



THE UNIVERSITY OF
WAIKATO
Te Whare Wānanga o Waikato

Department of Accounting

Working Paper Series

**IFRS for SMEs: A New Zealand
perspective**

By

R. Helen Samujh

Number 96

July 2007

MANAGEMENT SCHOOL
Te Raupapa

The *Working Paper Series* is published by the Department of Accounting, University of Waikato, and is intended to provide staff, visitors and postgraduate students with a forum for publishing developing research. The opinions expressed in the various papers in the Series are those of the author(s) and are not necessarily endorsed by the Department. Working Papers are preliminary in nature; their purpose is to stimulate discussion and comment, and the author(s) would welcome any feedback from readers.

Correspondence concerning the submission of manuscripts and the receipt of copy may be addressed to:

The Editor - Working Paper Series
Department of Accounting
University of Waikato
Private Bag 3105
Hamilton, New Zealand
Fax: 0064 (0)7 838 4332

Correspondence concerning the reproduction of, or comment on, any part of a Paper should be addressed to the author(s) concerned.

ISSN 1177-7230 (Online)

ISSN 1173-7182 (Print)

IFRS for SMEs: A New Zealand perspective

R. Helen Samujh
Senior Lecturer
University of Waikato, New Zealand
hsamujh@waikato.ac.nz

Abstract

The International Accounting Standards Board (IASB) in its concern to reduce the burden of compliance with the International Financial Reporting Standards (IFRS) has released its draft *IFRS for Small and Medium-sized Enterprises* (IFSME). The draft proposes reporting standards for non-publicly accountable entities that produce general purpose financial reports. This paper presents the background to the introduction of IFSME, introduces the IASB proposal, outlines the New Zealand (NZ) financial reporting concessions (viz. the exempt company system and the differential reporting framework), and examines the implications of adoption for NZ.

It is considered that few entities would be affected by the IFSME, the production and maintenance of a 'small book' would be costly, and report preparers need to be cognisant of both the IFRS and the IFSME. The users of financial information, identified by the IASB, rely on other forms of information in NZ to make investment and monitoring decisions. The IFSME appears redundant in the light of the existing frameworks for concessions. Further, it appears that second-class accountants and entities could emerge if the IFSME were adopted. The author concludes that the IFSME is not appropriate for NZ application and should be rejected.

Glossary of Abbreviations

DIFF	The Framework for Differential Reporting
ECS	Exempt Company System
FRSSE	Financial Reporting Standard for Smaller Entities
GAAP	Generally accepted accounting practice
GPFR	General purpose financial reports
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFSME	IFRS for SMEs
NZICA	NZ Institute of Chartered Accountants
SMEs	Small and Medium-sized Enterprises

1. INTRODUCTION

The introduction of International Financial Reporting Standards (IFRS) has led to a renewed interest and debate about the use of a differential reporting approach that reduces costs of compliance for firms where the benefits of complying with the accounting standards do not appear to justify the costs associated with compliance.

Reporting requirements are often relaxed to provide exemptions for smaller entities: for example, New Zealand (NZ) provides relief via the Exempt Company Scheme and the Framework for Differential Reporting, the United Kingdom (UK) has the *Financial Reporting Standard for Smaller Entities* (FRSSE), the USA has an alternative “Other Comprehensive Basis of Accounting” (Williams, 2005), and Europe has a high level of country specific differentiation for all firms other than for listed companies that produce consolidated financial statements (Jermakowicz & Gornik-Tomaszewski, 2006).

One of the concerns of the International Accounting Standards Board (IASB) is to minimise the impact on financial reports of member countries using different exemptions. To this end they initiated a project to develop IFRS for Small and Medium-sized Enterprises (SMEs) aimed at:

- providing high quality, understandable and enforceable accounting standards suitable for SMEs globally
- reducing compliance costs on SMEs who want to adopt global standards, and
- meeting user needs (Benson, 2007)

NZ needs to consider if the proposed *IFRS for SMEs* (IFSME) should be adopted, adapted or rejected. It is for individual jurisdictions to decide whether to adopt the proposed IFSME and which entities without public accountability should be required to comply with the proposed IFSME (IASB, 2005a).

This paper presents the background to the introduction of IFSME, introduces the IASB proposal, outlines the NZ financial reporting regime, discusses NZ concerns and implications of adoption for NZ and finally concludes that the IFSME is not appropriate for NZ application and should be rejected.

2. BACKGROUND

In December 2000 the IASB identified a demand for a “special version of International Accounting Standards for small enterprises” (IASB, 2007a, para. BC1). The IASB supported their proposal for an IFSME with claims that since more than 50 jurisdictions require full IFRS and 40 jurisdictions have exemptions or simplifications then the IFSME would “surely also be suitable” (IASB, 2005a, p. 6). Further, responses to their June 2004 Discussion Paper (IASB, 2004), “showed a clear demand for IASB SME standards and a preference, in many countries, to adopt global SME standards rather than locally or regionally developed standards.” (IASB, 2005b, para. 7a).

The IFSME is seen as a way to raise the standard of financial reporting in emerging economies (IASB, 2005a), and so provide a path towards compliance with IFRS:

To provide emerging economies with an internationally recognised basis for financial reporting, *helping to raise the quality of financial reporting in many countries* (emphasis added) while offering entities a clear path to upgrade to compliance with full IFRSs (IASB, 2005a, p. 4).

Further, the IASB appears to have moved to take the lead in developing standards in the face of the possibility of directives within the European Union designed to improve standards and comparability within their members (Flower, 2004). Therefore, ideally, education and training could be facilitated at a global level; investors across borders could ‘read’ the accounts without having to know the country’s particular approach to financial reporting and could rely on the credibility of globally developed concepts and standards.

The approach adopted by the IASB follows the UK example of producing a separate ‘book’ of accounting standards for smaller entities. The UK approach was to produce a “one-stop” edition of Financial Reporting Standards for Smaller Entities (FRSSE), first issued in November 1997, as a measure to reduce burdens on businesses. The FRSSE, developed specifically for smaller entities, presented a simplified set of requirements drawn from other accounting standards. Smaller entities being companies that satisfied a two-out-of-three test consisting of: annual turnover less than £5.6 million; gross assets less than £2.8 million; and fewer than 50 employees (AccountingWEB, 2005).

Under the FRSSE, basic measurement requirements were slightly modified but disclosure and presentation requirements were considerably reduced. However, the adoption of the

FRSSE was not as great as expected as the “disclosure exemptions in the FRSSE were of no benefit for the SMEs concerned because the items did not appear in their accounts in the first place” (Flower, 2004). Drawing on this experience the IASB appears to have spent considerable effort in eliminating items of no concern to the SMEs and also advocating different recognition and measurement rules. To create the IFSME, the IASB extracted relevant portions from the full IFRS with reference to a “typical entity” with around 50 employees (IASB, 2005a, p. 6; , 2007a).

3. THE IASB PROPOSAL

To make the standards less burdensome and easy to use, the IASB took steps to:

- eliminate topics not generally relevant to SMEs,
- remove choices for accounting treatment,
- simplify methods for recognition and measurement,
- reduce disclosure requirements, and
- use plain English.

The resultant IFSME is promoted as a simplified, self-contained and straightforward set of standards based on the full IFRS (IASB, 2005a). The Draft (IASB, 2007c), released for comment is approximately 1/8 the size of the full IFRS and is supplied with an Implementation Guide, which contains a checklist and examples (IASB, 2007b). Although the “persuasive principles” contained in the IFSME are derived from the conceptual framework underlying the full IFRS, the resulting IFSME is claimed to be simpler to follow and use.

SMEs are defined as those “entities that: do not have public accountability; and publish general purpose financial statements for external users” (IASB, 2007c, p249). The IASB rejects including a size test to determine a SME, preferring to propose only qualitative factors such as “public accountability”. Yet based on the ‘typical entity’ of about 50 employees, it identified the principal users replying on general purpose financial reports (GPFR) as resource providers (such as bankers, venture capitalists and development institutions), those having relationships with the SMEs (such as suppliers, customers and employees), and other external parties (such as credit rating agencies and consultants).

A “vexed question” for NZ seems to arise about the production of GPFRs. Whether there is a need for two sets of standards partly rests upon identifying:

Which, and how many, entities are expected to be deemed publicly accountable (requiring application of the full IFRS), and

Which, and how many, entities are expected to be not publicly accountable but produce GPFR (requiring application of the IFSMEs)?

The IASB has left it up to the individual jurisdictions to decide on a size criterion for SME. Various definitions for SMEs, small business and micro-business are employed throughout the world. Increasingly, ‘number of employees’ has been used as a surrogate measure of the size of businesses. In the literature, a ‘small business’ has been found to range between zero and 500 employees (Rutherford, McMullen, & Oswald, 2001; Terleckyj, 1999). However, there appears to be a move closer by some countries in terms of numbers of employees. Europe and the UK set the upper limit for SMEs at 249 employees and Australia at 199 (*see Table 1 below*). NZ has chosen not to distinguish between micro, small and medium sized businesses. NZ is somewhat out of line with Australia, Europe and the UK by grouping micro, small and medium sized businesses in one category of fewer than 20 employees.

Table 1: Size of business - numbers of employees

	Micro	Small	Medium	Large
Europe and the United Kingdom	<10	<50	<250	250+
Australia	<5	<20	<200	200+
New Zealand	Small and Medium Enterprises <20			20+

Source: Adapted from Ministry of Economic Development (2005)

The 2006 amendment ("Companies Amendment Act", 2006) to the NZ Financial Reporting Act ("Financial Reporting Act", 1993) lifted the concept of large. It defines a ‘large’ company as one that satisfies a two-out-of-three test consisting of: exceeds \$NZ20 million in annual turnover; exceeds \$NZ10 million in company assets (including intangibles and subsidiaries assets); and has 50 or more employees – a small company by European standards!

The IASB provides opportunities for consultation and comment on their proposed IFSME. However, their invitation to comment appears to be couched in terms of providing comment only on what is included or excluded in the draft IFSME. There appears to be a subtle suggestion that adoption (with or without adaptations) is a foregone conclusion. The IASB consulted preparers through the professional accounting bodies. It also had been concerned that users be represented in its deliberations. However, consultation has not been widely undertaken with those who are expected to bear the costs of compliance (the entities).

The invitation to adopt the IFSME has been treated by some as an opportunity to maintain a voice at the IASB: “It would extend and strengthen the standard setting ‘partnership’ with the IASB that New Zealand currently enjoys as national standard setter with liaison status” (Price-Waterhouse Coopers, 2004, p. 2). This statement recognises the political nature of developing accounting standards.

For NZ, balancing principles, politics and pragmatism could be difficult, particularly in processes of trying to converge with global standards. Sometimes the greater good may be achieved at cost to some jurisdictions. However,

Robust financial reporting standards are built from a sound conceptual framework, informed by economic and empirical analysis and assessed against a rigorous cost benefit framework. Allowing narrow sector interests to corrupt this process undermines the credibility of the standard setting system. And the risks that this will happen are real (ICANZ, 2005).

Standard setting is known to be a political process, subject to lobbying by various interested parties. For example, US government bodies interfered with pension obligations, share based payments recognition and European governments interfered with hedge accounting for financial instruments (ICANZ, 2005). Producing palatable standards may be the shortest route to gaining global acceptance, as the IASB is not a regulatory body and has to rely on goodwill and persuasion to gain acceptance of its standards. The IASB proposals may be subjected to ‘interference’ by the various jurisdictions as they seek to meet the needs and preference of their individual constituents and legal frameworks.

4. REPORTING CONCESSIONS IN NEW ZEALAND

This section outlines the current reporting regulation in New Zealand and considers the likely numbers of entities that could be affected by adoption of the IFSME. The exempt company system and the differential reporting framework currently soften the impact of IFRS in NZ.

4.1 The Exempt Company System (ECS)

A single set of standards applicable to all entities is deemed desirable (Ministry of Economic Development, 2004). However, the “full requirements for financial reporting are not justified for small and medium enterprises” (“Financial Reporting Act”, 1993, para. 68 (1)). Accordingly, under the ECS two categories of companies are identified as either reporting entities or exempt companies.

An exempt company must be “small” but neither a subsidiary nor have subsidiaries of its own. The size criteria for small (revised in November 2006) consist of a two-out-of-three test: total assets of less than \$1 million; turnover that does not exceed \$2 million; and 5 or fewer employees. Exempt companies must complete a very basic financial report, set out in the *Financial Reporting Order* (“The Financial Reporting Order”, 1994) which limits reporting requirements to core information and permits the use of income tax measurement rules e.g. depreciation. In effect, exempt companies do not have to comply with any formal reporting requirements, apart from what is necessary to comply with relevant regulations such as those of the Inland Revenue Department.

The assumption is that all companies are reporting entities and should comply with the IFRS unless they are ‘exempt’. The Financial Reporting Act 1993 s. 2(1) defines a ‘reporting entity’ as:

- (a) An issuer; or
- (b) A company, other than an exempt company; or
- (c) A person that is required by any Act, other than this Act, to comply with this Act as if it were a reporting entity.

There is a deliberate intention of the Government to reduce the burdens of financial reporting. For example, whilst all reporting companies are required to prepare full annual accounts, shareholders are able to elect not to receive a hard copy of the report (“Electronic Transactions Act”, 2002). Companies are allowed to provide shareholders with an active

hyperlink to the report as an alternative medium. Further, s. 209 of the Companies Act 1993 allows shareholders to elect to receive summarised annual reports ("Companies Amendment Act", 2006).

It is strongly believed that the “primary reason for financial reporting is to ensure shareholders of a company are able to hold management accountable for the financial position and performance of that company” (Ministry of Economic Development, 2004, para 238). Other stakeholders are not totally disregarded, as the Ministry of Economic Development (2004) advocates extending the concept of public accountability to large companies that have significant economic impact.

Under s.11 *Companies Act 1993* reporting entities must produce accounts in accordance with generally accepted accounting practices (GAAP), and provide a true and fair view. However the IFRS may not need to be complied with in full since GAAP allows reporting concessions under the *Framework for Differential Reporting*.

4.2 The Framework for Differential Reporting

The *Framework for Differential Reporting* (DIFF), issued initially in February 1994, is nine pages in length and applies only to GPFR (NZICA, 2007). DIFF provides reporting concessions to entities if they do not have public accountability and either, at balance date, all of their owners are members of the entity’s governing body or they are not large (as defined by the Financial Reporting Act 1993). Significantly, the discussion on GPFR contained in the earlier editions of DIFF has been removed from the 2007 edition. The meaning of GPFR included in the 2006 DIFF reads:

General purpose financial reports are financial reports which are intended to provide information to meet the needs of those external users who are unable to require, or to contract for, the preparation of special reports to meet their specific needs (NZICA, 2006, para. 2.1).

Examples are provided of what is not a GPFR (NZICA, 2006):

Where users (for example, the Inland Revenue) have the power to specify the information to be included in financial reports, these financial reports are considered to be special purpose (para. 4.3).

Where financial reports are prepared solely to meet the requirements of a contract or agreement, these financial reports are considered to be special purpose financial reports. Users likely to demand special purpose financial reports include:

- (a) major lenders such as banks and financial institutions:
- (b) government agencies such as the Inland Revenue or the Department of Statistics;
- (c) credit-rating agencies (para. 4.4).

Contrary to the IASB perceptions, the NZ Institute of Chartered Accountants (NZICA) considers the users under categories (a) and (c) can demand special purpose reports and do not require GPFR. The IASB includes non-executive owners, creditors and credit rating agencies as users of SME GPFRs (IASB, 2007c).

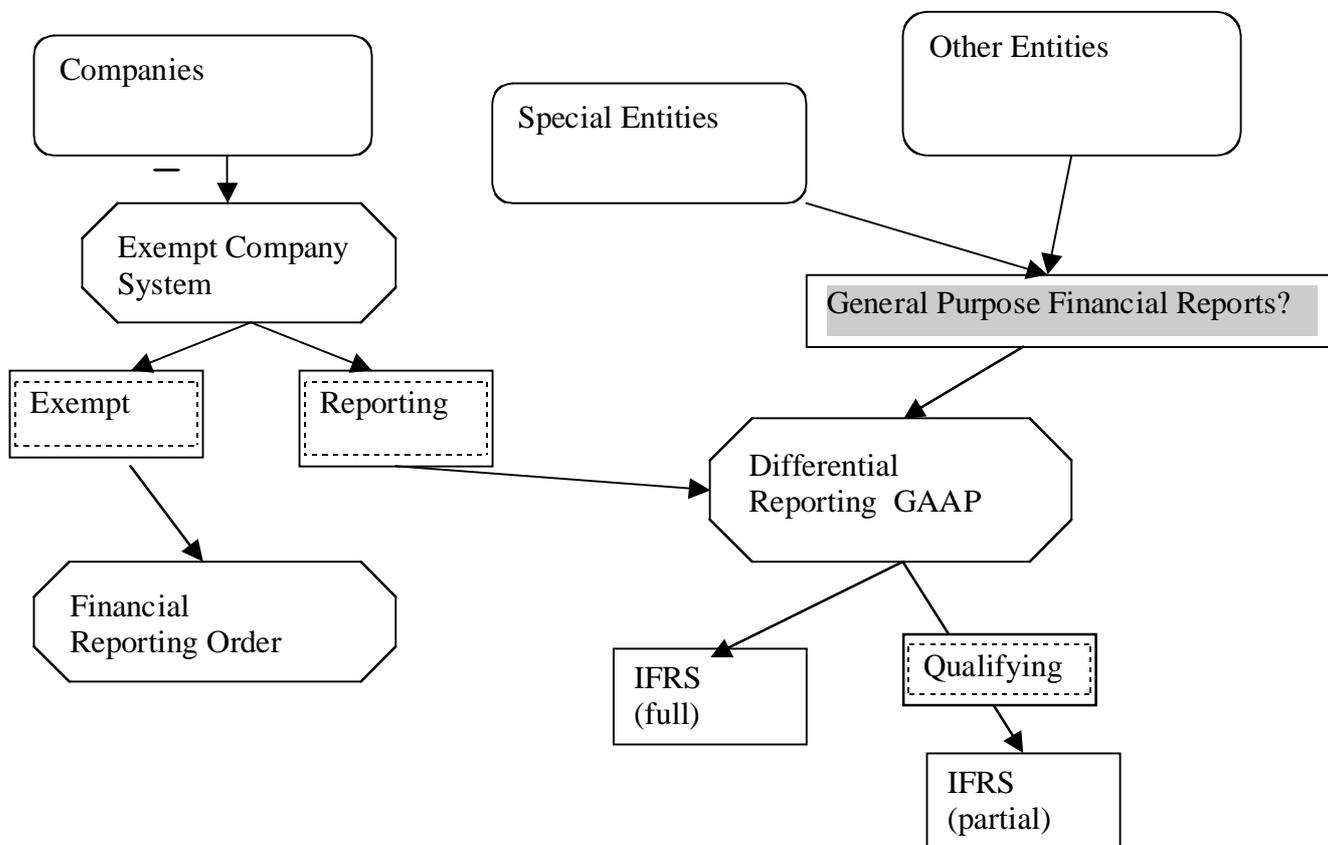
The NZ experience (more than 10 years) of working with one set of IFRS, with significant exemptions through DIFF, appears to have been simple and successful.

The existing Framework for Differential Reporting has provided a sensible way to reduce compliance costs for a large number of entities and there is no evidence that this framework has adversely affected users (Warren, Sealy-Fisher, & Scott, 2004, p 47).

Several countries have also adopted this approach (e.g. Malaysia, Australia, and Canada) to relieve compliance burdens. Within the NZ standards concessions are conveniently identified by using an asterisk (*). The IASB proposal uses a very different approach. The NZ submission to the IASB on the SME project in 2004, made by the Financial Reporting Standard Board expressed "disagreement with the approach proposed" (Warren, Sealy-Fisher, & Scott, 2004, p.47). However, the IASB has continued to pursue the development of a separate set of standards for SMEs.

Until there is some resolution about the adoption of IFSMEs DIFF continues to guide reporting requirements in NZ. The *Framework for differential reporting for entities applying the New Zealand equivalents to International Reporting Standards regime* was issued as an interim approach to be reviewed after the IASB has completed its project on reporting requirements for SMEs (NZICA, 2005). The interlocking nature of the ECS and the DIFF, for gaining reporting concessions, is illustrated in the following diagram:

New Zealand Entities



4.3 New Zealand practice

It is difficult to ascertain how many SMEs exist in NZ and how many might produce GPFR. The NZ Statistics Department records approximately 408,000 business entities (excluding those below the \$30,000 turnover GST registration threshold). Based on analysis of the employment levels (*see Appendix 1, Table A1*), approximately 92% entities have 10 or fewer employees, and 99% have fewer than 50 employees. Only 1,475 entities have more than 100 employees.

It is doubtful that many of the 99% of entities would produce GPFR; many would be family owned businesses, in the form of family trusts, trading trusts, partnerships, and one-person shareholder/director companies. The company structure is the predominant business form in NZ. There are approximately 400,000 companies registered with the Companies office. However not all of these companies are active (*See Appendix 1, Table A2*).

Deregulation, privatisation, restructuring, downsizing, and re-engineering, have provided an increased degree of flexibility at the individual level whereby the individual may choose between finding a new job, being unemployed or becoming self-employed. Advances in telecommunications and technology have further supported the increase in micro-businesses. Conroy (1999) notes that the incidence of micro-business is likely to further increase as a number of factors in the economy such as downsizing the public sector and trends towards outsourcing take effect. If the trend globally is towards greater numbers of micro-entities, then increasingly, the call for compliance with an IFSME may be deemed irrelevant to most entities.

The intent of the NZ Government is to support good business practices and stimulate business rather than to create burdens. The conditions of limited liability bring with it the solvency test and the provision of reliable financial information. Protection for users contained in the Companies Act ("Companies Act") provides that companies must:

- 1.) appoint an auditor – unless an unanimous resolution that an auditor not be appointed is passed (s.196(2)); and
- 2.) pass the solvency test¹ – the directors must satisfy the solvency test prior to authorising a distribution to shareholders (s. 52).

The Act was intended to, amongst other intentions, “(d) to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgement while at the same time providing protection for shareholders and creditors against the abuse of management power”(preamble before s1, p 6).

To make compliance ‘easy’, clear policies are promoted. To this end, many of the existing statutes have been reworded in plain English. Whilst the number of regulations increases, the aim is to reduce compliance costs. The costs incurred in compliance should be less than both the perceived and the real benefits of compliance (Ministerial Panel on Business Compliance Costs, 2001).

¹ A company “satisfies the solvency test if –

- (a) The company is able to pay its debts as they become due in the normal course of business; and
- (b) The value of the company’s assets is greater than the value of its liabilities, including contingent liabilities” (s.4(1)).

In NZ accounting practices are firmly based on financial reporting standards developed by the NZICA. Practising accountants have been trained in the full IFRS and tend to rely on them for authoritative guidance on recognition and measurement issues. There has been an ever-increasing complexity in business transactions that has for the most part necessitated the complex requirements (such as, financial instruments, options, and share purchase plans). Transactions used by business importers to protect themselves against currency fluctuations when purchase obligations are denominated in foreign currencies are likely to become more common as global trading is enhanced by using the Internet. When SMEs enter into such complex transactions then accounting professionals need guidance on how to account for the complexities. Providing simplifications could mislead rather than assist users and remove reality from the accounts of SMEs.

Accounting practitioners tend to use a single software package for preparing financial statements for their clients. The software complies with GAAP, including the differential reporting regime. Often accounts are prepared on the basis of GAAP and used for many purposes, whether or not the financial statements are made publicly available. Changes in software and the maintenance of two versions by GPFR preparers will ultimately be borne by the SMEs preparing the compliant accounts.

5. DISCUSSION

Applying the IFSME raises a number of issues for the NZ accounting profession, in particular, the claims of a self-contained standard for SMEs, identification of users, and relevance to NZ business practices.

5.1 A self-contained standard?

The IFSME does not appear to be a stand-alone document, two examples suffice: property, plant and equipment, and investments in associates.

Under the IFRS, provisions relating to valuation of most non-current assets are contained in *IAS-16: Property, Plant and Equipment*. The IFSME covers Property, Plant and Equipment in Chapter 16 (a co-incidence with the number 16) and provisions relating to impairment of non-financial assets are contained in Chapter 26. A SME is allowed to use the revaluation

model, but the fallback is directly to IAS-16 and the preparer must consult IAS-16.

An entity that elects to use the revaluation model for a class of items of property, plant and equipment shall apply paragraphs 31-42 of IAS 16 *Property, Plant and Equipment* and shall make the disclosures required by paragraph 77 of IAS 16 (IASB, 2007c, para. 16.13).

Further, the IFSME Implement Guide (on page 64) reproduces paras 26.25 and 26.26 of the IAS-16. Therefore, contrary to what has been purported to be, preparers need to be trained in and familiar with both the full IFRS and the IFSMEs. NZ Chartered Accountants expect to travel overseas and therefore advisedly should be equipped with the skills to operate at any level in NZ and overseas.

The SME is allowed to choose one of three methods for dealing with investments in associates. If the preparer elects to use the equity method then they are referred directly to IAS 28 *Investments in Associates*, and are required to make the disclosures required by IAS 28. Despite claims that the IFSME is a stand-alone ‘book’, readers need to refer to the full IFRS! Further, the claim to comparability is not likely to be assisted, as preparers are able to make the choice from a range of permitted measurement options.

5.2 Users or ease of use?

One predicted outcome of applying the IFSME is that users will be able to compare the financial performance of SMEs across international boundaries and to become acquainted with the contents of the standards. The IASB had difficulty identifying users’ needs. The IASB received 100 comment letters following the release of their 2004 discussion paper but found references to user needs were vague. Meeting minutes, of the IASB working party, February 2005 note, “the Board needed to find ‘real users’ of small company financial statements” (Deloitte, 2007, p 20). The working party was expanded to 34 members in April 2005 in the effort to include more preparers and users of SME financial statements. Colin Notley, of Michell Notley and Associates, became the one New Zealander on the working party.

Potential stakeholders in this debate could include three groups:

- a) Preparers, including accountants (including auditors), accounting technicians and clerks.

- b) External users, such as financial institutions (banks, and mortgage brokers); suppliers, and employees/Unions.
- c) Owners, who pay for the report preparation and distribution, as needed for their own purposes (e.g. fund raising, trading on global scene, and e-business)

The latter group seem to have been excluded in the deliberations of the IASB even though they carry the full burden of compliance costs. The IASB deliberations sometimes appear to tailor the IFSME to the end user of the reports and at other times to the preparers of the reports.

The topical organization of the IFSME may make it more readable than the IFRS. However, the IFSME have been developed to codify good accounting and reporting practices; not for general reading and SMEs should not be expected “to identify those aspects of the standards that are relevant for their circumstances” (IASB, 2007a, para. BC48), without assistance from a preparer. If those dealing with SMEs wanted to know about accounting requirements they would be more likely to want electronic access to standards with key word search abilities. Arguably, the IFRS is topically ordered according to principle of measurement whilst the IFSME is topically ordered by a disclosure based classification system!

Further, the size of the ‘small book’ (the IFSME) of 320 pages is being promoted as a reason for its expected wide acceptance. Persuasive tactics rather than principles appear to be being used to promote the acceptance and adoption of the IFSME. If electronic access were made freely available, with key word search ability, the size of the book would not matter. If any country does not have the technology for electronic access, then a smaller book may have some appeal. However, it is noted that neither the IFRS nor the IFSME have indexes.

The value of the initiative of providing a checklist and examples (IASB, 2007b) is dubious. There are examples of financial reports developed to illustrate compliance with IFRS, free and available on the World Wide Web. The additional guidance appears unnecessary although an element of convenience may be commended - but only for preparers who are not familiar with computer applications or are reluctant to undertake searching activities!

5.3 Relevance?

The IASB appears to desire wide application for the IFSME beyond the GPFR. One of the IASB's goals is "to develop a standard that will be suitable for, and easily applied by, even the smallest of SMEs – the so-called micro-sized entities with just a few employees" (IASB, 2005a, p5). In the *Basis for Conclusion* (IASB, 2007a), which accompanies the exposure draft, the IASB claims that micro-entities need to publish GPFR for external parties "such as lenders, vendors, customers, rating agencies and employees" because these users "are not in a position to demand reports tailored to meet their particular information needs" (IASB, 2007a, para. BC46). It is not entirely clear which entities are to apply the IFSME given that the reference is to GPFR.

In 2002, the Ministry of Economic Development consulted a number of potential user groups of financial reports of small companies, such as suppliers, customers and investors, and concluded that most would not rely on financial statements to make economic decisions about whether to conduct business with SME companies. They noted that trade suppliers and potential customers would "rely instead on credit checks by private companies and Personal Property Securities Register searchers" (Ministry of Economic Development, 2002, para. 13).

Further, banks and venture capitalists would not use the financial statements:

Firstly, because the statements largely portray the financial effect of past events and do not provide important non-financial information about the SME companies' management skills or growth plans. Secondly, banks and venture capitalists often make their decisions to provide equity or debt financing to a SME company on the basis of personal guarantees offered by directors and/or shareholders, ... (Ministry of Economic Development, 2002, para. 13)

SME companies are often required to complete more detailed financial reports under contracts with creditors and financiers. User groups routinely, as necessary, obtain additional financial and management data in forms that suit their particular needs (Ministry of Economic Development, 2002). Annual financial reports are just one source of data for the potential users of GPFR for SMEs and the production of reports compliant with the proposed IFSME would be an unnecessary burden for NZ entities.

Where finance is predominantly provided 'in-house' from family or shareholder sources financial reports are not required and not used. Gibson (2004), notes borrowing by privately held firms often are provided to the firm only because the owner's personal assets have been

provided as a security. The financial statements of the firm become less relevant than the assets of the owner to lenders of loans supported by personal guarantees.

In the name of conformity, standards and comparability, the IFSME appears unnecessarily restrictive. Smaller enterprises are forced to stay within the entirety of allowed practices of the IFSME. They are not to adopt parts of IFRS even if more applicable to their situation. This restriction is said to prevent “cherry picking” (Deloitte, 2007). However, standards are about improving overall the comparability and relevance and resultant quality of financial information. The latter point seems to have got lost in the IASB deliberations.

6. IMPLICATIONS OF ADOPTION OR REJECTION.

A number of issues have been raised indirectly during this paper about the possible consequences of adoption of the IFSME in NZ. The change may cause bifurcation, additional costs and avoidance.

6.1 Bifurcation

Two “books” may create 1st and 2nd class citizens, practices, entities and accountants based on which Book they apply or understand. There could be preparers who are qualified to deal with SME reporting (and not the “real” IFRS issues). There could be abbreviated courses of study for those who will become qualified for the SME level of work. There could be a reduction in credibility of the statements prepared for SMEs. Credibility in the public arena may also be affected: the general public may not know in which Book a practitioner is versed. Yet it appears that Chartered Accountants will need to be versed in both books since auditing and interpreting financial statements would require understanding of the full IFRS. Chartered Accountants in NZ are expected to be knowledgeable about share investment and the stock markets, and, to understand IFRS compliant statements of the listed companies.

Researchers do not agree that costs of compliance will reduce where entities adopt IFSME. There are other costs that the IASB has not entertained. Higher costs of capital may have to be borne by the SMEs using “second-class” GAAP and are being audited or reviewed by “second-tier” accountants.

The less complete such information is, the greater the perceived risk will be, and hence the higher the cost of capital, which will diminish the expected residual returns to the owners. In brief, it should be anticipated that banks and other lenders will punish companies that opt for less-than-“full” GAAP or IFRS compliance, ...(Epstein, 2007, p 9).

It could be that when the SMEs go to the market to gain finance their costs could rise.

6.2 Costs

Maintaining two sets of standards is likely to incur significant costs for the NZICA, in addition, there are the requirements for the public sector and auditing standards to be kept up-to-date. The 320+ pages of the IFSME does not compare favourably with the current regime of differential reporting in NZ, which is contained in a document of nine pages. However, with computer technology and its search functions, that have come standard in most software programmes, there should not be an emphasis on the size of the book. Access to the relevant clauses for a smaller entity should not be an issue.

Changes made by the IASB to the full IFRS do not automatically lead to changes in the IFSME. Hence, there can be a lag in application of revised principles, and the IFSME could become divorced over time from the underlying conceptual framework and so a fluid transition for growth of entity from IFSME to IFRS may require significant changes in measurement and disclosure practices. Transition from the IFSME to the full IFRS is not likely to be a large problem for NZ. SMEs are noted for their tendency to avoid growth (McMahon & Davies, 1992) and trends continue towards the existence of greater numbers of smaller entities.

NZ has advocated a one-standard approach whereby public and private sectors use the same set of standards, which have been developed to incorporate the reality of both sectors. The differential reporting framework has proved it works well. It is easy to update with minimal articulation problems. Familiarity with the existing IFRS may bring a level of comfort and resistance to change. Yet, the one conceptual framework, one set of principles and standards is cost effective in terms of education – there is one set of standards to learn, read, and keep up-to-date with. Greater comparability and uniformity is maintained over all entity sizes and types – the public and non-public sectors alike.

6.3 Avoidance

To avoid the imposition of IFSME entities and preparers could negotiate contracts on an individual client basis and declare all reports to be special purpose reports. Non-publicly accountable entities could produce reports based on IRD (taxation) rules. Alternatively, the differential reporting framework and exempt company system could be harmonised and extended. If the present exempt and qualifying entities regime were extended into the future, smaller entities wishing to obtain overseas financing, would be IFRS compliant, and if necessary could increase their disclosure to satisfy the targeted investor(s). SME account preparation would not be of a lower standard than those complying with IFSME. (Some advocates of maintaining the differential reporting framework, might suggest NZ would be leading with higher standards.) The IFSME appears to be designed for those countries having no financial reporting standards and does not sit well with the sophisticated approach to financial reporting as conducted in NZ.

Apart from appearing out-of line with global standards the consequences of rejection of the IFSME appear to be all positive. NZ could maintain their single tier profession and training status, with added benefits from:

- Higher standards overall
- Negligible transfer costs to the IFRS
- Easier and less costly updating

7. CONCLUSION – OF DOUBTFUL BENEFIT TO NZ

The objectives of the IASB are laudable, particularly their aspiration to facilitate the convergence of national accounting standards. It has good intent in aiming to assist harmonising the financial reporting practices of various countries. Appropriately it has left jurisdictions to decide the application of the IFSME and to adapt the IFRS as needed to meet local laws and regulations. The IASB has focused on producing a set of practical and workable standards to gain widespread adoption by preparers.

However, it is uncertain of the relevance and likely application of the IFSME in New Zealand. It appears that it would be applicable to a very few entities and further, a number of

adverse consequences are likely to arise. The costs of implementing and maintaining both the full IFRS and the IFSMEs is not warranted given the few entities that might apply the IFSME and the high standard of accounting practices and financial reporting in New Zealand. Further, the introduction of an IFSME could be redundant, as there does not appear to be any potential users of GPFR for smaller entities in NZ.

Despite the attractive packaging of simplification and clarity, the IFSME tends to be tainted with reduced standards as the IFSME partially adopts the practices of the IFRS. In the interests of moving “towards transparency and accountability in the financial reporting value chain” I suggest New Zealanders should reject the IFSME and retain the current approach.

“If it ain’t broke don’t fix it”

References

- AccountingWEB. (2005). New 'one stop' FRSSE effective from 1 Jan 2005.
- Benson, L. (2007). No IFRS for SMEs please, we're British. *AccountingWEB*.
- Companies Act, 105 (1993).
- Companies Amendment Act, 2 (2006).
- Conroy, D. K., & Hine, D. (1999). *A study of the underestimation of entrepreneurship in Australia*. Paper presented at the International Council for Small Business, Naples, Italy.
- Deloitte. (2007). IASB Agenda Project: IFRS for small and medium-sized entities: Deloitte.
- Electronic Transactions Act, (2002).
- Epstein, B. J. (2007). Information overload can threaten sound decision-making. *The CPA Journal* (March), 6,9,10.
- Financial Reporting Act, 105 (1993).
- Flower, J. (2004). The International Accounting Standards Board's proposals for small and medium sized entities: a fatally flawed project? *International Accountant* (December , 17.
- Gibson, B., McClelland, P., & Phillip, G. (2004). Quasi-debt and quasi-equity in the financial statements of small firms. *Small Enterprises Research: the journal of SEAANZ*, 12(2), 297-312.
- IASB. (2004). *Preliminary views on accounting standards for small and medium-sized entities (Discussion Paper)*. London, UK: International Accounting Standards Board.
- IASB. (2005a). Staff overview: International Accounting Standards Board.
- IASB. (2005b). Staff questionnaire on possible recognition and measurement modifications for Small and Medium-sized entities: International Accounting Standards Board.
- IASB. (2007a). *Basis for Conclusions on Exposure draft: IFRS for small and medium-sized entities* London, UK: International Accounting Standards Board.
- IASB. (2007b). *Draft implementation guidance: IFRS for small and medium-sized entities* London, UK: International Accounting Standards Board.
- IASB. (2007c). *IFRS for small and medium-sized entities (Exposure draft)*. London, UK: International Accounting Standards Board.
- ICANZ. (2005). *Submission to the Ministry of Economic Development on the review of the Financial Reporting Act 1993*: Institute of Chartered Accountants of New Zealand.

- Jermakowicz, E. K., & Gornik-Tomaszewski, S. (2006). IFRS and you: what are the implications of the European accounting revolution. *Strategic Finance*(March), 43-48.
- McMahon, R. G. P., & Davies, L. G. (1992). Financial Reporting and Analysis in Smaller Growth Enterprise: Descriptive evidence on practice. *Accounting Forum*, 16(1), 69-74.
- Ministerial Panel on Business Compliance Costs. (2001). *Finding the balance: maximum compliance at minimum cost*. Wellington, NZ: Ministry of Economic Development.
- Ministry of Economic Development. (2002). *Discussion Document - Financial reporting for small companies (the Exempt company regime)*. Retrieved. from.
- Ministry of Economic Development. (2004). *Discussion Document - Review of the Financial Reporting Act 1993: Part II* Retrieved. from.
- Ministry of Economic Development. (2005). *SMEs in New Zealand: Structure and dynamics*. Wellington: Ministry of Economic Development and Statistics New Zealand.
- NZ Companies Office. (2005). Entities on NZ Companies Register: NZ Government.
- NZICA. (2005). *Framework for differential reporting for entities applying the New Zealand equivalents to International Reporting Standards regime*. Retrieved. from.
- NZICA. (2006). *Framework for differential reporting* Retrieved. from.
- NZICA. (2007). *Framework for differential reporting* Retrieved. from.
- Price-Waterhouse Coopers. (2004). Differential reporting and accounting standards for SMEs. *NZ IFRS Essentials*(October), 2.
- Rutherford, M. W., McMullen, P., & Oswald, S. (2001). Examining the issue of size and the small business: a self-organizing map approach. *The Journal of Business and Economic Studies*, 7(2), 64-79.
- Statistics New Zealand. (2006). *New Zealand business demography statistics: at February 2006*. Retrieved 28 Feb 2007. from www.stats.govt.nz.
- Terleckyj, N. E. (1999). *Measuring contribution of small business to industry job growth by data in business association directories* (No. RS 191): United States Small Business Administration, office of Advocacy.
- The Financial Reporting Order. (1994). NZ Government.
- Warren, K., Sealy-Fisher, V., & Scott, J. (2004). Differential reporting - FRSB issues Exposure Draft. *Chartered Accountants Journal*, 47-48.
- Williams, R. E. (2005). OCBOA, small business GAAP alternative. *Chartered Accountants Journal*(July), 26-27.

APPENDIX 1: ENTITY SIZE (BY NUMBER OF EMPLOYEES) AND ENTITIES REGISTERED WITH THE NEW ZEALAND COMPANY REGISTER

Table A1: Employment size groups for geographic units

Equivalent Full-time Employees	% of total No. of entities	No. of Entities
0 – 5	83.88	271,629
6 - 9	7.31	23,662
10 – 19	4.99	16,165
20 – 49	2.64	8,552
50 – 99	0.73	2,356
100 +	0.45	1,475
Total in sample	100.00	323,839

Adapted from Statistics New Zealand (2006) data.

Table A2: Operating Entities registered on the New Zealand Company Register

Entity type (at December 2005)	Total Number
New Zealand Companies	404,514
Overseas Companies	1,291
Incorporated Societies	20,861
Charitable Trusts	15,900
Industrial and Provident Societies	288
Special Bodies	3
Total	442,857

Source: NZ Companies Office (2005)

OTHER PAPERS IN THIS SERIES

1. Lawrence, S.L. Rational and social aspects of management accounting practice: Report of a field study, June 1990.
2. Northcott, D.N. Capital budgeting in practice: Past research and future directions, August 1990.
3. Cheung, J., Vos., E. and Low, C.K. IPO underpricing in New Zealand, September 1990.
4. Van Peursem, K.A. Extant research in public sector accountability, March 1991.
5. Van Peursem, K.A. New Zealand auditor perceptions: Difficult and critical audit procedures, July 1991.
6. Alam, M. The budgetary process from information processing perspectives, September 1991.
7. McCracken, T. & Hooper, K. The New Zealand goods and services tax (GST): Identifying the problem areas, September 1991.
8. Lowe, A. Strategic management accounting, September 1991.
9. McCracken, T. Pricing: A review of contemporary approaches, February 1992.
10. Cheung, J. Estimating costs of capital for small ventures, March 1992.
11. Cheung, J., Vos, E., & Bishop, D. Pre-holiday returns in the New Zealand share market, May 1992.
12. Van Peursem, K.A. Accountability for social policy: A moral framework, June 1992.
13. Alam, M. & Poulin, B.J. Budget as a discipline: Lessons from a turnaround enterprise, December 1992.
14. Raj, M. Pricing options on short and long-term yields using stochastic arbitrage based models, May 1993.
15. Godfrey, A. & Hooper, K. Domesday Book: Its significance as an accounting document, June 1993.
16. Van Peursem, K.A., Lawrence, S.R. & Pratt, M.J. Health management performance: A classification and review of measures and indicators, July 1993.
17. Coy, D. & Goh, G.H. Overhead cost allocations by tertiary education institutions 1989-91, September 1993.
18. Coy, D., Dixon, K. & Tower, G. The 1992 annual reports of tertiary education institutions: quality, timeliness and distribution, November 1993.
19. Van Peursem, K.A. & Tuson, C. Financial reporting in Area Health Boards 1987-1992, January 1994.
20. Vos, E. & Davey, H. Time consistent accounting standards as a necessary condition for relating "point in time" accounting information to market returns, April 1994.
21. Coy, D., Buchanan, J. & Dixon, K. The users of New Zealand tertiary education institutions' annual reports: who are they and what information do they seek? December 1994.
22. Coombes, R. & Davey, H. The New Zealand accountant's role in environmental accountability, December 1994.
23. Wells, P.K. Marketing regulation and compliance programmes, November 1995.
24. Haslam, J. Analysis of accounting as at the end of the Napoleonic war: towards a critical theoretical history of the prescribing of accounting by the British State, November 1995.
25. Haslam, J. The British state and the prescribing of accounting, 1815-1830: a focus upon the regulating of friendly societies and savings banks in the post-Napoleonic war context, November 1995.

26. Haslam, J. Accounting publicity and the revolution in government, November 1995.
27. Haslam, J. Accounting history as critique of the present: a critical theorising of interfaces between accounting and the British state of the early 1840s, November 1995.
28. Dosa, L., Gallhofer, S. & Haslam, J. Accounting's location in a transition process: a focus upon Hungary, November 1995.
29. Gallhofer, S. & Haslam, J. Accounting on the road: turnpike administration in early nineteenth century Britain, November 1995.
30. Ciancanelli, P., Gallhofer, S., Haslam, J. & Watson, R. Pay systems and social ideology: the case of profit related pay, November 1995.
31. Jenkin, Erica and Van Peurseem, Karen A. Expert systems in auditing: New Zealand auditor perspectives, November 1995.
32. Wells, P.K. Marketing regulation and compliance programmes: Attitudes and reactions of New Zealand marketing managers in 1988, November 1995.
33. Davey, H.B., Bowker, T. & Porter, B. New Zealand's controlled foreign company regime, November 1995.
34. Davey, H.B., Barnes, H. and Porter, B. External environmental reporting: The need for a New Zealand standard, November 1995.
35. Lawrence, Stewart, Rethinking professional ethics: A religious metaphor for accountants, November 1995.
36. Ciancanelli, P., Watson, R., Gallhofer, S. & Haslam, J. Alternative perspectives on finance: A critical analysis, November 1995.
37. Gallhofer, Sonja & Haslam, J., Beyond accounting: The possibilities of accounting and "critical" accounting research, November 1995.
38. Gallhofer, Sonja, "It really challenged everybody": Accounting and critical and feminist pedagogy, January 1996.
39. Gallhofer, Sonja, and Haslam, Jim, The direction of green accounting policy: Critical reflections, January 1996.
40. Wells, P.K., Marketing regulation and compliance programmes: attitudes and reactions of New Zealand marketing managers in 1995, February 1996.
41. Pratt, Michael and Coy, David, Managing teaching allocations in a university department: the TAMM model, June 1996.
42. Coy, David and Pratt, Michael, The spider's web: politics and accountability in universities, June 1996.
43. Doolin, Bill, Organisational roles of decision support systems, June 1996.
44. Beale, Bob and Davey, Howard, The nature and origins of comprehensive income, August 1996.
45. Davey, Howard, and Holden, Mark, Emerging directions in the evaluation of foreign subsidiary performance, September 1996.
46. Kelly, Martin, A personal perspective on action-research, October 1996.
47. Doolin, Bill, Defining decision support systems, November 1996.

48. Gallhofer, Sonja, Haslam, Jim and Pratt, Mike, Developing environmental accounting: insights from indigenous cultures, November 1996.
49. Ciancanelli, Penny, Gallhofer, Sonja, Haslam, Jim and Watson, Robert, In the name of an enabling accounting: critical reflections developed and enhanced through an analysis of accounting and profit-related pay, November 1996.
50. Lowe, Alan, The role of accounting in the processes of health reform: providing a "black box" in the cost of blood products, November 1996.
51. Coy, David and Buchanan, John, Information technology diffusion among business professionals: Preliminary findings of a longitudinal study of spreadsheet use by accountants 1986-96, February 1997.
52. Beale, Bob and Davey, Howard, Total recognised revenues and expenses: an empirical study in New Zealand, March 1997.
53. Coy, David, Nelson, Mort, Buchanan, John and Jim Fisher, Spreadsheet use by accountants in Australia, Canada and New Zealand: Preliminary findings, March 1998.
54. Wells, P.K., Manapouri: catalyst or consequence? October 1998.
55. Lowe, Alan, Tracing networks through case studies, October 1998.
56. Kim, S.N. and Mfodwo, K., Prospects for the establishment of Islamic banking in New Zealand: a contextual analysis, November 1998.
57. Van Peurseem, K.A., Method for a methodology: a new approach for the middle range, November 1998.
58. Locke, Joanne and Perera, Hector, An analysis of international accounting as a catalyst for the re-integration of accounting research, August 1999.
59. Julian, Aileen and Van Peurseem, Karen, Ethics education and the accounting curriculum: Can ethics be taught?, August 1999.
60. Van Peurseem, K.A., Wells, P.K. and L'Huillier, B. Contracting services in SMEs: A New Zealand professional accounting firm case study, September 1999.
61. Lowe, Alan, Accounting in health care: Providing evidence of a real impact, September 1999.
62. Alam, Manzurul and Wells, Philippa, Control systems of government-owned business enterprises: a critical analysis of the New Zealand model, November 1999.
63. Kelly, Martin, In praise of holistic education in accounting, December 1999.
64. Smith, Susan Ann and Coy, David, The quality of city council annual reports, 1996-97 and 1997-98: Preliminary findings, March 2000.
65. Hooper, Keith and Low, Mary, Representations in accounting: the metaphor effect, June 2000.
66. Dixon, Keith, The impact of management control across a hospital system, August 2000.
67. Lowe, Alan, Accounting information systems as knowledge-objects: some effects of objectualization, August 2000.
68. Locke, Joanne and Lowe, Alan, A market test of the ranking of accounting journals: an Australasian perspective, October 2000.
69. Francis, Graham, Humphreys, Ian and Jackie Fry, Lessons for other counties from the privatisation, commercialisation and regulation of UK municipal airports, December 2000.

70. Hooks, Jill, Coy, David and Howard Davey, Information disclosure in the annual reports of New Zealand electricity retail and distribution companies: Preliminary findings, January 2001.
71. Lowe, Alan, Methodology, method and meaning in field research: Intensive versus extensive research styles in management accounting, March 2001
72. Van Peurse, Karen, Locke, Joanne and Harnisch, Neil, Audit Standard Analysis: An Illocutionary Perspective on the New Zealand Going Concern Standard April 2001
73. France, Necia, Francis, Graham, Lawrence, Stewart and Sacks, Sydney, Measuring Performance Improvement in a Pathology Laboratory: A Case Study, April 2001
74. Hooper, Keith and Davey, Howard, Preferences on learning options in accounting education: a new zealand/asian perspective, May 2002
75. Lowe, Alan and Locke, Joanne, A paradigm sensitive perspective on the ranking of accounting journals: A web-based survey approach, May 2002
76. France, Necia, Francis, Graham and Lawrence, Stewart Redesigning clinical laboratory services: Securing efficient diagnoses for New Zealanders, January 2003
77. Lowe, Alan and Jones, Angela, Emergent strategy and the measurement of performance: The formulation of performance indicators at the micro-level, May 2003
78. Francis, Graham, Humphreys, Ian, Ison, Stephen and Aldridge, Kelly, Airport surface access strategies and targets, September 2004
79. Bourke, Nikki and Van Peurse, Karen, Detecting fraudulent financial reporting: teaching the 'watchdog' new tricks, September 2004
80. Low, Mary and Francis, Graham, Improving the research skills of the first-year accounting class by incorporating corporate annual report analysis into the classroom, November 2004
81. Nath, Nirmala, Van Peurse, Karen and Lowe, Alan, Public sector performance auditing: Emergence, purpose and meaning, February 2005
82. Bather, Andrea and Kelly, Martin, Whistleblowing: The advantages of self-regulation, September 2005
83. Samkin, Grant and Lawrence, Stewart, Limits to corporate social responsibility: The challenge of HIV/AIDS to sustainable business in South Africa, November 2005
84. Alley, Clinton and James, Simon, The interface between financial accounting and tax accounting – a summary of current research, December 2005
85. Samkin, Grant, Trader, Sailor, Spy, December 2005
86. Van Peurse, Karen, The auditor's dilemma: an economic perspective on an old problem, December 2005.
87. Alley, Clinton and Maples, Andrew, The concept of income within the New Zealand taxation system, October 2006
88. Francis, Graham, Lawrence, Stewart, Humphreys, Ian and Ison, Stephen, Risk transfer and uncertainty in privatisation: Cases from air transport, October 2006
89. Van Peurse, Karen A., Public benefit vs private entities: A fresh look at accounting principles, October, 2006
90. Bather, Andrea, The Companies Act 1993 and Directors' Duties: Small and medium entities are not well catered for, December 2006

91. Ryan, Jim, Tax relief still available for small property owners?, December 2006
92. Samkin, Grant and Schneider, Annika, Reviewing the changing face of financial reporting: The case of a public benefit entity, May 2007
93. Lowe, Alan and Locke, Joanne, Biography of an ERP: Tracing the Fabrication of a Virtual Object, May 2007
94. Van Peurse, Karen A., Zhou, Maiqing, Flood, Tracey and Buttimore, James, Three Cases of Corporate Fraud: An Audit Perspective, June 2007
95. Schneider, Annika and Samkin, Grant, Intellectual Capital Reporting by the New Zealand Local Government Sector, June 2007