

## 2 BACKGROUND

### 2.1. IASB AND CONVERGENCE ISSUES

#### *2.1.1 Dilemma of developing economies and economies in transition*

The International Accounting Standards Committee (IASC), the predecessor of the International Accounting Standards Board (IASB), decided in December 1988 to embark upon a study of the needs of developing and newly industrialised countries for accounting standards. An Issues Paper was submitted to the Steering Committee for deliberations. However, the matter was not pursued any further because at that time it was noted that “...the IASC’s secretariat has to tackle more urgent matters before proceeding with the project” (Wallace, 1993, p.121).

The factors that motivated IASC then to focus on, among other things, the demand for accounting standards that developing countries and newly industrialised countries can use as the basis for national standards and assisting with the implementation of such standards are explored and discussed in depth in Wallace (1993). During the same time, calls were made to identify the particular needs of these countries in the areas of accounting and corporate financial reporting (Peasnell, 1989; UNCTC, 1988).

#### *2.1.2. Needs of users*

A financial report, to be adequate, ought to serve the needs of expected users. Serving the needs of users implies that information disclosed in a financial report:

- Fulfils the common needs of all users of that report
- Is presented in a manner which can be readily understood by its user and would enable that user to receive or select the relevant signals from such a disclosure, and
- Complies with disclosure regulation regime – the companies’ law, accounting standards and generally accepted accounting practices.

It is accepted that the role of an accounting standard is to motivate the attainment of the first two obligations. There were comments that if the goal of an IAS is to promote the fulfilment of the needs of corporate reports then more attention need to be paid to the wishes and interest of users in developing and newly industrialised countries.

The IASB’s Framework for the Preparation and Presentation of Financial Statements (1989) stipulates that financial statements should serve the needs of users, which include investors, employee, lenders, suppliers and other trade creditors, customers, government and their agencies and the public. The framework further states:

While all the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

The problem with this quotation as has been highlighted by Wallace (1993) is that in the context of developing and newly industrialised countries, risk capital cannot be limited to equity or financial contributions. Many of these countries provide financial incentives, such as tax concessions and tariff protection, in order to attract a transnational enterprise

to locate in their territory. To the extent that these resources can be put to other uses, they are risk capital; and allocating them to an enterprise is an investment. Herein lies the key to the difference between the objectives of financial reporting of developing nations (including emerging economies and economies in transition).

According to Ayo Oni (1986) the key to such a difference “will lie in whether the most important user groups in developing economies are different from their counterparts in the more developed countries.

The importance of understanding the needs of the developing and newly industrialised countries was articulated by several researchers (Scott, 1970, Washington Sycip, 1981, Perera, 1989; Wallace, 1990). It was suggested that a more proactive view be taken leading to positive measures as to provide as an opportunity for consensual global solution leading to a more convergent thinking as participants would readily explore options, outside their cultural parameters of the issue, in the service of global harmonisation of national accounting differences.

A major obstacle to the initiatives appears to be that comparable international statistics on the needs of corporate financial reporting was not easily attainable. It was recognised that corporate reporting regulation is a response to technological as well as economic and social changes. In the process of a country’s growth, the characteristics and functions of reporting enterprises – and particularly of the needs of the different users, preparers, auditors and regulators of corporate reports – are transformed and this raised the questions of the relevance of comparisons and generalisations.

It was alerted from earlier on that the problem of implementation of IASs in different countries arise from the inability to incorporate the provisions of an IAS in a related domestic standard, especially when the local IASC member body has little or no control over (or influence on) the domestic accounting standard setting process. More importantly the issue of “political visibility” of complying with the IASs was raised. Further questions were raised: “Why should a local business community operating in a totally domestic environment adopt IASs which are formulated on the basis of operations in an international capital market?”

The IASC project got further and further down the agenda and the issue of addressing the needs of developing countries did not seem all that urgent as time progressed as IASC got heavily involved with the IOSCO work programme.

However in 1998, the IASC did bring back the project onto the agenda in a slightly different version as Financial Reporting Needs of Emerging Economies and Economies in Transition (IASC, 1998). A preparatory committee was appointed but no further work has been forthcoming.

In the meantime, with IOSCO endorsement, many nation states (including developing countries) were persuaded to adopt IASs. However, the difference between most developing countries that adopted IASs and developed countries was that in most of the developing countries, the application of IASs was for all categories of business enterprises or in some cases to all enterprises incorporated as companies.

The increased use of IASs by developing countries that lack technical support and capital markets and the apparent over sophistication of IASs raised concerns. From very early on it was suggested that a dual standard approach involving primary and secondary standards was proposed (Enthoven, 1981). However, such notions were generally rejected by the IASC.

There is general consensus that the IASC was, and the IASB continues to be, short of sufficient funds and personnel to do all that ought to be done. Like in any capital rationing scheme, sometimes attention is paid to those with the loudest voice or the largest clout. Developing nations and SMEs largely have been absent from the international radar screen simply because they are insignificant players in the international capital markets. They have little influence and hence little impact on the decisions taken and there has been a perception, driven in part by IOSCO, that the multi-national enterprises and their needs were more important. As this report illustrates the SME sector in most cases is the engine that drives most local economies and as many have argued (for example, CGA-Canada and Institute of Chartered Accountants of Sri Lanka) favouring multi-nationals is a short-term viewpoint.

### ***2.1.3 Size problem of the enterprise***

However the issue persisted and it is noted that arising from the different regional and country characteristics is the size problem of reporting enterprises in different countries as allude earlier. In many cases, the biggest enterprise in a developing country is equivalent, if not smaller than a relatively small enterprise in a developed country. It became obvious to more and more countries that it seems inappropriate to apply a single standard uniformly to all sizes, especially when it is obvious that the benefits of a particular disclosure rule far outweigh the costs of that disclosure for only a few of the reporting enterprises.

There is a gradual realisation that in the context of international harmonization, an IAS that is worthwhile in terms of benefit/ cost analysis for a transnational enterprise may be less worthwhile for a domestic enterprise in a developing country. The question was raised as to whether IASC should prescribe differential rules (Wallace, 1993). The question remains unanswered.

## **2.2. ACCOUNTING AND REPORTING BY SMEs**

### ***2.2.1. Importance of SMEs***

One of the most significant changes that is encountered during the last twenty years is the growth of small and medium enterprises (SMEs) (Jarvis and Collis, 2002). In the developing countries, SMEs account for nearly 80 –95 per cent of the total number of enterprises (Abdullah, 1999; Heymans, 2000; Martin, 2002). Within the European Community small businesses constitute at least 95% of all enterprises (Storey, 1994). The same applies to developed countries (Ministry of Economic Development, 2002; Randall, 2002). For example, Canadian small businesses employ approximately half the work force, their numbers are said to far outweigh the number of public companies (Pugsley, 2000). Randall (2002) pointed out that in Australia in 1998-1999, the private sector non-agricultural small businesses represented 96 per cent of all businesses and employed about 47 per cent of the non-agricultural workforce. The increase in small businesses has

also been phenomenal as observed by Randall (2002) in that in Australia, over a 15 year period from 1983/84-1998/99 small business had an annual growth rate of 3.7 per cent compared with the growth rate of 2.6% of other businesses.

### ***2.2.2. Biggest employer***

The small business sector is said to have had a lot of influence in the last ten year. It employs 50 per cent of the workforce and in fact in the early nineties was said to be the net employer (Randall, 2002). Similar experiences are mentioned in other developed and developing countries. For example, in the 10 years from 1987 to 1997 in the USA, government and large businesses reduced their employment by 2 million people whereas the SMEs increased their employment during the same period by 16 million people (Randall, 2002).

The phenomenon of family businesses does stretch beyond developing countries. For example, in the USA 50 per cent of all US exports are said to come from businesses with less than 19 employees (Randall, 2002). Small businesses contribute 50 –60 per cent of gross domestic product in the US. Similar experiences are noted for other parts of the world. For example, in Western Europe, family businesses employ about 50 per cent (similar to Australia).

### ***2.2.3. Focus on financial reporting***

In recent years the development of financial reporting has been rapid and designed primarily to address information needs of users of financial statements of public listed, the multinationals and transnational corporations. Many of these developments arise out of the initiatives towards international convergence of accounting standards, primarily driven by the globalisation of financial markets efforts and need to meet securities regulators' concerns (Hora, Tondkar and Adhikari, 1997; UNCTAD, 2002).

Whilst these developments can be justified for public companies on the grounds of public interest, applying the same financial reporting standards to all enterprises has become more and more debatable (Hite, 1998; HKSA, 2002; Heymans, 2000; Pugsley, 2000; FRC, 1999).

A significant factor that appears to have hastened the cries for reconsideration is the proliferation of accounting pronouncements in the past few years that has added complexities to the preparation of financial statements and therefore increasingly burdensome to small business enterprises.

The problem of accounting standards overload and the notion of reporting burdens imposed on small enterprises have become quite significant. In New Zealand, for example, even with a differential reporting regime, questions are being raised as to whether smaller enterprises face disproportionately higher compliance costs relative to larger companies (Ministry of Economic Development, 2002).

### ***2.2.4. Addressing issues of SMEs relevant to both developed and developing countries***

Whilst the issue of addressing the accounting standards overload on SMEs is crucial in both developed and developing countries as noted earlier, the need for an authoritative guideline is much felt in the developing countries. In the developing

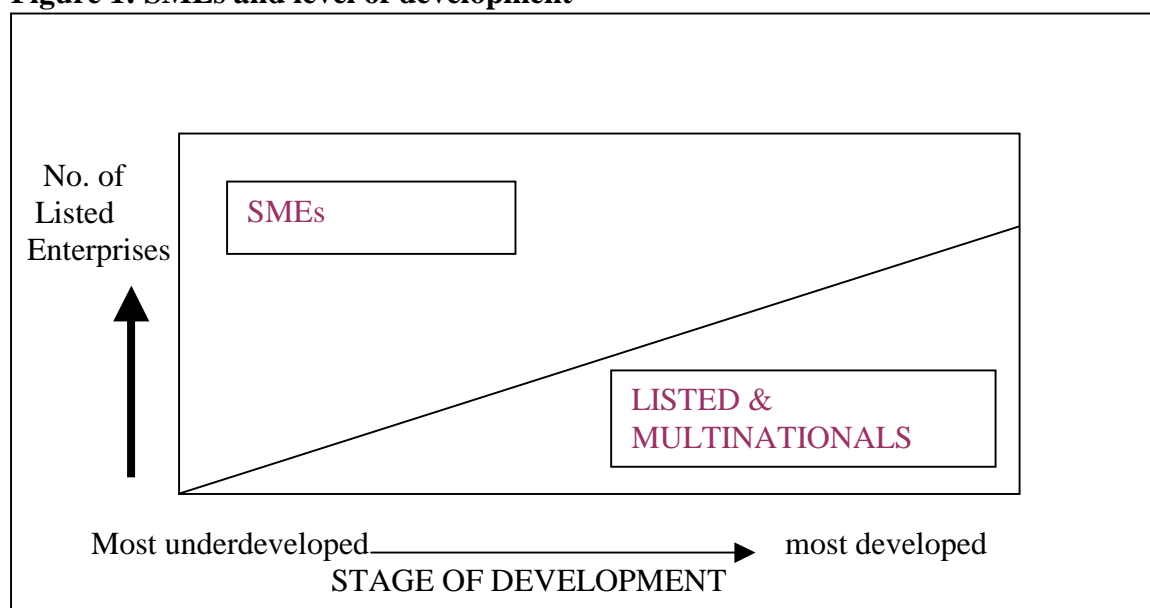
countries the lack of adequate accounting infrastructure (in terms of organized professional body, technical expertise and resources) further hampers initiatives to elevate the reporting burden on smaller enterprises.

A significant number of the developing countries do not have well-developed capital markets (Saudagaran and Diga, 1997). To this extent, the stage of economic development of a country seems more relevant when discussing accounting standards and practices (Wallace, 1993).

However, the initiative to introduce differential reporting regimes have already been undertaken by the major developed countries as discussed in the next section. Some of the more advanced (in terms of accounting development) developing countries like, Singapore, Malaysia, Hong Kong and Sri Lanka have already taken steps in this direction.

Figure 1 shows that the level of economic development can be associated with the level of capital market development (measured in terms of number of listed companies) as inferred in Wallace (1993). It has been acknowledged that there is an apparent positive association between corporate reporting and the level of economic development.

**Figure 1: SMEs and level of development**



It is clear that especially for countries which are underdeveloped, with no capital market, the significance of addressing issues of SMEs cannot be undermined (Saudagaran and Diga, 1997).

## **2.3 ISAR INITIATIVE: ISAR GUIDELINES**

### **2.3.1 *Improving accounting infrastructure of developing economies and economies in transition***

The lack of a developed accounting infrastructure has been identified by many multilateral agencies (example, the World Bank, OECD, ADB, UNCTAD) as a major obstacle to economic development. ISAR contend that a lack of accountability contributes to financial instability, discourages foreign direct investment and acts as a brake on aid

panels. From an individual enterprise's perspective, lack of transparency and adequate financial disclosure leads to difficulties in obtaining finance and lack of knowledge with which to manage the enterprise.

### **2.3.2. ISAR Proposals**

The focus on the issue of differential reporting is very timely and the effort of ISAR (UNCTAD 2002) in formulating guidelines for SMEs accounting and reporting is commendable. ISAR recognised the need for a user-friendly, understandable and flexible financial accounting and reporting system that accommodates the needs of small and medium-sized enterprises at various stages in their development that will enable it to maintain accounting records and generate meaningful financial information. To this end ISAR has identified 3 levels of enterprises, namely:

- Level 1: Listed entities whose securities are publicly traded and those with a significant public interest should follow IFRS.
- Level 2: Significant commercial, industrial and business entities that issue neither public securities nor financial reports to the general public may follow a single set of requirements derived from the IFRS and consistent with them, but embodying only requirements for the simplest and most regularly encountered transactions.
- Level 3: the smallest entities that are owner- managed and have few employees should follow a simple accruals-based accounting system, closely linked to cash transaction, and with a derogation for businesses to use cash accounting for a limited time when establishing their accounting systems.

The recommendations by ISAR briefly are as follows:

- The proposed guidelines would be a technical aid;
- Definition of SME and the levels must be determined by each member state that chooses to apply this approach, taking into account the prevailing economic, legal and social circumstances. (As noted in Table 2, different countries have determined different definitions of SMEs).

The guidelines represent a major step towards introducing differential reporting regimes in member states.

## **2.4 FRAMEWORK FOR DIFFERENTIAL REPORTING**

### **2.4.1 What is differential reporting?**

Differential reporting is the notion that some entities should be allowed to depart from particular requirements of accounting standards or entire accounting standards in preparing their financial statements (HKSA, 2002). Therefore, it permeates the idea that different entities should be subject to different accounting rules (Harvey and Walton, 1996). Differential reporting means tailoring requirements to the circumstances, not necessarily fewer requirements for financial statement preparers or less information for users.

The case for differential reporting has been articulated and to some extent practiced for a long time in some developed countries (for example, USA, UK, Canada, Australia and New Zealand and the European countries). Increasing, developing countries have raised this issue and taken proactive steps to introduce a differential reporting

framework (for example, Hong Kong, Sri Lanka, South Africa, Thailand and Malaysia, to name a few).

#### ***2.4.2 Why the concern with differential reporting?***

- **Increased Differences Between Users Of Financial Statements**

It is noted the rapid and widespread developments in financial reporting have increased the differences between the needs of users of financial statements. A number of these developments were designed primarily to address the information needs of users of financial statements of public companies in response to the needs of international capital markets. While these developments are justified for public companies on the grounds of public interest, applying the same accounting requirements to all profit-oriented enterprises became more open to question.

This is a quote from the experience of the Canadians:

... After extensive research and consultation, including discussions with other standard-setters who have made similar changes, the Accounting Standards Board (AcSB)<sup>1</sup> decided it was time for action. The idea that accounting requirements for non-public companies may differ in certain areas from those applicable to public companies has become reality. (Canadian Accounting Standards Board, 2000).

- **Intensified efforts at convergence**

Again the Canadian perspective sheds more light in this development:

... In Canada, the pace of harmonization with US standards has also been a contributing factor to the need for change. In the US, bylaw standards are only applicable to public companies, but in Canada federal and provincial statutory regulations require all Canadian corporations prepare financial statements in accordance with Canadian GAAP. The universality of this approach has led public accountants to report increasing concerns amongst their non-public clients regarding work and related costs necessary to comply with certain GAAP requirements perceived to be of limited value. To limit the costs of engagements, some clients chose to depart from certain GAAP requirements and to have qualified audit or review reports, or moved from audited or reviewed statements to compilation engagements.

It must be noted that Canada is the third major standard-setter to implement a differential reporting approach. In 1997, Britain set out a separate reporting standard for smaller companies, and the New Zealand standard-setter implemented a framework for differential reporting. Other jurisdictions, such as South Africa and Hong Kong, have launched differential reporting projects and the issue is emerging at the international level.

#### ***2.4.3 Practices of Differential Reporting in Developed and Developing Countries***

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<sup>1</sup> Refers to the Canadian Accounting Standards Board.

### **The Australian experience**

Table 1 provides an analysis of the development of differential reporting. The initiatives began in early 1990. Australia, for example, confined financial reporting to enterprises which are deemed as reporting entities.

The Australian regime links the obligation to prepare statutory financial statements to the existence of external users dependent on financial statements to make decisions. Under Australian Corporations Law, small proprietary companies have to prepare annual financial statements only if shareholders with at least 5 per cent of the votes give the company the direction to do so, or if it is controlled by a foreign company. However, it is noted that while the Corporations Law itself may not require a small proprietary company to prepare accounts, the company may need to prepare the accounts for the purposes of other laws (example, income tax laws).

### **The New Zealand Experience**

Similarly, New Zealand introduced a differential reporting regime in 1994. It is also interesting to note that in New Zealand, there is in fact three levels of reporting:

1. Enterprises referred to as **reporting entities** where it is reasonable to expect the existence of users dependent on general-purpose financial reports. These enterprises comply fully with all Financial Reporting Standards (FRS).
2. Enterprises referred to as **qualifying entities** which meet the requirements of the Framework for Differential Reporting to qualify for differential reporting exemptions in the financial reporting standards.
3. Enterprises referred to as exempt companies in terms of Section 2<sup>2</sup> of the Financial Reporting Act 1993. Exempt companies do not have to prepare financial statements in accordance with GAAP, or any statutory requirement for the financial statements to show a true and fair view. However exempt companies are still required to prepare simplified financial statements that comply with the form and directions set out in the Financial Reporting Order 1994 (FRO).

Currently the New Zealand regulators are reviewing this exempt company regime and the issue of compliance costs differences between the exempt company regime and differential reporting regime (Ministry of Economic Development, 2002).

### **The UK experience**

The Companies Act in 1981 first introduced differential reporting in the UK. The Financial Reporting Standard for Smaller Entities (FRSSE) issued in November 1997 is applicable to all reporting entities that qualify as small under the Companies Act. The FRSSE recognises that the balance between users' needs in respect of stewardship and economic decision-making for smaller entities is different from that for other reporting entities (ASB, 1997). Jarvis and Collis (2002) note that this statement recognises the important distinction regarding stewardship between large and small companies.

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<sup>2</sup> Exempt company is a company whose total assets do not exceed \$450,000; whose business turnover do not exceed \$1m, does not issue shares; who is not an overseas company; does not have any subsidiary companies; and is not a subsidiary of another company. Ministry of Economic Development (2002) reports that of the 195,000 registered companies 89 per cent have a turnover of less than \$500,000 which indicates that a large proportion of companies are small to medium and probably fall within the exempt company regime.

The emphasis here again is to reduce compliance costs. Jarvis and Collis (2002) report that the FRSSE is 50 disclosure requirements lighter than the full set of standards. However, the focus of reduced disclosure will not necessarily result in shorter accounts since many of the disclosures were rarely or never applicable to smaller companies.

Some argue that the FRSSE has not gone far enough and if the ASB wanted to help small companies:

...it would have recognised that they are not just scaled down versions of large ones. The accounts users, the purpose they use the accounts for and the relationships among stakeholders are typically quite unlike those in large companies, and there is much less public interest in their activities.... The reluctance of ASB to adopt different recognition and measurement rules is what stops it from making a much more radical reduction in the reporting burden on small companies” (Murphy and Page, 1998, p.87).

In February 2001 the ASB issued a Discussion Paper called “Review of the Financial Reporting Standard for Smaller Entities (FRSSE)

### **The Canadian experience**

In May 2000, the AcSB established the Small Business enterprises Advisory Committee (subsequently renamed the Differential Reporting Advisory Committee) as a standing committee to provide input to the standard-setting process from a non-public enterprise perspective and to consider further the need for differential reporting and the ways to make the principle operational. The advisory committee supported introducing differential reporting into Canadian GAAP and made a number of practical recommendations to the AcSB. The exposure draft approved in July 2001 by the AcSB attracted more than 120 letters. Although the proposal to allow differential measurement options generated some controversy, in general the comment letters strongly supported the introduction of differential reporting (Mersereau, 2002)

The Canadian approached differential reporting yet from another perspective. They used the public/ non-public distinction. The differential reporting principle acknowledges that the information needs of users of non-public companies’ financial statements differ from those of the users of public entities’ financial statements.

Public company financial statements are widely circulated and available to an unlimited number and wide variety of users who benefit from access to a broad range of detailed financial information. The fewer the users of an enterprise’s financial statements and the greater their ability to gain access to information in addition to that provided in the financial statements, the smaller the benefits to be derived from information contained in financial statements. Therefore, the AcSB accepts that the application of a benefit/ cost test may lead to the differential application of GAAP to non-public enterprises, in limited circumstances.

### *Application of the Differential Reporting Rules*

To qualify for differential reporting, profit-oriented enterprises must:

- Have no public accountability. The public accountability criterion, as defined in Section 1300, encompasses public share ownership, public debt and other forms of public interest.
- Not be public enterprises, cooperative business enterprises, regulated financial institutions (and regulated financial institution holding companies), rate-regulated enterprises and government business enterprises and government business-type organisations.
- Not be “not-for-profit entities” whose particular reporting needs are already dealt with in Handbook Sections 4400 to 4460.
- Have obtained consent in writing of all voting and nonvoting owners of the enterprise to the application of differential reporting. This is to protect the position of non-managing owners for whom financial statements may be the primary source of information. When all owners consider that differential reporting fulfils their needs, this signals that owners consider the costs of applying certain accounting requirements exceed the benefits to their enterprise and to themselves.

The Canadian position is also different in that there is no size cap. It is opined that, regardless of their size, all non-publicly accountable enterprises share a common feature that distinguishes them from publicly accountable entities in that they have a narrower range of users of their financial statements. Mersereau (2002) highlights that this lack of a size condition is consistent with current Canadian public policy decisions with respect to non-public companies. Most non-public companies, regardless of size, are not required to make their financial statements publicly available and shareholders, by unanimous consent, may waive an audit of the financial statements.

In the Canadian approach to differential reporting is designed to help private companies produce more useful and understandable information for the users of their financial statements, and is optional. Therefore, it presents an opportunity for a non-publicly accountable enterprise to re-examine the objective of its financial reporting and tailor it to the users’ needs. In practice, management of a non-publicly accountable enterprise will make a first assessment of whether:

- to adopt differential reporting and
- which options to apply, since selective application is permitted. In certain circumstances — for example if the enterprise is likely to go public in the future or report to a public investor — differential reporting may not be an appropriate decision. Management will benefit from consulting with its public accountant and banker(s).
- Creditors’ information needs were carefully considered by the AcSB in deciding which differential reporting options to include in standards. However, lenders’ acceptance of differential reporting may vary, depending on an enterprise’s characteristics, circumstances and the type and size of loan.

In the future, the AcSB will examine differential reporting issues as new accounting standards are developed, so that potential differential reporting options may be considered in a timely manner. In its next step, the AcSB will consider recommendations by the advisory committee regarding certain standards recently issued or still under development.

### **Developing countries' experiences**

As can be noted from Table 2 of this report, several developing countries have moved towards differential reporting. In the case of Malaysia, the Malaysian Accounting Standards Board (MASB) has issued Statement of Principle SOP 1, Exempt Enterprises, in 2000. The approach is similar to that taken in New Zealand where exempt enterprises are the equivalent of qualifying entities in New Zealand. The focus is on the existence of dependent users of financial statements.

### ***Cost Benefit Issues***

The development of differential reporting is premised on the basis that cost-benefit criteria specified in the conceptual framework is met when the benefits of financial accounting and reporting requirements outweigh the costs borne or imposed upon the enterprise in the preparation of financial reports. Although it may appear that benefits are not always evident or measurable, it is contended that generally the benefits will increase with:

- The number and diversity of users
- The satisfaction of their information needs; and
- The existence of qualitative characteristics of the information, such as reliability, relevance and timeliness.

In defining an exempt enterprise, SOP1 premises that the concept of a reporting enterprise is tied to the information needs of users and the nature of general purpose financial statements. The need to prepare general purpose financial statements is linked to the existence of dependent users who rely on those statements.

Three surrogates are identified as indicators of circumstances where dependent users exist for such enterprises:

- Public accountability
- Separation between owners and governing body of an enterprise
- Size

Whilst MASB too believes that the path to providing exemptions should not solely be based on size, in general, the larger the enterprise the more likely the existence of dependent users. This is based on the reasoning that in a more extensive group of users benefiting from the information the greater the benefits are likely to be derived.

Similar approach is suggested by the Hong Kong Society of Accountants in their Consultation Paper on a Proposed Framework for Differential Reporting issued in August 2002. South Africa has also followed a similar route in focusing on dependent users.

Sri Lanka on the other hand has focused on the listed/ non listed distinction with size measurements.

In the Sri Lankan case, Smaller Enterprises do not include:

- (1) Companies licensed under the Banking Act, No. 30 of 1988.
- (2) Companies authorised under the Control of Insurance Act, No. 25 of 1962, to carry on business.
- (3) Companies carrying on leasing business.
- (4) Factoring companies.
- (5) Companies registered under the Finance Companies Act, No. 78 of 1988.
- (6) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate unit trust.
- (7) Fund management companies
- (8) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to carry on business as stock brokers or stock dealers.
- (9) Companies licensed under the Securities and Exchange Commission Act, No. 36 of 1987, to operate a Stock Exchange.
- (10) Companies listed in a Stock Exchange licensed under the Securities and Exchange Commission Act No. 36 of 1987.

These companies should apply other Sri Lanka Accounting Standards when preparing financial statements. However, for enterprises which fall below the minimum levels specified, the requirement is that they follow the *Framework for Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants Sri Lanka. Appendix A provides a summary of reporting entities in Sri Lanka.

## 2.5 ISSUES AND CONCERNS

### 2.5.1. Size measurements

The discussion of the various approaches adopted by different countries indicates there is consensus that size should not be the ultimate criterion for a differential reporting framework although it is acknowledged that it may act as a surrogate to the existence of dependent users. As can be seen from Table 2, size benchmarks differ among countries and therefore should be left to the countries to adopt measures that reflect their economic and social environment. However, studies show that the preference for qualitative rather than quantitative measures (John and Healeas, 2000).

### 2.5.2. Two approaches: *Integral versus Distinct*

It is also noted that the approaches taken are different. On one hand some countries adopt an **integral approach** whereby the individual accounting standards address the issue of SMEs and provide exemptions in the standards (New Zealand, Canada, Malaysia, Hong Kong) and on the other hand, some adopt the **distinct approach (or some refer to it as “separate” approach)** as seen in the case of FRSSE in UK and SLASSE in Sri Lanka.

#### **Integral approach**

Under the integral approach, the exemptions given to smaller entities are prescribed in the mainstream accounting standard. For example, in the case of New

Zealand, when the differential reporting framework was introduced in 1994 and then revised in 1997, an appendix was included with the framework detailing exemptions that are given to smaller enterprises (in their case, referred to as qualifying entities) in the extant FRSs and SSAPs. Subsequent to that any new FRSs issued contained provisions with respect to qualifying entities.

There is merit in this approach because the standard setters are required to address the specific needs of the users of the qualifying entities for each specific issue. This compels the Board (the standard setting authority) to consider involvement of the SMEs as well in the process.

### **Distinct approach**

This appears to be an ad hoc approach undertaken at a specific point of time to introduce a separate standard comprising all the issues that are addressed in the IASs but which are relevant to SMEs. It is referred to as ad hoc simply because it considers the standards existing at a specific point of time.

This approach is used by UCTAD in the ISAR Guidelines for Level 2 SMEs whereby, 15 Guidelines are compiled into a document. Under this approach, each time there is an issue raised by the IASB, a separate working committee would have to review the IAS and decide what options need to be given to SMEs.

This approach may be ideal as a short-term measure but in the long run it would be advisable to consider the integral approach. The integral approach complements the efforts of IASB to achieve higher convergence of accounting practices. The involvement of experts from SMES in developing and developed countries would enhance the acceptance of IFRSs.

Some jurisdictions have discussed the merits of both approaches and have felt compelled to adopt the integral approach. The UNCTAD ISAR Guidelines has not dwelt on the choice of an appropriate approach to the individual nation states. The guidelines issued only provide the distinct approach.

Whilst it is acknowledged that the **distinct** approach may be less desirable than the integral, it is only because the **integral** approach appears to be the result of assessing all existing standards. Some view the distinct approach as a form of “cherry picking” and thus the approach is susceptible to being criticised as “arbitrary”.

However, it must be highlighted here that one needs to focus on the substance rather than form. It is important to realise that a package of standards such as the UNCTAD guidelines suffers by comparison to an integral approach because it is incomplete. An SME using, for example, Canada’s approach has a complete set of GAAP to use; and SME using the UNCTAD ISAR document will find gaps that require the SME to refer to the full size IASs (or perhaps they are not applicable).

Nevertheless, countries that have chosen to adopt the distinct approach (for example) have spent considerable time debating the issue and pragmatism suggests given the limited resources to support the distinct approach. Some have addressed the issue of “arbitrariness” by providing a guide. In Sri Lanka’s case, the SLASSE provides a derivative table which clearly explains how the smaller enterprises’ standards had been formulated to be in line with the main standards.

Again as rightly pointed out by a CAPA member body, the real issue is that “the IASB must take ownership of this matter and deal with it as part of its mandate. Until it does, there can be no resolution as to which method is superior.”

### ***2.5.3. Conceptual underpinning***

The conceptual underpinning for the adoption of differential reporting is not clear in most of the countries’ practice or suggested practice. Almost all focus on providing exemptions for disclosure items with no exception for recognition and measurement basis. There is contention that the change brought about by some jurisdiction’s differential reporting regime is cosmetic rather than fundamental (John and Healeas, 2000).

The point to be explored would be why should an owner-manager who might be the only significant shareholder need to produce a set of statutory accounts which is not useful to understand the business. It is argued that for the owner “key management accounting information would be more important.

Arsing from comments from CAPA member bodies, it is important to acknowledge that financial accounting and management accounting are clearly seen as two separate and distinct issues. The question that arises is: should financial reporting standards not generate management information if that is useful information for the predominant user? The question is: Is there a need for a paradigm change in financial reporting (Upton, 2001).

### ***2.5.4. Summary and discussion***

Thus far it is not clear from the initiatives undertaken in various countries that there is a congruence of the conceptual / theoretical framework and the implementation of the concepts.

It really begets the question as to what is the purpose of accounting and reporting for the small and medium sized enterprises. This issue has not been thoroughly explored in the practices that have been implemented thus far.