SMALL BUSINESS CONVERGENCE WITH INTERNATIONAL ACCOUNTING STANDARDS

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ABSTRACT

The purpose of this paper is to explore the intersection between financial reporting research and small business management by examining issues surrounding the differential reporting debate. In particular the impact on small business of a policy to adopt international financial reporting standards is examined. Data gathered from a survey of the preparers of small business financial reports is used and the analysis indicates that the concept of user dependency is favoured as a valid discriminator for differential reporting purposes.

INTRODUCTION

Concern about the need for the convergence of financial reporting philosophies across national borders has been evident in the literature from the early 1960s [5; 10). More recently [9], convergence has been seen as a means to reduce the cost of capital in a global economy, and as resulting from the globalisation of financial markets and the need to meet securities regulators concerns to reduce the information costs of transporting capital around the world [11]. Research exists to suggest that financial markets are capable of reconciling financial reports prepared using national generally accepted accounting principles (GAAP) to reflect numbers that would be determined under another jurisdiction's GAAP or under international accounting standards (IAS) [4], so clearly capital market efficiency provides the theoretical justification for convergence. The rationale is that through standardisation of accounting standards companies would avoid the cost of compliance with GAAP of different jurisdictions (*preparer* perspective), and security analysts would not need to acquire costly specialised expertise (*user* perspective). This paper focuses on the preferred model of financial reporting for small business entities, and identification of the users of small business financial reports. If financial reports prepared in compliance with IAS fail to meet the needs of small business report users a strong case for differentiating rather than standardising the financial reporting of small business entities, exists. Practitioner opinions that provide a direction to the vexing issues surrounding differential reporting are important so that submissions to the government and the international regulators, from the accounting profession, are provided on an informed basis. Differential reporting (DR) is a notion that some organisations should be permitted to depart from either all, or some, of the requirements of accounting standards when preparing their own financial reports [3]. DR has been described [8] as a notion that certain reporting entities may be exempted from the application of specific accounting standards because of their size, legal structure, ownership, sector (public/private/industry), or the presence of a dependent user. The implication arising from these views is that distinct accounting and reporting rules should govern conceptually different organisations. It has also been asserted [6] that DR is a response to the problem of accounting standards overload. This argument has been advanced in favour of exempting small entities from the application of certain requirements on the basis that the costs of preparing reports, which comply with all financial reporting regulation, exceed the benefits that flow from compliance. DR does not necessarily mean fewer requirements for financial report preparers or less information for users, rather, it should help preparers produce more useful and understandable information. While much of the discussion on the verbatim adoption of IAS has focused on large organisations, there is also room for a fuller consideration of the impact of this policy change on small business. Small businesses have fewer resources available to deal with financial reporting compliance thus concerns regarding the financial reporting burden on small business are justified given the disproportionately higher compliance costs that this sector faces. The DR debate was an issue of considerable importance in the 1980s. In Australia, the regulators formed the view that the focus of financial reporting should be to provide general-purpose information that is common to the needs of the broad range of users who are unable to command the preparation of reports tailored to their own particular needs. The regulators labelled these organisations *reporting entities*. Under this conceptual approach no exceptions were deemed appropriate on the basis of defining characteristics such as size, ownership, structure, sector, users or nature of operations although it has been acknowledged that size may act as a surrogate for the existence of dependent users [2; 7]. Australia has to some extent embraced the concept of differential reporting through the Corporations Act 2001 (the *Act*) and the conceptual framework for financial reporting (CF). The Act contains a *Small/Large* test that directs whether or not a company must comply with the accounting and financial reporting requirements of the Act. Also, the CF focuses on reporting entities which are required to provide general-purpose financial reports. If a company is not regarded as a reporting entity it need not comply with Australian accounting standards. Under the Act, whether the accounting and financial reporting requirements of the Act are imposed on an unquoted company, depends on whether it is classified as small or large. An unquoted company is classified as small if it satisfies at least two of the following tests: (1) gross operating revenue of less than $10 million for the year; (2) gross assets of less than $5 million at the end of the year; (3) fewer than 50 employees at the end of the year. An unquoted company that does not satisfy at least two of these tests is classified as large. The majority of unquoted companies in Australia are small under these tests.

RESEARCH METHOD AND DATA

An internet survey of practitioners engaged in small business financial reporting was conducted to determine their attitudes to the convergence with IAS. Participation was invited from members of a professional organisation, CPA Australia, who were involved in small business financial reporting matters. The invitation to participate was extended through a weekly electronic newsletter. The use of CPA Australia's database of members is restricted in order to protect members' privacy and confidentiality and as a consequence the survey could only be administered once. This restriction resulted in 52 practitioners providing usable responses. Details of the size of the population and demographic representativeness of the population were not made available to the researchers. An aim of this research was to explore practitioners' perceptions of the appropriateness of the DR models as specified in the CF and the Act. The existence of users dependent on general-purpose financial reports was deemed by more than 71% of respondents to be an appropriate criterion for classifying businesses as small or large. This is not a surprising outcome given that Australian accounting practitioners have, since 1991, operated within a CF that determines the need for financial reporting solely on the basis of the existence of reliant users. However, there appears to be a significant lack of support amongst respondents for the criteria specified in the Act. Importantly, the *Small versus Larg*e test contained in the Act is not conceptually based, it is arbitrary. There may be other measures that determine the difference between small and large entities more effectively.

Table 1: Applicability of differential models to small business

Differential point	Small	Large
	%	%
User dependency	73.1	71.2
Gross revenue < $10m	42.3	0.0
Gross assets < $5m	38.5	32.7
Fewer than 50 employees	30.8	25.0

The respondents were asked to rank groups they considered to be the main users of small business financial reports. Two major groups were identified as extensive users: (1) Finance companies and Trading banks; and (2) Owners/non-manager shareholders/Managers. This result supports a view that the primary users of small business financial reports are owners as managers, and banks that provide the main source of funding to small business. Those users considered to have little use for the financial reports of small business include: Competitors; Industry/Trade associations; Employees/Unions; and the public. This outcome gives cause to reconsider the real, as opposed to the theorised, relevance of small business financial reports to the user groups identified under the CF. Respondents also provided feedback on their perception of the purpose of small business financial reports. The highest ranked use of small business financial reports reflects the need for compliance (taxation). Respondents also provided a strong view that small business financial reports were used for management purposes. Stewardship and Investment purposes ranked lowest. An implication of this outcome is that small business financial reports are regarded as of limited relevance to capital market participants other than to those bank(er)s directly involved in venture capital loans to small business. The low ranking for Stewardship may be reflecting the low intensity (or absence) of the agency problem that, theory holds, is created when ownership is separated from management.

CONCLUSIONS

The overarching intention in this research was to identify practitioners' preferred model of financial reporting for small business. In the process an investigation of the appropriateness of the differential reporting models of the CF and the Act was also conducted. The existence of users who are dependent on general-purpose financial reports as an appropriate discriminator for small/large entities for the purposes of financial reporting, appears to have practitioner support. However, a lack of support for the criteria specified in the Act as relevant discriminators. It would appear that the Revenue/Assets/Employee test may need to be revised with a view to replacement with discriminators that are selected conceptually rather than arbitrarily. The data used did pose some limitations on the form of analysis that could be undertaken and the relationships that could be explored. In particular the survey instrument could only be delivered once to the population of interest. Therefore a relatively small sample size was obtained. Further the data is a single snapshot providing a preparer, rather than a user, perspective. However, the data provides some important indicators that the theoretical underpinnings of the CF may have relevance for small business financial reporting; but, that the financial reports of small business are not relevant to the full range of users identified in the CF.