's very important. Then you go to the next step. Yes, if we could come up with an easy to use financial regulations and the clients readily accept them and are able to understand them, if the basics are those they used before for P&L, balance sheet, explanatory notes, – yes, that would make life a lot easier.*

> *Yeah, I'm not sure whether we are doing anything with the number of employees. I do not know if this is a good measure of the size of entities. I would look at the turnover and probably the activity of the entity more than the employees as you find that especially with*

the technology now, an enterprise can afford not to employ a number of employees, but the size of their operations is quite big. So, I think I would look at it from the point of view of the level of their activity or their level of operation more than the number of employees, but again I would still go for international regulation.

3.35 In other countries, support for a new standard appears to depend crucially upon the form that it takes and in particular the extent to which the guidance is congruent with the local taxation rules, seen as crucial for its success in all three of the other countries. The Italian respondents felt that it was crucial that the recommendations were developed by, or at least had the endorsement of, the local professional body while their acceptability to both local credit providers and taxation authorities would also be helpful. In the other two countries, congruence with taxation was seen as being the single most important criteria for their success. Ease of adoption, support by credit providers and endorsement by the national accountancy body were also seen as important in Poland.

3.36 The questionnaires provided more evidence on what the main concerns of SMEs might be. While there were some county specific differences, these were not large. It was generally agreed that SMEs were likely to be most concerned about understandability of the information provided and the costs involved. However, the Kenyan respondents felt that SMEs would be particularly concerned about the cost of professional advice while respondents from other countries felt that the costs of producing the information would be more significant. All agreed that the inconvenience of producing the required information would be of moderate concern while concern over confidentiality issues would not be significant.

The form of new guidance for micro entities

3.37 Most of the UK respondents suggested that if such guidance was to be issued, a disclosure checklist approach might be most appropriate:

I think we've actually discussed this one in the office before now. I think we'd probably go down the road of disclosure checklist, they're very simple. And in terms of rules, to me that reads like more rules whereas I would suggest and probably agree with the comments that I'd want less rules. A lot of things come down to disclosure rather than anything else.

There was also support for fixed format statements. However, the point was made that there was such variation in business at the micro-entity level that it might be difficult to limit the disclosure required and attempt to enforce fixed format statements. Again, here the question of ownership was raised and calls made for a statement of principles to support the disclosures required:

There's no logical reason for saying they are small or micro. Once you say private, i.e., that all the shareholders or directors are connected to directors, I think you're absolutely right, there's got to be some kind of disclosure checklist, but because it's private it's going to be very cut down. Basically you don't need to disclose much to your own managers and owners. Now a fixed format of statements I guess they would be kind of helpful – but the one thing that's missing from there is the equivalent of the statement of principles which, I think, for the small companies is this much text and it's the lower of cost or market and whatever other principles there might be.

3.38 Similar calls were made by the Kenya group. Here the participants also felt that a statement of principles supported by a disclosure checklist and fixed format statements (balance sheet and income statement) might be the most appropriate approach:

> *I would like to try and get to a principles-based standard and it would be lovely if we could re-write them. This might be an opportunity to actually try a principles-based standard. So I'd like a statement of principles. I don't quite understand the emphasis on disclosure checklist because how can you have a checklist unless you've already defined what has to be disclosed? So the checklist is just a tool. If you want disclosures you've got to actually say what those disclosures should be, but I think that combination of minimum disclosure requirement and a statement of principles.*

> *I would go with disclosure requirements more than a checklist. How do you say? Well, we should know what the requirement is. Checklist is whatever you want to make it. I mean it's just a tool to go with the requirements. We want to know what the requirements are, plus a statement of principles.*

3.39 This is the area where perhaps the largest difference emerges between preparers from the UK and Kenya and preparers from the code law countries. Thus, none of the Italian or Polish respondents supported either a statement of principles or a checklist of items to be disclosed and only one Polish respondent favored a checklist plus fixed formats. In contrast, all the other Polish and all the Italian respondents instead supported a statement that contained rules on how to account for all of the most common and most important items or transactions that most SMEs are likely to encounter.

Publication of guidance

3.40 In both the UK and in Kenya, the groups accepted that a web version of any regulations for micro entities would be appropriate and relatively easy for most to access. However, given the difficulty of navigating the web pages of some international organizations and the access to computers for some of the smallest entities (particularly in rural Kenya), it was suggested that the document should be available in hard copy in addition to a web version.

3.41 Participants in both groups agreed that the current IASB draft document was "too bulky" and complicated and were adamant that any new guidance should be as short as possible and suggestions ranged as follows:

> *I mean I think it would have to be very, very short. I think maximum length would be ten pages, but I mean I really would like to see people really aiming for one page.*

> *No more than one-half of that I should think. The number of pages is an important measure of a document - I'd say 100 pages.*

> *Also maximum length should be not more than 120 pages.*

3.42 Italian respondents appeared indifferent to whether the standard was produced in a web-based form or a hard copy providing that it was not updated frequently. However, they all agreed that it should not be more than 100 pages in length. In contrast, the Polish respondents felt that if the final document was comprehensive, accessible and easy to use then the length was relatively unimportant.

3.43 In Kenya, there was strong support for a two format approach: a shorter document with practical guidance for owners of small entities and another longer, technical version suitable for preparers:

> *I'd suggest two formats. It should have one really small, probably like 20 page for the real businesses themselves and then the people who would be ... We're talking about the small like the jua kali*[17]*, something which that person would be able to read and know what is required of him. So there you're looking at probably a 20 page document and then for us, the practitioners, you're probably looking at 100 to 140 page size document*

3.44 There were a variety of suggestions regarding frequency of updates, although all favored updates being issued on a regular cycle rather than on an ad hoc basis. In the UK, some participants argued in favor of an annual update to coincide with the businesses year end, others argued that if a principles-based approach was adopted the need for updates would be rare if not redundant:

> *As for the frequency of updates, the simplicity of what we're talking about should be such that you would almost never need to update it. You should aim to never need to update it because every time you update it you're just making it more complicated and the object is simplicity. So you're trying to make rules which are so clear and so obvious they're likely to never change because I think if you get rid of rules and then you go for principles, the principles really don't change.*

> *It would be ideally a principles-based publication which would probably take, at most, two pages for the principles and the rest of it would just be guidance to apply the principles.*

Several Kenyan participants suggested that updates should be annually, although it was noted that if a principles-based approach was adopted, then updates should not be frequent.

> *I mean if you have a good principles-based standard I can't think why you'd need to update it all, but there should be a single revision no more than once a year; from a particular effective date once a year.*

The Italian respondents, while not in favor of a principles-based standard, also felt that updates need not, and should not, be very frequent. Indeed, they supported less frequent updates than the UK or Kenyan respondents suggesting that once every two, three or even five years should be sufficient.

3.45 The timing of any annual review was also raised and participants advised that their busiest time of the year were January and June (for tax deadlines). Therefore any updates should coincide with less busy periods and should also allow a lead time of at least six months before changes are to be implemented:

> *It is very important for us to have some time to study internally, understand, and then put it in practice and not immediately.*

3.46 All of the participants agreed that such regulations should be aimed at all businesses rather than take an industry-specific format.

[17] This is the informal sector which is referred to in Kenya by the Swahili term jua kali ('the hot sun' referring to the typical outdoors situation of such entrepreneurs).

National, regional or international regulation

3.47 The responses were varied, several UK participants supported the notion that accounting regulations for micro entities should be developed at the national level since in the case of the smallest entities international comparability was not an issue:

> *They are still really UK clients and those standards which we need to apply for them should be the ones which they can understand and from which they can benefit rather than worry about what America is thinking. I don't think we need to worry about that.*

However, others in the UK supported the development of international regulation for all entities in the long term:

> *I think that with more global markets there is going to be a lot more small businesses going to be trading with Europe or America and you've got to be able to compare for buy-out and so on, combinations of businesses, you know, they have to work together and you've got to be able to compare one with the other and if we're all working to different national standards, you just can't do that.*

3.48 Several UK participants suggested that their reasoning would not be different for entities with more than 50 employees, perhaps surprisingly as those employing a larger number of employees may have a public interest element in that they are a significant local employer. Further all agreed that, rather than distinguishing between incorporated and unincorporated entities, perhaps more appropriate criteria would be public accountability. For instance, charities are generally unincorporated but their activities are often of wider interest. However, the following comment was made:

> *Whether you can define public accountability for micro entities? Is there a definition of a micro entity being publicly accountable?*

3.49 Amongst the Kenya group, too, there were a variety of views on the issue of regulation for micro entities. These ranged from the suggestion that there should be no regulations at all for entities with less than ten employees to international regulations for larger entities. Although most participants agreed that regulations should apply to both incorporated and unincorporated entities, one participant suggested a more radical approach arguing that unincorporated micro entities with less than ten employees often have no plans for growth and should not be burdened with any regulations at all.

> *I would take a bit of a radical approach. I would really say for ten employees or less it should be left to them to decide what they want. That's how I see it. No regulations. If the tax man wants his taxes from them, let him go and calculate all that and then present a tax report for what taxes are due; but really for a small enterprise which you feel does not necessarily want to produce financial statements, they shouldn't be preparing them, so I think it should be left up to them. I think once it becomes a bigger enterprise they should because there are more interested parties in it, so it should have now some financial reporting guidance and that should be determined, I think, by international regulators so that it's the same across the world.*

> *And then should the guidance be aimed at incorporated entities? Again, going back to the radical proposals, the ones which are not incorporated should not really be forced to do so. Because what we find, is that there are a lot of businesses which find themselves burdened with these financial statements. But if you talk to him, he knows if he's making a profit or a loss. So really for tax purposes maybe they should have some way of determining how they should pay that and they really should not use us to do that if they don't want to.*

But if they're a small enterprise which really is just going to be small forever, it could just be a heavy burden on them. Because, you know, take for example audit fees, you find some clients where the audit fee is the biggest expense. That becomes a bit bad.

However, in Kenya, amongst those that supported the concept of regulations for micro entities, there was general support for international regulation rather than national or regional regulation:

I would advocate for international regulation. My reasons are basically that one it has become a global village. I'd want to go and practice and be able to practice in a different country. You should be able to go elsewhere to work. If you have international regulation that makes it's easier.

3.50 There were somewhat different views in the other countries. In particular there was no support for international regulation of the smallest entities, with all responding preparers in both Italy and Poland instead believing that regulation should be at the national or possibly regional level, so that they reflected local circumstances and national taxation rules. All the Polish respondents felt that the regulations should apply to all organizations that have to apply the national Accounting Law irrespective of whether they were SMEs or micros, incorporated or unincorporated. In Italy there was more divergence of view, with most respondents believing that any standard for micro entities should be different from that for larger SMEs and opinion was divided on the issue of whether or not regulations for unincorporated and incorporated entities should be identical.

Suggestions to regulators

3.51 Suggestions from the UK group:

*Don't forget that for private companies / small companies **simplicity** is the thing that drives.*

*Don't forget that you really don't have investor protection. You're really only talking about **protecting** creditors and to a large extent you're not even talking about protecting banks who can make their own rules about what information is needed and you're just protecting the suppliers.*

Don't start from big GAAP and see how to modify it. Start from a clean sheet and say what do these things need?

*Don't get hung up on the issue of size because it's more to do with an issue of **ownership** and it's not exactly a one for one mapping between ownership and size, but it's close.*

*Keep it simple, keep it **short**, don't change things. Mounting regulation is a great burden on companies of this size.*

*Keep it **simple and easy** so that even non-accountants can understand. I think that's very important. We accountants, we can crunch the numbers, we can understand things, but the documents are really meant for non-accountants so we should try and keep it simple and easy bearing in mind who the user group is at the end of the day.*

Don't forget that … I don't know what the number is, but half of the world economic activity is produced by these companies and the other half produced by the listed companies. These are a very important feature of the global economy and the cost of regulation is a significant feature of those companies.

Make them stop and think because there is a better alternative than this 243 page nightmare that's about to come out.

I think it's just important that they are made aware that they've got to take on board the ***views*** *of the people who are actually preparing the accounts and using the accounts. I think that's the most important thing.*

I would suggest to the regulators first of all that they ask each other precisely what they know about micro entities. What are their backgrounds? If they're international regulators do they actually know anything about these tiny, small businesses?

3.52 Suggestions from the Kenya group included:

Whenever they're intending to issue new reporting standards there must be an intensive ***awareness program*** *to be carried out not only with the accountants or auditors but also with the businessmen at large and also with all the regulatory bodies because they're the two bodies which are partners of us and they should be aware of what are the standards coming in. So education or training programs and a 20 page standard like that because you should be made aware of what are the standards, what is being proposed, why it is being implemented, what are the advantages of it and how will it affect them, but that awareness is important.*

Keep it ***simple****; principles rather than rules and the stakeholders and the users – work out who are really the users of the financial statements. It's not just investment analysts who seem to be taking over financial reporting standards! …. The owners of the business, the banks who are the financiers of the business and the revenue authorities.*

Make sure the ***cost*** *is really made as small as possible.*

Attestation/assurance

3.53 In all countries, there was support for some form of attestation, generally a statement made by the accountant, although some participants suggested that owners should also accept some responsibility, although it was conceded that they may not always understand what they are signing:

I think we'd probably go for the short statement made by the owners rather than something made by us. We don't put an accountants report on non-audit clients anyway or not on incorporated either, but we do already have a statement by the owners of the business and we'd probably just continue with that.

I think to protect ourselves as accountants you need some statement from the owners. As I said at the beginning, we always put an accountants report with any set of accounts following the guidance ……… people aren't going to pay extra for something that doesn't actually mean anything.

I think a short accountants' report would carry more weight overall generally than statements made by the owner. Well, certainly some owners of some businesses. I'm not sure that a statement made by the owners … What are the owners going to say about the accounts that comes from any knowledge other than signing a form of words which was put in front of them by the accountants? Does it really mean anything? I just don't think a statement by the owners means anything.

I would not want to see an accountants report. A short statement made by the owners – yes if they can assure us, then it would make sense. If they can't, then it makes no sense.

4. Findings: Lenders

4.1 The participants in the UK lenders group were involved in lending to small and micro entities in various capacities. For instance, one was involved in an SME project team where they financed various simple products such as vehicle and asset finance as well as general relationship banking, treasury, repayment international services and insurance. Another ran a team of people *"that will sanction advances presented to us by the relationship managers out in the field and they will be from a range of businesses – probably from the ultimately micro end through to probably about £20m to £25m turnover"*. The majority of the participants in the lenders group in Kenya were representatives from banks that offered credit to smaller entities and others included:

> *What we do is we do financing and we also provide work space for our clients, we provide work space - consultancy services and advice service*. (Representative from Kenya Industrial Estate, a development finance institution)

> *Faula Kenya is a microfinance institution which deals in lending to those people who cannot borrow from banks and our mode of lending is group lending. We put people in groups of about 15. We train them in group dynamics and thereafter we get them to do some training for them to start learning how to save, so we are able to start lending to them. In addition to that we also give other financial services to individuals who have actually grown out of the group*.

Use of financial statements

4.2 As may be expected, the UK lenders suggested that they use the financial statements of the small enterprises mainly to make judgments about the entities to which they may or may not extend credit. For the smallest entities the financial statements are only one component of the decision-making process for lenders, perhaps of greater importance are other non-financial indicators, such as the relationship that the bank has with the client and the client's account history. The participants commented that for the smallest entities, there is often little value in looking only at the financial statements as they do not always provide a lot of information, although for larger loans and for growing businesses more detailed financial statements are expected:

> *To ascertain their history, the type of management behind the business, the established accounting function, do they have good business plan, what is their cash flow … basically trying to understand the financial status of the company and that will be used going forward in the credit expansion process and I guess depending on the quality of the data that comes through and the history of the management then, you know, we'll want to know the financial status. I think it often depends on how comfortable the bank is at lending. I guess the better the quality, the more likely you've got a chance of, you know, being accepted for credit.*

> *At the very micro end we do work on pretty much a behavioral scorecard. So that's looking at ultimately how they maintain their account with us, so there's not a lot of value comes out of sort of a sole trader in terms of their performance. It's sort of a score and it's over time. You're trying to test the serviceability of any advances put forward against the histories… So if you've got an existing business you're trying to see if they can actually afford to service the loan. So what detail do we want those financial reports to go into? Obviously the more money you're lending, the more detailed the finance reports and the more assurances you want behind that as to whether it's audited or not.*

We do use annual financial reports mainly for businesses where we regard them as growth businesses, i.e. businesses which have been going for more than 18 months. Now how detailed they are and how far they've gone is another matter. We'd normally expect them certainly to be in draft. Small businesses always have a problem producing accounts. The main reason I suppose we have asked for them is to demonstrate to our auditors that we've effected due diligence. We tend to look ahead rather than look backwards. The reliance placed on financial statements is not substantial….the majority of the businesses that we deal with in the enterprise agency world are the businesses where the banks have already said no. We're effectively lender of last resort, so we have other methods for due diligence.

Certainly for micros it doesn't because it's more about relationship management than looking at the numbers. As you say, there's a limited value with these reports which are often prepared for the income tax man. I'm sure that all banks are the same as ourselves – that if you're borrowing a very modest amount the financial information is one element of the behavioral scorecard. If somebody runs a very good account then that probably means more to us.

4.3 The Kenya lenders group also uses financial statements to make lending decisions. Here, the point was made that for those applying for larger amounts; audited financial statements were requested and for smaller clients applying for smaller amounts financial statements were not always available. In the case of the latter the historical bank statements and the clients themselves are potentially a substitute source of information or personnel from the credit organization will visit the client to ascertain the position of the business:

In some instances there are those who maintain no records. So you go and try to construct how much the customer has made or what are his sales or what are his purchases and what are his expenses. But there are those who have nothing at all – it is word of mouth. So it's according to the people, he actually has nothing written down and just tells you "Okay, I buy every Monday and every Wednesday. My peak day is on Tuesday and on Friday," they tell me what happened. One of the things we do is once you get a client, you know, its relationship banking… First you'll get the client and the client banks with you, so actually if you know he's been banking … He may not actually tell you how much he makes, but you can view from his bank statements how much his inflows are and then based on the historical data, you are able to project and know how much the customer is making and what are his whatever.

For the very small client it will be difficult actually for them to prepare those financial statements, so in that case we do have a kind of personnel which they come and they make like a business plan, where they will feel they are teachers and because our officers are very few, they're able to visit the client and assess the type of business they are and the size of the business and even be able to look through their records, whatever records they have, so that they can ascertain the truth of the information contained in the business plan and eventually that kind of information will assist us in evaluating the data of that client.

4.4 In Kenya, as in some other developing countries organizations involved in "group lending" have emerged. The representative from one such organization explained how they recruited economically active micro-entity owners, placed them in a group, trained them to maintain records and then after several weeks of monitoring extend credit to them. As the businesses within the group grow, they receive further training to prepare financial statements and key financial ratios. The group dynamic helps to provide a cohesion that prevents owners leaving as soon as they have received funds:

> *For our case most of our customers are starting from the bottom. We recruit a group people who are able … They're economically active, but they cannot, not able to organize well. We put them in a group, we train them on how to make financial records. It's simple; not the financial statements, and we actually assess them by looking at the business they do and we're able to assess the income they have received. Once we have done that and they have started saving for about six weeks we start lending to them, but as the customer grows up we now start training them and by the time they are borrowing a loan of about 300,000 shillings [US $4,450] we start now telling them to start preparing financial statements. By the time they are asking for a loan of over 500,000 Kenyan shillings [US $7,270] we must get those financial statements so that it can assist us in generating now the key financial ratios so that we are able to know whether they are making profits. Now I usually generate a historical cash flow so that I am able to know whatever profits they are reporting and they are getting the cash. From there I'm going to advise them whether they're putting a lot of money in capital expenditure to start slowing that down. I have had some of them, many who want working capital. So actually from 500 [thousand shillings] I must see a financial statement and still the cash flows matter, but some of them try to cook that.*

Usefulness of financial statements for lending decisions

4.5 UK participants suggested that from a lending viewpoint the most useful components of the financial statements were the cash flow statement and the balance sheet followed by the income statement, although often the information therein was quite limited given the small size of the businesses. In addition the presentation of audited accounts was also thought to add some comfort and the more information you can provide to your banker, the more the chance you're going to receive the credit. However it would appear that the strength of the bank-client relationship also determines the extent of financial information requested by the bank. Non-financial information such as credit reference agency checks were also considered just as important as financial statements:

> *You know, creditor credit lists, creditors and debtors report. Because there's an inconsistency in the types or the formats of reports and apparently the bank's quite keen to force the client to use Sage so there's some kind of consistency and there's regular reports being sent to the relationship manager by email on a regular basis.*

> *We would try and look at other information about the business as well when we try and assess for potential risk. We run searches to see if there's any issues around fraudulent behavior in the past with any financial institution. We will often do Internet searches to see if there's anything out in the public domain.*

4.6 Again, a key point of discussion amongst the lenders groups was the contentious definition of small and micro enterprises and in particular reliance upon characteristics such as turnover and number of employees. It was also noted that different lenders have different internal criteria for the classification of clients:

> *If you define a micro as less than ten I've got customers that maybe have two or three employees but they're turning over like £10m. So that's a really dangerous game.*

> *We regard micro businesses as zero to five employees.*

4.7 In Kenya, the participants in this group suggested that the most important sources of financial information for entities that do produce financial statements included: the fact that the accounts had been audited and were not qualified; the income statement; the balance sheet; and the cash flow statement. In addition to this it was suggested again that key ratios were useful for analyzing trends and benchmarking and management accounts were used as a source of up to date information:

> *We'll be looking at ratios and we compare their trends ... Yes and then we'll compare trends. Sometimes we may benchmark the ratio as well, yes ... comparative business in the industry and we use them, but by and large we'll be looking at trends and maybe the income statements and the balance situations. We actually rely more heavily on management accounts. So if a guy brings you what he had last year, what has passed, then I want to see what is happening. You are telling them to do management accounts, you know, usually on a quarterly basis.*

4.8 Here too, in the case of smaller entities that do not present financial statements, the lenders rely upon non-financial information to ascertain cash flows and potential for growth, such as interviews with clients, review of bank statements, lists of debtors and creditors, preparation of business plans for the client and site visits:

> *There are those who don't have them. So you do visits and you do relations and you do referees, which is not financial. It's still a source of information which is even more powerful than these statements, as it is so easy to cook these things. We want to see the cash flow.*

> *But for the small ones, as I say, we prepare a business plan and the clients are involved. So at the end of the day you come out with something like a balance sheet and an income statement. We want to see whether there is evidence of growth in that SME; and in the balance sheet we want to sort of see the kind of assets which they have and the cash flow of course we need too. For those ones, as I say, we can even ask for the recent bank statements, because most of them they will not be able to prepare a cash flow, unless they're really assisted. With a bank statement you are able to see what kind of movements there is in the bank statement.*

However, in the case of group lending, a different approach is used as group members cross guarantee each others' loans:

> *For the small group ones we use the group dynamics because they cross guarantee one another. So before a loan is given all the group members must go and assess the business.*

Accounting information requested by lenders

4.9 UK lenders indicated that they did not have specific requirements for the presentation of financial statements. However, there was some concern that the information provided by end of year financial statements was not always in a format that the bank found useful. Participants commented that they were keen to get clients to use packages such as Sage to ensure some form of consistency. Therefore it appears to be the case that accruals-based statements are presented by the smallest entities when applying for finance. The use of computerized accounting packages also allows for the production of periodic management accounts and potentially a means of more regular monitoring of clients:

> *We can now receive information quicker and perhaps by email and again when I say that we have to have it based on a Sage system. I don't know if that's mandatory from the bank or whether that's something we're trying to encourage, but certainly we do try and encourage a format of some description to make it easier for the relationship managers.*

> *End of year accounts we would expect to be just drawn up to the normal accounting practices which is whatever. To be honest, at the very micro-level we're happy with*

whatever we can get because trying to get hold of it is the biggest challenge we have. As again we've got the value chain we will then start looking at whether and how they're drawn up and what accounting standards they've used.

Yes we do ask for the periodic management accounts. As you say, it's quite a demanding task actually to get somebody to produce quality interim numbers, so often we will give them a template or something to work to. We encourage Sage support because there's a benefit to the business in that as well in terms of when it comes to their year end and they're producing it it's easier for the accountant to reformat. So we see that as almost a coaching and development tool for the client to get used to Sage or similar.

We fit in very much in that line. To keep a tag on what people are doing we usually ask for regularly – although we don't receive them regularly – copies of VAT returns and personal tax returns and income tax returns.

4.10 For the smallest entities, UK lenders deal with owners themselves, rather than speaking to preparers/accountants. Although participants did indicate that wherever possible it was preferable to invite the accountant along to meetings as they acted as a source of support for the business owner, who was often not financially literate. In some lending organizations, emphasis is placed on assisting the small business owner to understand and produce financial information:

As a rough feel when you move down to that level of business they tend to start having an accountant they can rely on and we would encourage the use of a joint meeting with their accountant present because then he can probably translate for them because probably the owner's not that clever in terms of accounting so we try and encourage the accountant to be there if we can which is best practice – and I wouldn't like to say that was standard across our organization.

I think for us our business counselors provide quite a hands-on service, less transactional and more involvement with the client if we're lending money and for the majority of the small businesses we would actually help them in producing their financial information. It's just the annual accounts which we wouldn't get involved in. They would have an accountant to do that and usually for very small businesses the quality of what's provided is very incomplete as you'd expect

4.11 In Kenya, for those entities that apply for funds and produce financial statements, lenders suggested that they were satisfied for these to be prepared in accordance with guidance from ICPAK (which currently recommends IFRSs for all accounts). Therefore these are all prepared on an accruals basis along with any periodic management accounts that lenders encourage clients to prepare. One lender commented that from this information they could make their own projections using standardized templates:

When it comes to projections; especially the cash flow projections we have a template. It's a simple template which captures the information we require. And of course, for a list of debtors and creditors, we want them named and aged so that this is not necessarily as the customer keeps them. And, of course, we have periodic management accounts, yes, we do ask for that, usually quarterly, where we want to monitor the performance of the facility after the loan has been granted.

In terms of management accounts, where you know, if we're looking at a borrowing, for example, from a completely new customer we are looking at three years audited accounts and if there is a period of time between the time the audited accounts are produced and the time he's borrowing, then we need actual management accounts for that period of time.

4.12 Smaller entities do not always have financial statements and some of them operate on a cash basis rather than an accruals basis. Here, too, there was some discussion about the definition of what constituted a micro entity:

> *For us a micro - it is slightly smaller than SMEs in terms of size and cash flows. Based on amount and size of the business, capital invested, number of staff if they do have. For a micro you'll find one or two people up to around five people. The majority of them are own businesses, very small. Those have no financial statement and what I do is how much cash do they actually have in the bank and how much cash they have in their pocket and how much cash they have in the till, so there's nothing to do with accruals.*

The purpose of financial statements in lending decisions

4.13 The participants in the UK group indicated that financial statements were a source of intelligence when conducting due diligence tests in order to assess a credit risk. A "good set" of statements were believed to be a good indicator of the control that the owner has over their business and supported a particular perception about the prospective client:

> *I think if you have got a good set of accounts I think it actually shows you've got more control over your finances as well. So, you know, whether its perception, but you know if you have a professional set of accounts and it's from an accountant, it does provide more comfort in the finances which again you're more likely to consider giving a loan. At the end of the day regardless of the format, you know, the figures are going to tell you the same story.*

4.14 They were also considered to be a useful indicator of future performance, to the extent that past statements could serve as a benchmark for that client and provide some indication of whether future predictions were realistic. On a more general level financial statements were used to assess the application in relation to its peer group and in some cases to assess collateral:

> *Predictor of future performance? Obviously if somebody's got a track record of five or ten years of consistent trade we'll use it obviously to cross-reference against their forecast to benchmark really and to see whether that's realistic. Just to assess the collateral? Yeah, at the further end it may impact on the level of the funding we can probably advance. Probably most banks, certainly the micro and small business level, principally asset backed lending. I think all organizations will issue statements and it gives us an ability to assess its peer group and we will then use that information to assess the future applications that come to us; so we can actually benchmark an application. We can benchmark from another organization, we can slot it in against someone else. That gives us a fairly good peer group across the whole country.*

> *It's only one factor and I think probably lending money is an art more than a science in many ways – otherwise I'd be looking for a job. The thing is it's one of the factors that goes in. You may have a rubbish set of accounts but still want to lend the money because of other factors – because in terms of where the business is going, who's running it, security. If you do get a quality set of accounts that's very positive, very profitable, that will build our confidence. That goes into our decision and again it's going to be one of those factors, but it does influence the decision.*

4.15 Kenyan lenders indicated that financial statements were used, where available, to assess credit risk (by benchmarking) and therefore protect against default, to calculate key ratio indicators to assess future performance and in some instances to assess the level of security/collateral (assets such as land, or stock or debtors) required for funding applications, although for many of the smallest entities there is very little available in terms of business assets. Some participants raised the issue of the importance of receiving applications for funding, including financial statements, in a standardized format. Such standardization makes it easier for the lender to make decisions quickly and allow access to credit quickly whilst the business opportunity still exists and to make sector comparisons. As hiring a commercial accountant is often beyond the means of the smallest clients, lenders often get involved in training applicants to prepare their own financial records. Therefore, given the usefulness of financial statements and the reliance placed upon them, there was general support for standardization at the micro level:

> *The first one of course is to decide whether we are going to give you the money or not. So we make the decision based on the information they give us and we assess the level of risk. I've already said, we have several levels of risk. To provide protection in case something goes wrong? Well, to some extent yes because we use that information to decide whether or not, for instance, if this business was to go bust what would be the bank's position in the event that that has happened. We have a position that we can fall back to, how we can protect the interest of the bank. As a predictor of future performance? Obviously, as I have said, we can use the ratio to determine the level of risk and that will enable you to be able to decide are you going to lend or not. To assess collateral? Yes, we use that particularly when we take what we call a debenture – a debenture basically being a security represented by the company's assets, mainly stock and debtors.*

> *So time is very important. I need to get those applications in a format which will allow me to make a credit risk analysis very quickly and let the client go. Because delay one or two days means he's off and he's lost the business. So if I could get for those businesses who are having those financial statements, if I could get them in a particular format would be very useful and you always try to encourage and train and advise and counsel so that it will be easier for me, you know.*

4.16 Another issue raised by the group was the extent to which reliance could be placed upon such statements. In many cases owners (or their accountants) prepared statements for tax purposes and therefore often important information may be excluded and profits suppressed. The lenders need to ascertain for whom the financial statements were prepared before making their decisions:

> *Some of our customers have not been too keen on tax issues, so sometimes they do not show some information in particular statements. But you know them, you have dealt with them, you have your relationship with them and in some cases they trade in their personal names but this is a business and so you have to analyze quite a number of other factors.*

4.17 With the smallest entities, Kenyan lenders suggested that it was sometimes difficult to distinguish between the owners personally and the business. Also in Kenya, given the lack of a credit reference bureau, it is difficult for lenders to ascertain whether a client already has a loan from another organization, if such detail is excluded from the financial statements. Lenders were particularly concerned about "fraudulent" financial statements prepared by accountants and the "lack of action by the Institute", although ICPAK representatives at the discussion did point out that whenever such complaints are received they are pursued:

> *In this country we don't have a credit reference bureau. So he will prepare a statement and he's not telling you he's borrowed from elsewhere. He is borrowing all over and I need to*

know actually how much has he borrowed from one of you. Is he borrowing from me only and then are there stakeholders in that same business? So it is possible to pick some of those issues from those statements.

I remember a client who was showing me his financial statements. I generated a cash flow statement and I had a difference of 15 million, and that 15 million when I checked in the balance sheet there was an increase in goodwill of 15 million. When you come across things like that and that the financial statements are audited, they're prepared by accountants, it does knock your confidence in accountants then.

But it teaches you to be skeptical. Even if you do not have an accountant, you still have to look between the lines of those accounts. Actually, you get a person who is cheating in the balance sheet and the income statement, if you can get your own cash flow statement and check where you cash flow has come from and where it has been financed from and then you will be able to see where somebody has cooked unless he's a very good accountant.

Problems faced by lenders with respect to financial statements

4.18 UK lenders suggested that the main problem is obtaining financial statements for the smallest clients and the time taken in gathering information necessary to make a lending decision, often accounts are not even in existence. Business owners of the smallest entities tended to not be financially literate and often any statements that are produced "bear little relation to what's going on in the business". Participants indicated that their organizations try and support clients through education and training, to help them understand their finances and better control their business:

So quite often we will work very closely with a client to understand what it is that's being produced because we find that the accountancy firms which are involved have got time just to produce, because everything is on price so you can only spend so much time with a client and quite often the figures are produced and the client says "Well, my accountant's done those. I'm not quite sure where he's got the figures from, but he's told me that's okay and I've signed them and that's it." So we use them for education.

If you asked most guys "Have you made any money this month?" they probably wouldn't know and it's quite an enlightened customer that comes to you and actually understands month by month where they're going. So yeah, the biggest problem is time delay and the customer not actually understanding again what's been put in front of them.

4.19 They also suggested that incomplete information and the use of a variety of formats were problematic and welcomed the idea of fixed format financial statements for the smallest entities. Others commented that relevant performance information (break even, debtor days, creditor days and other ratios) in annual and periodic financial statements might also be more useful to smaller clients:

You see in the budgets and plans, it's unsophisticated, different formats and basically my colleagues were saying that often they'd rather have the simpler the better. And receiving the information on a regular basis. More understanding of their own business and – it's probably not relevant – but having stable management in place.

From an education process it would make a difference if accounts automatically have in there break even or debtor days, creditor days which the client then might tune in more to? So I wonder if there's – looking back on the education side of it – whether there's some tastier things that could be put in accounts which would help build the client for the future.

4.20 Problems faced by Kenyan lenders with respect to obtaining financial statements and the areas of accounting that present challenges include:

- Obtaining financial statements from the smallest entities and the cost to small business owners: *Based on the fact that we have been quite a relationship based bank, a lot of our customers seem not to understand why all of a sudden we are demanding too much paperwork.*
- The time taken for applicants to prepare/present financial statements: *One of the problems we have experienced is the collation of that information in that sometimes customers take time. They go to their accountants and their accountants take more time to provide it. That means of course that it ends up being a cost to the customer in terms of pricing. It's not a very good where the customer has not brought in his financials so that we can consider giving him another overdraft or something of the sort and it becomes a negative.*
- The preparation of information for particular users (e.g., tax) and the exclusion of items from the financial statements for the purposes of suppressing taxation: *So they will tell you "This is what the accountants came up with," yes, but then they will try to explain that "this is for taxation purposes," "this is for my own reason, I did not do this." For example, I've dealt with customers…maybe they were putting up a building or something or they were doing some development; that does not show anywhere.*
- Inadequate disclosures: *In terms of using these financial statements, I think most of the time, the notes which are given by the auditors are not enough to actually calculate the historical cash flows (myself).*
- Timeliness of information that is produced*: The main problem we face basically is that this information is historical. Normally you find now that most people will be doing the audited accounts for 2005 and now it's 2007 and now they lose their meaning as you are talking of accounts that are two years ago, so it's not timely enough.*
- Reliability and accountants/auditors who do not qualify fraudulent statements: *How reliable are they because you depend on the statement by the auditors that they give a true and fair view. But how can you verify that? I've had cases of a customer with three sets of accounts. I discovered one was for the income tax, one for the man himself and the other one for the wife.*

4.21 All of these views are very largely also supported by the respondents from the other three countries. All of these respondents used financial statements, irrespective of whether they were new or existing clients, at least as a basis to understand the client. In many cases, clients did not produce complete financial statements. In these cases, the lenders from Uruguay tended to ask for a complete set of accounts based upon IFRS, while only some lenders in Italy and Poland would ask for cash flow statements if they were not provided. Lenders in all three countries also frequently asked to see the tax returns, while other items such as lists of creditors or details of assets owned might also be asked for depending upon the specific circumstances of the SME. Most of the lenders across all three countries found the accounts useful as they generally were produced using a standard format and language and thus allowed them to compare different SMEs. The main problem they had was simply that of obtaining timely accounts and sometimes they felt there was also a tendency to present an unduly optimistic picture in an attempt to increase the probability of obtaining credit.

4.22 More information on this issue was obtained from the responses to the questionnaires. The UK lenders all appeared to believe that the suggested items were relevant with the possible exceptions of information on profits from continued and discontinued operations and related parties information. There was far less consensus across the Kenyan respondents. Most items were felt to be of high or medium relevance, although there was some disagreement about the relevance to lenders of disclosing expenses by either function or nature, guarantees given, contingent assets and liabilities, tangible and intangible asset revaluations, or impairments, finance leases, profits from continuing and discontinued operations and related parties information. The Italian and Polish respondents also felt that most of the items listed would generally be relevant. The items that were often thought to be not relevant in Uruguay were: impairment and revaluation of tangible and intangible assets; deferred taxation; and the total of all forms of management compensation. In Poland, in contrast the following were thought to be of low relevance: deferred taxation; splitting profit into profit from continuing and from discontinued operations and key assumptions and judgments made. The largest list of items of little or no relevance was that from the Italian respondents: impairment and revaluation intangible assets; disposal assets; disclosure comprehensive income; expenses by function; financial assets pledged as collateral; and management compensation.

4.23 The UK lenders were confident that they understood and could use all the suggested items of information, with no one thinking that the use of any of them presented any challenges. The Kenyan lenders in contrast were far less sure that the items could be easily used with more than one respondent believing that it would be challenging to use information on: fair values of intangibles, capitalization of leases, and, the split of profits into profit from continuing and from discontinued operations.

Form of useful guidance

4.24 The key concern of the participants in both the UK and Kenya was that any guidance issued to small and micro entities should be "simple". With this in mind and the need to benchmark clients, there was support amongst the groups for fixed format statements, a simple disclosure checklist and a statement of principles. Reflecting the views of preparers, in Poland and Italy there was instead support for a disclosure checklist, fixed formats and rules for the most common or important issues facing SMEs. Given levels of financial literacy it was suggested that business owners preparing their own statements would not be able to cope with the complexity of regulations issued for accountants and a "précis version" would be more appropriate in this case. The lenders also pointed out that they preferred owners to employ accountants to prepare their financial statements as this added a degree of confidence and comfort:

> *I think the format's important and probably a simple set of rules on how to account for most or all transactions.*

> *It is a very, very précis version on how an accountant would prepare it effectively so that you're basically working to, in essence, the same rules.*

> *Actually we then rely on the fact that they don't know what they're doing and they have to employ an accountant to produce the figures. It gives us some confidence in those figures. They're great businessmen often, but they're not necessarily financially astute. And, you*

> *know, we might be making a loan of a million pounds on the back of those figures, you know, so it then drives us more and more into giving on security rather than ability to service.*
>
> *I would go for disclosure checklist plus statement of principles together with "a set of rules on how to account for most or all of the transactions," so that I can be able from them to compare one small enterprise in Kisu and in Mombassa for comparison purposes.*

Education and training

4.25 In 1999 IFRSs were adopted in Kenya and participants here commented that little was available for them by way of education and training at the time. All were therefore very supportive of the idea of education/training support in the event of new regulations for SMEs or micros:

> *I've been working for one of the big banks for about 15 years, so when I went there I had to sensitize people on International Financial Reporting Standards. I carried them through some financial training ... financial analysis training course to be able to know that template and use the ratios and how to interpret them and all that. So if we are going to change to this new one it means all my users, all my loan officers at one time or another will have to use this so it means that capacity will need to be greater for them to be able to interpret and understand the use of this financial standard is necessary.*

In addition to training for lenders the group also raised the issue of training that they themselves may then provide for their smallest clients:

> *We have quite a number of them which are illiterate, but we still take them through some training on entrepreneurship and on how to keep proper records. Not financial statements, but how to be able to record every transaction they make, how to be able to record every expense they make, so that at the end of the year if somebody who's an accountant is able to come, is able to tell you what their profits are.*

Publication of guidance

4.26 All groups agreed that any guidance should be both web based and in hard copy form, given that micro-entity owners do not always have web access while Kenyan business owners outside the cities did not always have computers and web access (or if they did then there is the issue of regular electricity supplies). Again calls for simplicity were made and a summary version for owners (no more than three pages in length), with a more complex version for accountants was supported. In terms of length, as others have suggested, the "shorter the better" using simple language and the groups agreed that any regulations should apply to all entities regardless. Updates should be no more than annually, the feeling being that if a principles-based approach is used then updates and changes should actually be rare. If changes are required, it was suggested that it might be useful to classify them as major or minor amendments and to give adequate notice of impending changes. The groups also agreed that any guidance should be aimed at all micro entities rather than certain businesses or industries:

> *Anything more than annually would be a disaster and I would argue that anyway even then it's a nightmare because you prepare a set of accounts that year, you think you know how to do it and the rules change for next year so you've got to relearn them again.*

I love your idea actually of a key pointer list so there's I would call it an idiot's guide on how to do this, but then behind that there is a further detailed explanation. I believe that there should be working examples.

I would be happy if you can make it as understandable as possible – you know, very easy language…. So to give you an example like the banks. We used to prepare statements with debits and credits. But many people did not understand what this meant on the statement. So we did, we changed this to one that said: 'money in' 'money out'.

Looking at this document (IASB draft) it appears it's just taken information from most of the standards to be just incorporated in one. You see, it would be unfair to deny professional accountants, you know, the chance to go into the details of these things, but I know that most of the small businesses may never even look at some of this information outside just one or two. For those who are in business, for them, a small one, a summary, easy for them to understand, but you also have a format for the professionals because they want to really go into the details and they are the ones who are really going to guide these people and prepare them.

National, regional or international regulations

4.27 Within the UK lenders group there were differences of opinion, some supported international regulations for micro entities and others felt that national regulators were better placed to issue financial accounting regulations. Those that fell into the latter camp conceded that it may be more appropriate for larger entities (with 50 or more employees) to be subject to international regulations:

I'm going to say by international regulators just again for consistency purposes and my answer would be the same for 50 plus employees again just for IFRS rules. I should think it's easier to encompass everyone as opposed to segregating it between if it's an international standard or unincorporated or incorporated.

As a lender probably it's because most of my business obviously is in the UK so if it's nationally issued that's fine. I think as everyone tries to widen the scope and take a larger view on it, we are going to have to go international.

4.28 The group in Kenya had a very different outlook from the UK group. Here there was far greater support for international regulation, perhaps because here international standards are already applicable and are the key source of accounting regulation. It was argued that international regulation should also be applicable to the smallest entities on the basis that many of them undertook national, regional and international trade and that they might grow into businesses that would be required, in Kenya, to use IFRSs. Thus there was general support for international standards for smaller and larger entities (over 50 employees) and for both incorporated and unincorporated businesses:

We do microfinance and we do a lot of trade with Asia, with Africa in terms of management of types of microfinance and you see the way business dynamics are now. So the best thing is to have standards that hold in every part of the world.

I think I will go for the international regulation because these SMEs are just … they're just small for a period and when they grow big there is no need for someone to come and start having a problem of change-over from regional guidelines to international. It should be able to continue.

4.29 Respondents in Italy and Poland more nearly mirrored the UK respondents rather than the Kenyan. Most respondents, but not all, favored standards being set locally or, at the very least, with input from local institutes. They feared that if this was not the case, any recommendations may not be appropriate for the specific circumstances of the country.

Suggestions for international regulators

4.30 Key suggestions from the UK lenders group were: to keep it simple; to provide two versions for the different levels of sophistication of owners and accountants; to offer support and to consider compatibility with existing computer packages:

> *Just keep it simple. If they have got to be issued, keep it simple.*
>
> *Simple, plain English and some support and advice in the back. Let this be a resource that somebody can actually refer to it to make sure they are doing it right so if you bring in a regulation you've got to have some sort of help and support.*
>
> *Again simple and perhaps some working examples. You know, we talked about Sage or something that we could encourage them to use that takes away most of the work for them and it's all on-line.*

4.31 Key suggestions from the group to international regulators included:

- Regulators should understand the needs of the smallest businesses: *Why they prepare this financial information and for what value they get out of it*.
- Consider the cost burden to the small business: *They must make sure that whatever they produce in terms of financial reporting regulations they must make sense to terms of the cost effectiveness. They must not be meant to strangle the business, but actually to be helpful to the business.*
- The information produced by accountants on this basis should be credible*: They should make these members produce information that is credible. As users sometimes we get concerns because of how the accountant is fully qualified, but he can give you four or five sets of accounts for the same year and for the same entity*.
- Simple language: *Whatever language they use it has to be globally accepted, the language has to be easily understandable for everyone from whatever part of the world you are*.
- Disseminate information and education: *They need to understand the sector and they also need to sensitize people on the new standards. For example, they can hold seminars so that people are aware. Disseminate that information.*
- Enforcement of regulations to facilitate comparison: *How to enforce this regulation because there has to be a way of making sure that whatever regulations are being issued whoever has agreed to prepare financial statements according to those regulations should actually follow those regulations to the letter. If people are saying they are preparing according to these standards and they are not actually, then it is meaningless because then you will not be able to compare a customer who has followed them and a customer who has no*t.

Assurance and attestation

4.32 The UK lenders group agreed that since they place reliance upon the financial statements that are presented to them, some form of attestation would provide a greater degree of surety and more importantly from the viewpoint of lenders, who has signed the accounts off and on what basis they were prepared:

> *I would say yes, a short accountants' report and a short statement by the owner I think, keeping it simple. I don't know, maybe also a statement, what their plans are for the next 12 to 18 months or short-term and long-term goals.*

> *Certainly, assurance is important to us, particularly the more we're lending. We do like the accountant's report. That's already there. We do like the owner's report. Plans for the next year actually are quite important. At the moment post Balance sheet events are quite useful.*

> *If I've got a sole proprietor or a very small business that, you know, isn't turning over much, all I get is a signature by the owner and maybe a review of business activity at best by the bookkeeper or something and that's it. You know, what I need to know is on what basis were these accounts prepared and who prepared them. Was it a qualified accountant? Was it a bookkeeper who's been to night school for 6 months or whatever? Have they prepared it in line with accounting regulations or have they just done them as they think? Has it just come out of a computer package? That's fine as long as I know that and then I can adjust my reliance accordingly. So on what basis was it prepared and then who signed it off?*

> *On what basis is it signed? But I would say that for the majority of small businesses whatever else is on there is just a waste of time and nobody pays any attention to it.*

4.33 In Kenya, the group suggested that the issue of ownership and accepting responsibility for the financial statements was an important one and supported the idea of some form of attestation. There was a suggestion that owners, too, accept some responsibility rather than:

> *Just putting their hands up and saying the accountant tells me to do that.*

> *I think the first thing or the integrity of any system is right from the source of the information you are given. As for these particular statements, for them to be able to give a picture which can be useful to the users and the owners, the owners must actually give the first statement. Actually saying they have actually kept the proper records of accounts which will assist whoever is preparing these accounts to help them prepare. So that statement from the owner is key – that they own the company, they are keeping the records and they are availing these records of their transactions and making available to the accountants.*

> *And I think a short report by the accountants to show what considerations were made or what assumptions were made or, you know, whatever, will help the user of that information to look at it as credible information.*

4.34 Respondents in the other countries also agreed that a statement accompanying the financial statements would be useful. However, the Polish respondents all agreed that this should take the form of a short report by an accountant and that a statement by owners would be of little or no value. In contrast, the Italian respondents thought that a statement by the owners would be valuable.

5. Findings: Owners

5.1 UK participants represented small businesses that prepared accruals-based financial statements. They indicated that their key concerns were to meet the requirements of tax authorities while other users, such as banks and customers, were not considered as important:

> *Well, I mean our business is very small and in terms of annual reports it's really the sort of the statutory stuff. I mean there's other operational stuff that I would do on a periodic basis, like customer information… but not any other annual reports and they just go then for tax purposes or for any other purposes.*
>
> *As far as my current business is concerned, I'm only interested in the tax returns at the moment.*
>
> *They're (other micro owners) all saying they prepare accounts at the year end for the Inland Revenue and tax purposes or VAT as well and they have little need for interim accounts; and most of them are one man businesses…. All I want is for the accountant to add credibility to my year end reports and am looking for other values from the accountant than just preparing the year end reports.*

5.2 The participants in Kenya also produced financial statements mainly for the purposes of presentation to the Kenya Revenue Authority, for sourcing funding from banks and for their own internal use. However, they did indicate that there were instances when entities produced more than one set of financial statements depending on the intended user:

> *Yes, we do prepare financial reports every year. The main use has actually been a regulation requirement by the Kenya Revenue Authority. You must get the necessary certificates from the Revenue Authority to show that you comply with the regulations. The other thing is probably for sourcing finance it's a requirement. I've found it more important now to really use the reports for my own company analysis.*
>
> *I prepare accounts and financial statements. I will prepare them for other external agencies. Such as the KRA or the bank who wants them, but after some time you realize the same information is the same that can help you to know where you are or where you are coming from and it's really helpful to see the future.*
>
> *In fact most companies used to do that - have what I call two or three sets of accounts and even other big companies I know they do that. They have one for the bank that's going to paint a picture, they have another one for tax purposes and another one for internal.*

Form and presentation of financial statements

5.3 Depending on the size and nature of the business, financial statements take a variety of forms. For instance, a partnership represented produced only audited, accruals-based income statement annually but no balance sheet or cash flow statement and on a monthly basis, produced management accounts, aged debtors listings and cash flows that were for internal purposes as a management tool. Those representing limited companies had employed an external accountant to produce and audit accruals-based statements from the trail balance presented by the owner. An income statement, balance sheet and cash flow statement were all produced annually, although the latter was not found to be of any use to the owner. Statements were tailored to suit the requirements of end users, for instance when applying for funding the owner was encouraged to include assets, previously not recognized, on the balance sheet:

> *For instance if you applied for a stock debenture – that's when you started tailoring your accounts to the needs of the users. Until that happens that's when you realize that "I have this and this is an asset really and I've not accounted for that." The assets you had in mind were fixtures, motor vehicle, you know, but one has so many other things. There are some capital tools that you are not actually … they're not for re-sale but we use them to, for example …….. and we never used to account for them.*

5.4 Participants indicated that accounts produced were accruals based. In some instances they submitted invoices to an external accountant who then prepared financial statements, in other cases the business owner (or employee) maintained data on an Excel spreadsheet: "I do everything in excel… keeping track of invoicing, credit control, assets, payroll". Others employed a bookkeeper to input data into the accounts package, QuickBooks. A key issue raised here was the need for growing businesses to make the transition from employing a bookkeeper to an accountant and to balance that with increased associated cost:

> *We have an employee for that, using the purchase day book, to record the transactions, to check receipts and salaries. Key to our kind of business is really the debtors collection…we are collecting debts of last year….QuickBooks is easy to use, so we run it , so that's why we use it.*

> *I do employ, yes, a bookkeeper - we have a lot of transactions. We have a lot of things taking place. Unfortunately, if anything, I do believe that …… We need an accountant and really an accounts clerk to look at it for us to be … able to use the monthly reports well. There is a report that we have to do monthly because of VAT.*

> *Now the only problem is, I must really confess, being small … we have to pay more and the market rates for good bookkeepers, it is a big problem….the costs are quite high. We want to pay less and get somebody who can give you results. It doesn't happen because sometimes they just do data entry… they don't really question why is this happening and they don't really introduce systems and they don't do the accounts.*

Why statements are in their current form

5.5 UK participants indicated that the advice of their accountant was the key to determining the form of their financial statements: "My accountant produces them in line with the Inland Revenue requirements". In Kenya, the key determinants of the form of financial regulations were ICPAK pronouncements (standards) and legislation. However, entities using accounts packages such as QuickBooks found that they needed to tailor the statements produced to meet the requirements of the tax authorities and banks when seeking funding:

> *Even to get a tender we have now to comply with tax authorities and we have to tender, especially for the government, there's a lot of tax compliance and things. You need a tax return - so that you have to have done. For facilities of the banks each year there are requirements to do audited accounts - sometimes they would ask for ageing of debtors and creditors. In fact that is also a requirement, to go with the accounts and also cash flow projection for the next 12 months.*

> *Computer packages - QuickBooks, you find like you can use it alone, the way it is….the accounts produced will not really comply with the standards. We've got to translate that to Excel so that you can change it to comply with standards and balance sheet or P&L regulations…..because even the terminology used in QuickBooks is not to standard.*

5.6 On the issue of having to tailor information produced by the computer package, the Kenyan participants commented that packages that were popular locally were so because they were cheap. However, most packages used were of US or UK origin and did not meet the disclosure requirements of the Kenyan environment:

> *Probably the package being used now is because, first, we've not had any suitable locally produced package which is going to be able to capture third world issues for example. Whatever we use is not compatible with the Kenya regulations. It's specifically UK or US depending on which package that we're using and so it doesn't have that capacity. We find*

that you can't get a lot out of it properly in terms of the software that we use. And, secondly, I must admit it's something that people have pirated….most of them are not original.

5.7 The views of the respondents in Poland and Italy were very similar to those from the UK and Kenya. Where applicable, the most important determinant of what information was produced was national accounting regulation. Where entities did not have to follow national legislation, the needs of taxation authorities and then credit providers were of key importance. In contrast to this few respondents found the information produced useful for themselves in running the business. All produced accruals-based balance sheet and income statement with a cash flow statement being less commonly produced. The final form of the accounts produced also tended to depend upon the specific computer package used by the entity.

Issues presenting challenges for micro entities

5.8 In the UK and Kenya these included:

- Bad debts and deferred tax: *Those transactions are complex and a problem. Some of these transactions or jobs can give you artificial revenue and it is not very clear. When clients don't pay you, you have to chase throughput each month, even if you chase them they will not pay you and it costs to chase them. I would rather not have the deferred tax except for fulfilling the standard. I do not see in terms of helping me in the decision making when using the financial statements.*
- Stocks and valuing finished products: *One of the biggest problems of our operation is stock – stock issues – because in our work we fabricate or assemble stuff. We buy items individually and we buy many, many things (components) that we have to bring in and know how to measure the cost of each item. For us that is quite a problem. Because our products are based on people's requirements so, you know, different sizes, different people and sometimes you customize the products and it becomes hard for you to have a particular standard and say "This is so much for this and this is so much for this," or whatever.. Measuring what you're going to … how much use of this. We have to look at standard costing – how much to absorb the different costs.*
- Depreciation: *Another area I could talk about is depreciation. Sometimes I rely on my auditor to tell me – this is the requirement and you depreciate this or this much, but in some other areas I tell him "I think in this area, these particular items, because if it's a medical area where you have technology" ….I mean things are moving very fast. So if you're using things based on software or computers and that kind of stuff, then sometimes I'll and say "Well probably these instruments we'll be using in 2 years time so I can't value them at the rate you're telling me " … So that's where I know I have problems in terms of measurement.*

5.9 In contrast to this, the main problem mentioned by the Italian group was the production of cash flow statements while the Polish group focused upon two areas of particular concern namely taxation, both VAT and deferred taxation, and the problems faced in dealing with cross-border transactions.

5.10 The responses to the questionnaires provide some more evidence on the issue of the areas of particular concern to the owners. However, there was relatively little consensus across the participants reflecting the fact that their accounting knowledge and expertise varied greatly from fairly low to extensive, while the entities they represented also varied considerably in terms of turnover and numbers employed and business sectors which varied from IT consultancy services to manufacturing.

5.11 UK respondents generally felt that most of the items that they might be asked to disclose were of little relevance to them, but that if required, disclosure would present them with little or no challenge. In contrast, the Kenyan respondents felt that more items were relevant and more would also provide them with a challenge. The items that they thought would be particularly relevant included: the impairment or revaluation of tangible, but not intangible, assets; expenses by nature, but not by function; accounting policies; judgments and key assumptions made; loan defaults; financial assets pledged; and related parties information. Items that were felt to be particularly challenging were: write-down on inventory; impairment or revaluation of tangible and intangible assets; capitalization of finance leases; management compensation; and related parties information.

5.12 Most of the items that would present the greatest challenge related to fair value measurements, including the write-down of stock, impairment of intangible assets and the revaluation of tangible and intangible assets, although at least some participants thought the items were very relevant. Some disclosures were also considered very challenging, in particular: contingent assets; management compensation; expenses by function; related party transactions; and judgments made that significantly affect the amounts recognized.

5.13 Items that are particularly interesting are those perceived to be of little relevance but also being very challenging as perhaps these items should not be included in the regulations for micros. This list included the following items: write-down of inventory; impairment and revaluation of intangible assets; and contingent assets and liabilities.

Use and form of new financial reporting guidance for micro entities

5.14 In most instances, micro-entity owners in all the countries would utilize new financial reporting guidance if it was recommended by their accountants and acceptable to the tax authorities and credit granters and supported by computer software:

> *It's a non-starter as far as small businesses are concerned. If the government says it's going to do this, we have to do it. The software people will simply align their stuff and our accountants will say "This is how we're going to do it."*
>
> *Financial reporting is trouble for small and micro entities. It should be a tool for them to use. So there is need to have a regulation system for small enterprises and some of them are so small – we are talking about a kiosk. A very small kiosk – if there was a way they could account and use that information that would help the business grow because one of the biggest problems is small business people running businesses… It is not now within reach for the small business to actually produce that type of financial information and through an accountant is expensive. If it's simple enough - there is reasonable literacy to make sense that they use it.*

5.15 If micro entities are to use new guidance, it was suggested that there needs to be an appropriate way of defining a micro. In Kenya, the business environment is different from the UK and participants questioned the classification of a micro entity as one with less than ten employees:

> *I have eight employees – I'm probably classified maybe as a small business in this country - not really micro in this country.*

> *I have 12 employees - it's called medium. Between ten and five is the majority who are small. Medium 10 to 15. The majority of what you'd call big companies maybe have between 15 and 100 employees.*

Form and publication of new guidance

5.16 In the UK, the owners group was reluctant to support the idea of another tier of financial reporting guidance: *"I really don't see the point of this. There are already Statements of Standard Accounting Practice for limited companies. I don't see that size makes a difference providing it's a private company. I haven't any confidence in checklists. I can't see the point in changing it. I can't see the advantage"*. In the other countries, support was forthcoming amongst owners, who suggested that the most appropriate form might be a disclosure checklist, fixed formats for statements and a set of rules on how to account for the most common types of transactions.

5.17 The Italian respondents in particular intimated that it was important that any new regulations or guidance was supported by computer software. Without this, it would be more difficult and expensive to produce the required information.

5.18 Participants supporting the prospect of new guidance suggested that it should be web based and preferably also in hard copy form, but, most importantly, it should be easily accessible, short and simple with relatively infrequent updates. However, the Italian respondents in particular supported more frequent updates if these meant that the resulting information could also be used for taxation purposes:

> *As for the maximum length, I see no reason for this sort of thing to go past an A4*
>
> *I think a printed copy is the most convenient for most business people. A useful document must be three pages and an update every two years.*
>
> *So if it is going to be web based it really does need to be accessible because what happens is you spend nearly two hours and in the end you sit down and write a letter.*
>
> *But another thing that's quite important is not just to slow down the updates so that people get a chance to cope with it – maybe three to five years.*

5.19 In the case of the smallest entities, it was suggested that guidance be aimed at keeping good accounting records and that business owners employ accountants to prepare financial statements. Whilst there is an associated cost with this it is was felt that this approach was preferable to the alternative when owners are not financially literate:

> *It is really because, you see, what you're doing is guidance for the sole trader who's not an accountant because generally he's something else – he's a barrow boy, he's a taxi driver, a whatever. His job is not accounting, but if you can impress upon him keep records, get yourself a qualified accountant. I see a lot of court cases brought against sole traders not because they're fraudulent or anything, but they've been incompetent in the running of their business affairs.*

5.20 There were also some calls for specific guidance to be aimed at different sized businesses and different types of businesses (incorporated/unincorporated):

> *Well, the sole traders and partnerships, the minute you have guidance aimed at all these entities but it's only one set of guidance you've got problems because you're trying to be all*

things to all men and your single A4 sheet of paper, has gone out of the window. So I think guidance should be quite specific.

We're reporting as a limited company, we're reporting as a limited partnership or by general partnerships or by sole trader. It should be tiered specifically.

National, regional or international regulation

5.21 Participants in all three European countries supported the idea of national standards and regulations for micro entities rather than international regulations. The Polish and UK participants favored identical regulations for both smaller (less than ten employees) and larger entities and participants from all three countries generally favored identical regulations for incorporated and unincorporated entities:

I think in this case I would rather have a British standard, a French standard, a German standard because half the time people what they don't like they don't use.

5.22 As in the case of other Kenya groups, this group supported the idea of international regulations/guidance for micro entities:

By international regulators - because there would be more recognition and I think the law here might be more biased than the international. I suppose I want to see a business to see international growth rather than just country-wide. International would really be better. And the guidance should be aimed at all entities.

International regulation gives my accounts credibility to deal with international suppliers and customers. And I don't think that should be different for any bigger entity or even for people who are not incorporated because at the end of the day it's still a business.

Suggestions to regulators

5.23 The general feeling from the UK group was that international guidance for micro or SMEs was not required as such guidance already existed in the UK:

Don't.

Well when they (small entities) grow they will become international and then they can fit to international standards because they're doing international trade. I mean one assumes that's what international means. But I think if you're a local corner shop or you're a local business, I think we should stay as we are.

Most people are employed by small businesses in this country and I just think we should leave them alone to get on with making money. Then I think, roughly, we should ask them to leave Britain well alone to be honest. We're a successful country; people come here because they like the way we run our company affairs and our accounts and I wouldn't want our standards adjusted to meet somebody else's idea of an international standard.

5.24 Generally the feelings from the other groups were that any such guidance be simple and easy to apply. In addition the Kenyan respondents supported the better dissemination of guidance to those applying it, that is, the business owners themselves:

I would argue that you make the standard international but bear in mind that you are dealing with a small enterprise so make it easy, fewer regulations to simplify it. And comprehensive and easy to understand.

I think we need mechanisms, stronger mechanisms to pass the message about the standards to business. Because it appears like the standard is for the accountant who is assisting the

> *client who is following the regulation imposed on the business. We need a marketing tool to actually pass the message.*
>
> *You only get to know about that law existed when you're busted about something that you did. You are never made aware that actually you were supposed to do this and this – it's very bad. That's why people have a negative attitude towards book-keeping and paying taxes and that kind of stuff because most of the small people think book-keeping will make you get caught.*

5.25 When asked to look at the draft IASB standard, participants in the UK and Kenya suggested that it was not something that micro-entity owners would find useful or use because of its complexity and length:

> *I think the business of preparing accounts would still remain for the accountant ... It's (the IASB document) not a document to be read by an ordinary accounts clerk… So it still remains a document to be used with guidance from accountants.*

Assurance and attestation

5.26 The UK group expressed a degree of support for attestation of financial statements produced by micro entities:

> *I think that in any business somebody in the business should say "This is what I think it is." You need responsibility. I mean my accountant, does he sign them? No, now he doesn't even say it's a true and fair view. It's entirely washing their hands.*
>
> *And that would apply to sole traders as well. I think people should sign the accounts. And the accountant's statement should say "on the basis of the information given to me…"*

5.27 In Kenya the group indicated that it was appropriate for someone to accept responsibility for the financial statements and argued that this should be the accountant who has produced them, as most business owners did not understand the contents:

> *I don't know about the owners ... If you're confident with accounts then you can do that, but if you're not then it's basically it's what you are given by the accountant …..and I'd rather they do what they're going to do.*

5.28 In Kenya, the issue of the role of auditors and accountants was also raised in respect of accepting responsibility. It was suggested that some, particularly smaller accountants offering services to smaller clients, are prone to producing accounts that are unduly influenced by the clients desire to produce a particular picture of the entity's performance:

> *"What profits do you want me to show?" instead of they have a view telling you "Well, you need to do this and you need to be straight here." Instead of starting from the back and creating your books the way they are supposed to be ….that's what my previous accountant and auditor did, "What do you want me to report?" after all its an opinion – they are not obligated to detect fraud..*

5.29 The Polish respondents were particularly concerned that any recommendations should not result in additional bureaucracy. They felt that asking entities to provide a statement of attestation would have little or no additional benefit over that obtained by the simpler requirement for the person responsible for their production being required to sign them off.

6. Conclusion

6.1 This study has sought to ascertain the views of interested stakeholders on the suitability of the proposed IFRS for SMEs for micro entities and considers the need for new international guidance aimed specifically at these entities. Preparers, lenders and business owners were identified as the three key stakeholder groups from a prior literature search, a finding reiterated by the evidence presented here. Focus groups were established and questions were devised for the three groups, taking into account the fact that many business owners and lenders were not as technically aware as the preparers.

6.2 Although focus groups afford the advantage of gathering very rich data at a relatively low cost compared with interviews, there are several methodological frailties associated with the process, as highlighted in section two. Key amongst these is the issue of generalization. Whilst not claiming to be comprehensive or even widely representative, this study has drawn attention to some important points in the debate surrounding financial reporting guidance for SMEs and micro entities. Extending this study to examine, more closely, the specific issues raised here may be an option in the future.

6.3 Small entities are known to be economically important and in many countries, particularly in developing countries, are the key providers of employment. In this study, significant differences emerged between the two different business environments: the UK and Kenya. In the UK the existence of the FRSSE means that guidance is already available for the preparation of the financial statements of small limited companies. Thus, commentators have suggested that *"UK FRSSE users who read through the lengthy draft standard might note some familiar features"* but that *"the draft standard might be regarded as an improvement over the current FRSSE"* (Shearer and Sleigh-Johnson, 2007, p.78). However, in general, the findings of this study do not suggest that a new international standard in this area would be well received in the UK. In Kenya, IFRSs have been the main source of accounting regulation for all entities since 1999 and there is no specific financial reporting guidance available for smaller entities. Thus whilst the groups in the UK were generally reluctant to support the introduction of yet another tier of regulation, the groups in Kenya were more convinced of the need for new guidance. Participants recognized the global nature of business and the need for guidance for entities trading internationally and growing, but some questioned the increased burden that such blanket guidance would impose upon small entities that intended to remain small and traded locally.

6.4 While UK respondents generally were not convinced of the need for a new standard and the Kenyan respondents were generally in favor of one, the respondents from Italy and Poland generally favored a new standard being produced at the local level, so that the statements produced were also fully compliant with the local taxation rules.

6.5 However, in both UK and Kenya, there were very real concerns about what constituted a micro entity[18]. Participants suggested that number of employees was not an appropriate mode of classification. For instance, in Kenya a business with ten employees could easily

[18] The proposed IFRS for SMEs was drafted while having in mind a typical entity with 50 employees, although this is simply a guide rather than a definition of an SME. Potentially the IASB standard extends to "non-publicly-accountable entities", which could range from a small sole trader to a very large, but privately owned company.

be classified as medium sized, or in certain industries a business with 20 employees was considered to be large and there were sole traders in the UK who had a turnover in excess of £1m. The findings here suggest that regulators consider instead the ownership structure of the business and the extent of need for investor and creditor protection.

6.6 In all the countries small entities are already required to produce financial statements, although their form may vary significantly. These are generally accruals-based statements, although in certain cases very small businesses might utilize a cash-based approach. The fact that accounting is less regulated at the small entity end of the spectrum in Kenya might help to explain the extent of support for new guidance here. Participants suggested that it was far more likely that, here, accounts would be *"tailored"* for specific users. For instance, items may be excluded or *"profits suppressed"* in statements presented to the tax authorities or "*items capitalized in statements presented to potential lenders"*. Further, owners suggested that they were reliant upon the advice of their accountants and were sometimes asked *"what do you want me show in the accounts"*. Such practices may well be applicable to small (and larger) entities anywhere, but participants in our groups raised the issue and suggested that enforcement of regulations/guidance might be a solution.

6.7 The data highlights the variety of methods of preparation of financial statements, ranging from presenting preparers with invoices and receipts, recording transactions on spreadsheets, using a computerized package to prepare a trial balance for the external accountant or producing a full set of statements internally. The trend here is the growing use of computerized packages by smaller businesses, although in most instances the output needs to be tailored for presentation purposes. Bearing this in mind, the suggestion was made that any form of new guidance for micro entities be supported by or compatible with commonly available computer packages.

6.8 Given the low levels of financial literacy amongst small business owners, it is the case that many are completely reliant upon their accountants for financial advice and the preparation of accounts and the cost burden associated with this. Perhaps because of the cost burden, the evidence found that some of the smallest entities do not have prepared financial statements when approaching lenders and are therefore less likely to be successful. There was general support, therefore, for two levels of guidance, a simple précis version that would be easy for business owners to follow and understand and a more technical version for preparers. Related to this was the issue of education and training, as calls were made for the dissemination of information relating to any new regulations to reach owners, preparers and lenders.

6.9 Despite some reluctance amongst the UK groups to support new guidance, most respondents both here and in the other countries agreed that the proposed IFRS for SMEs would probably prove to be too complex and long (at over 200 pages) to be useful to most micro entities. The groups were emphatic that any new guidance should be simple and use non-technical language. In terms of outline content, there was general support for fixed format statements, a simple disclosure checklist supported by a statement of principles in the UK and Kenya while respondents in Italy and Poland preferred a set of rules covering the most common or important items alongside fixed formats and disclosure checklists. It was argued that if a principles-based approach was adopted, updates would not need to be frequent and indeed could almost be rare[19]. As regards publication, any such guidance should be available both on the Internet and in hard copy, as not all small business owners have access to computers, particularly those in rural areas in developing countries.

6.10 Participants were questioned about the areas that were particularly challenging for micro entities, these included: deferred tax; VAT; bad debts; leasing and hire purchase; stock valuations; fair value measurements; contingencies; related party transactions; and depreciation. Clearly, these are the responses received from these groups only and different responses may well have been received had the composition of the groups been different. However, as such, they do give some indication of areas that particularly present difficulties for micro entities and which therefore should be of concern to regulators. The IASB's ED does specifically exclude some of the IFRS topics that are not considered relevant for SMEs, does allow the simplest policy option choices for SMEs where a choice is offered and is structured by topic with practical guidance on accounting treatments for transactions commonly encountered by SMEs. However, there is perhaps a feeling that more could be done to meet the very specific needs of micro entities.

6.11 Respondents were also asked to offer advice to international regulators who may be considering regulations/guidance for micro entities, their responses included:

- regulators should understand the needs of the smallest businesses;
- consider the cost burden to the small business;
- better dissemination of guidance to those applying it, i.e. the business owners themselves;
- enforcement of regulations to facilitate comparison;
- don't start from big GAAP and see how to modify it;
- consider carefully the definition of a micro or small entity;
- consultation - how much do international regulators actually know about these tiny, small businesses?
- education or training programs for preparers and users are important;
- provide two versions for the different levels of sophistication of owners and accountants; and
- consider compatibility with existing computer packages.

6.12 This study set out to canvas the views of interested stakeholders and has raised issues that an international financial reporting regulator might wish to consider as part of its due process in issuing guidance to small and micro entities. It is the case that the IFRS for SMEs ED has been produced with many of the issues raised here in mind (Pacter, 2007). Such congruence is reflected in IASB's goals in developing the ED, which include: simple "self-contained" standards; cost-benefit considerations; eliminating topics not relevant for SMEs; enabling investors, lenders and others to make comparison while reducing the

19 The IFRS for SMEs ED was "developed by extracting the fundamental concepts from the IASB's conceptual framework and the principles from IFRSs" and updates are anticipated once every 2 years (Pacter, 2007, p.77).

burden of preparation; basing the ED on concepts and principles drawn from full IFRSs and use of simple language. However, in this study, even those that supported international regulations for SMEs and micro entities felt that the ED is not *"suitable for, and easily applied by, even the smallest of SMEs – the so-called 'micro-sized' entities with just a few employees"* (Pacter, 2007, p.76). This may be because the proposed IFRS for SMEs was drafted with an entity with about 50 employees in mind[20], whereas most micro entities, particularly in developing countries, are much smaller in terms of number of employees and therefore exhibit different characteristics.

6.13 Finally, tentative conclusions may also be drawn in response to the questions raised in the introduction:

- The proposed IFRS for SMEs is too complex for micro entities.
- It seems unlikely that simply making changes to the ED will make it sufficiently suited to users and preparers of micro-entity financial reports.
- The case for a separate tier of accounting guidance for micro entities - whilst there is support for new guidance for micro entities in Kenya, there was much less so in the UK and the other countries. If such guidance was to be issued, there was support for two levels: a simple précis version that would be easy for business owners to follow and understand and a more technical version for preparers[21].
- There was general support for some form of attestation to be attached to the financial reports of micro entities. It has been suggested that this perhaps should take the form of a statement made by the accountant, rather than the owner who may not always appreciate/understand the contents.

[20] This is only a guide rather than a quantifying test to determine an SME.

[21] Key characteristics include: simple, easy to understand, as short as possible, low cost of compliance.

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