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Issues in the adoption of international financial reporting standards (IFRS) for small and medium-sized enterprises (SMES)

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ABSTRACT

Small and Medium-Sized Enterprises (SMEs) in various jurisdictions are currently attracting enormous attention and have also stepped into the global accounting reporting arena as a result of the introduction of International Financial Reporting Standards (IFRS) for SMEs. This study critically reviews the IFRS for SMEs including the development and implementation process of the standards. Furthermore, it applies the framework of decision usefulness theory and the pecking order theory to evaluate issues pertaining to the development and implementation of IFRS for SMEs. This study provides evidence that IFRS for SMEs have been a challenge for non-publicly accountable entities to adopt and there are several conceptual and practical issues with IFRS for SMEs. The analyses and insights provided by this study will have implications for revising the IFRS for SMEs and will assist in addressing future complications in the SME convergence process.

1. Introduction

Small and Medium-Sized Enterprises (SMEs) in various jurisdictions are currently attracting enormous attention and have also stepped into the global accounting reporting arena as a result of the introduction of International Financial Reporting Standards (IFRS) for SMEs. Whilst many countries have adopted full IFRS for publicly accountable entities, they were reluctant to adopt this set of complex, onerous and costly standards for non-publicly accountable entities, particularly SMEs (Dang-Duc, 2011; Fearnley & Hines, 2007; Tyrrall, Woodward, & Rakhimbekova, 2007). The IFRS for SMEs was therefore an outcome of a rigorous process pioneered by the International Accounting Standards Board (IASB) to introduce a simplified version of the full IFRS with significantly reduced recognition and measurement principles and disclosure requirements. IFRS for SMEs have been issued in anticipation that they will be applied by entities that do not have public accountability but who prepare general purpose financial statements for external users (IASB, 2009a).

It is important to note that the majority of entities around the world are represented by 'SMEs' (Alp & Ustundag, 2009). Moreover, the SME sector is regarded as the backbone of many economies in both developed and developing countries. This sector makes an enormous contribution to employment creation, technological innovation and economic output (see Chen, 2006; OECD, 2005; Reddy, 2007). Prior to the introduction of IFRS for SMEs in 2009, individual jurisdictions adopted either local generally accepted accounting principles (GAAP) or full IFRS for the financial reporting purposes of non-publicly accountable entities and SMEs around the world (Alp & Ustundag, 2009; Tyrrall et al., 2007). The IASB believes that the adoption of IFRS for SMEs will possibly enhance SMEs' access to international finance through harmonized and high quality financial information (IASB, 2009a). It is likely that a global financial reporting language will elevate the international comparability and global recognition of SMEs across the globe. Therefore, this changeover is expected to be a major breakthrough for SMEs if the perceived benefits are appropriately recognized by countries and they adopt IFRS for SMEs.

This movement towards the convergence of IFRS for SMEs still seems to be controversial for a number of reasons. Interestingly, the degree to which IFRS for SMEs have been accepted or rejected by countries creates several arguments. Deloitte Touche Tohmatsu reports that "many countries are moving towards adoption of the IFRS for SMEs, although it appears those countries may not have required IFRS accounting 'across the board' prior to moving to implementation" (AASB, 2010a, 1). In contrast, more prominent developed countries that have adopted the full set of IFRS, such as Australia, the United Kingdom, and European Union member states, have not yet adopted IFRS for SMEs.

Many countries including Australia are of the view that IFRS for SMEs still appear to be complex in recognition and measurement principles (AASB, 2010a). Moreover, the European Commission (EC) is of the view that the objectives of simplification and reduction of administrative burden for SMEs has not yet been served by the IFRS for SMEs (European Commission (EC) Explanatory Memorandum, 2011). Such

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concerns raised by prominent countries or regions highlight several issues for IFRS for SMEs and their implementation. The entities (non-publicly accountable entities) that are envisaged as being eligible to apply the IFRS for SMEs represent more than 95% of all companies globally (RSM International Association, 2009). The need to develop an appropriate regulatory framework and to enable comparable accounting information to be provided by SMEs is considered to be highly important. Therefore, it is vital to examine the conceptual and technical difficulties encountered by those countries that have rushed to adopt IFRS for SMEs. This paper attempts to provide extensive insights on the development and implementation process of IFRS for SMEs around the world. Such analyses and insights will assist in revising the IFRS for SMEs and will minimize future complications in the SME convergence process.

Prior studies on the financial reporting transformation process with the convergence of international standards have revealed several functional complications and persistent issues with the full set of IFRS. Lack of expertise in the accounting and auditing professions, and inadequate resources and infrastructure facilities for the implementation of complex, principles-based international standards in developing and transitional economies have been widely articulated (Alp & Ustundag, 2009; UNCTAD, 2007a). In particular, the potential knowledge shortfall and strangeness of IFRS and their adverse impact on the professional judgments of accountants in applying the standards are evident (Alp & Ustundag, 2009; Chand, Patel, & Patel, 2010; Wong, 2004). Both Alp and Ustundag (2009) and Chand et al. (2010) pointed out the need for an international mechanism to enable the effective enforcement of IFRS in individual jurisdictions. Inconsistencies in the regulatory frameworks and deficiencies in the legal support for implementing international standards at national level have posed significant challenges for implementing the full IFRS (Alp & Ustundag, 2009). Moreover, Chand et al. (2010) found that country-specific characteristics, such as existing accounting standards at national level prior to the implementation of international standards, and accounting regulatory frameworks themselves, influence the adoption of IFRS across countries.

Generally, prior studies reveal that the implementation of IFRS by individual countries seems to be challenging, in spite of whether the standard is complex or is a simplified version. Therefore, more research on the financial reporting transformation experience of and by non-publicly accountable entities and SMEs is timely and essential (Evans et al., 2005). More specifically, the possible transition issues that may arise when moving from local GAAP/full IFRS to the IFRS for SMEs, such as arguments against "differential reporting", cost–benefit considerations in adopting IFRS for SMEs, and technical issues inherent in the recognition and measurement principles of the standard, have been regarded as challenging issues which have not been addressed in depth so far in the literature (AASB, 2010a; Evans et al., 2005).

Importantly, the IASB's objective of introducing IFRS for SMEs is centred on a new paradigm of "enhancing decision usefulness" and "reducing information asymmetry" of financial information provided by the SMEs across the globe. In accordance with this new paradigm, this study applies the framework of decision usefulness theory and the pecking order theory to evaluate issues pertaining to the development and implementation of new IFRS for SMEs. This paper provides evidence that IFRS for SMEs have been a challenge for non-publicly accountable entities to adopt. This study identifies several issues with IFRS for SMEs and their implementation in a variety of countries. The analyses also provide important insights for prospective countries that are planning to adopt IFRS for SMEs in the future.

2. Accounting regulatory framework for SMEs

It is widely accepted that explicit accounting information leads to the successful management of a business, irrespective of its size—large or small (EC, 2012). Generally, SMEs are exempt from statutory audit requirements and/or are subject to simplified accounting standards (IFC, 2011).[2] With the full set of IFRS applied for publicly accountable entities, several arguments were raised by small entities about the complexity of applying full IFRS. Therefore, the need for a simplified set of accounting standards suitable for SMEs was extensively appealed by many jurisdictions. Consequently, the IASB issued the IFRS for SMEs in July 2009 with the intention that they would be applied by SMEs around the globe.

It is recognized that IFRS enhance the comparability of financial information of different entities across the globe (IASB, 2009b). Unlike publicly accountable entities whose securities are traded in public capital markets, SMEs usually do not have the accountability to present high quality comparable financial information for users. However, the IASB is of the view that SMEs would benefit by being able to access competitive loans from multinational financial lenders, if the financial statements between the countries were comparable. The primary objective of introducing this standard is to provide financial reporting relaxation and reduce the administrative burden of entities that do not have public accountability but prepare general purpose financial statements (GPFSs) for external users. The IASB believes that the simple version would reflect the needs of users of SMEs' financial statements and the cost–benefit considerations of SMEs (IASB, 2009b).

The IASB's objective of introducing a new accounting regulatory framework for SMEs embraces the concept of 'user oriented financial information'. The attention on decision usefulness in IFRS for SMEs is a paradigm shift from the traditional focus of financial reporting of SMEs. The decision usefulness theory assumes that "the basic objective of accounting is to aid the decision-making process of the relevant 'users' of accounting reports by providing useful or relevant accounting data" (Godfrey, Hodgson, Tarca, Hamilton, & Holmes, 2010, 24). This theory provides a logical framework from which to derive accounting principles and practices. In the history of financial reporting standard setting process, decision usefulness theory has been an important yardstick in choosing appropriate accounting treatments that fit the information needs of users (Son, Marriott, & Marriott, 2006).

Extant literature points out that little is known about the real users and their information needs of SME financial statements (see Dang-Duc, 2011; Evans et al., 2005; Sian & Roberts, 2008; Son et al., 2006 for review). Even in the limited available literature, there is an inconsistency in the findings on users and their information needs of SME financial statements and those questions remain unanswered (Son et al., 2006). Users and their information needs are varied between publicly accountable entities and non-publicly accountable entities. The development process of simplifying the accounting principles and practices based on the same conceptual framework and the extent to which those simplifications are derived from the information needs of the users of SMEs financial information is however unclear.

Another revolutionary idea of introducing IFRS for SMEs is to enhance SMEs access to international capital through high quality, harmonized financial statements. As suggested by the pecking order theory, entities prioritize their sources of financing in a hierarchical order of preference from internal sources of financing, debt financing to equity financing (Myers, 1984). According to this theory, the information asymmetry affects the choice between internal and external sources of financing (Myers, 1984). As far as the effective use of financial information in accessing external sources of funds is concerned, the IASB's objective of reducing information asymmetry of SMEs by preparing high quality financial statements using IFRS for SMEs needs to be evaluated using the pecking order theory.

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