How IFRS has destabilised financial reporting for UK non-listed entities

Stella Fearnley and Tony Hines
University of Portsmouth Business School, Portsmouth, UK

Abstract

Purpose – The paper aims to trace the development of attitudes towards financial reporting solutions for entities not subject to the European Union (EU) Regulation. This Regulation mandated application of IFRS for the group accounts of listed companies for financial years beginning 1 January 2005. It seeks to evaluate the alternatives in the light of changing attitudes to IFRS, and the accounting model being adopted, particularly focusing on the problems facing smaller companies.

Design/methodology/approach – The paper employs qualitative analysis of data from two main sources: first, a series of interviews with financially literate individuals before IFRS was implemented in the UK; and second, from responses to ASB’s consultations on the future of financial reporting for non-listed entities.

Findings – The increasing perception is that IFRS is overly complex and is complicating the search for appropriate form of financial reporting for entities not covered by the EU Regulation. In particular, there is a difficulty in knowing the correct dividing point between large and small company accounting, and views on this have evolved over time. The needs of small and medium enterprises appear to have been ignored in the debates dominated by the requirements of global players.

Research limitations/implications – The implications are that further, possibly more radical policy options need to be considered for smaller companies to ensure that the costs of financial reporting remain in proportion to the benefits.

Originality/value – The paper identifies the changing views in the UK of the suitability of IFRS for non-listed entities.

Keywords Regulation, Accounting standards, Small to medium-sized enterprises

Paper type Research paper

Introduction

In 2002, the European Union (EU) issued a Regulation (EU, 2002) requiring all EU listed companies to adopt International Financial Reporting Standards (IFRS), set by the International Accounting Standards Board (IASB), for their consolidated financial statements for financial years beginning on or after 1 January 2005. Until this time all UK companies, regardless of size or listing status, prepared their financial statements under UK Generally Accepted Accounting Principles (GAAP). The Financial Services Authority Listing Rules required extra disclosures for listed companies and, in order to accommodate small companies, the UK Accounting Standards Board (ASB) prepared a Financial Reporting Standard for Small Entities (FRSSE) which brought together small company reporting requirements[1] in one document with some minor concessions to the overall framework. Thus, UK GAAP with adjustments at the top and bottom end succeeded in accommodating all UK companies. The UK domestic corporate market comprises approximately 1,080,000 small companies, 30,000 medium companies and 20,700 large companies (ASB, 2006a) of which roughly 1,500 are listed.
IFRS is recognised as a more complex accounting model than UK GAAP and is primarily intended for listed companies trading in the global capital markets. The EU (2002) left it to member states to resolve the problem of the reporting regime which should apply to entities which report under GAAP, but which were not included in the scope of the Regulation. These include: subsidiaries within a listed group; listed companies which are not part of a group; large unlisted companies; mutuals; small and medium enterprises (SMEs); and public sector entities. In the UK, there has been a long drawn out debate about whether IFRS should be mandatory for all UK reporting entities; and if it should not, what the alternatives might be. These issues were discussed at a public meeting of the ASB held in January 2006 (ASB, 2006b) and in a consultation process launched in May 2006 (ASB, 2006c).

There is evidence that the first year’s experience of applying of IFRS in UK has gone quite well (FRRP, 2006) but there remains some debate about the IFRS fair value accounting model and the IASB’s plans to converge their standards with US GAAP (Dilks, 2006). A recent consultation about the joint conceptual framework developed by IASB and the US Financial Accounting Standards Board (FASB)[2] has generated some concerns mainly directed at the assertion that the fundamental purpose of accounting is for directors to provide investors with information for decision usefulness purposes, with stewardship, i.e. directors’ accountability to shareholders, being a subsidiary objective (Mackintosh, 2006).

In this qualitative paper, we trace the development of attitudes towards possible financial reporting solutions for entities not subject to the EU regulation. We evaluate the alternatives in the light of changing attitudes to IFRS, and the accounting model being adopted, particularly focussing on the problems facing smaller companies. We draw our data from two main sources: first, a series on interviews with financially literate individuals before IFRS was implemented in the UK; and second, from responses to ASB’s consultations on the future of financial reporting for non-listed entities.

The paper is divided into six sections. This section is the introduction. In section two, we provide some context and literature for the study. Section three describes our methodology. In section four, we analyse the attitudes of our interviewees to the IFRS project and in section five, we examine the responses to the ASB’s consultation processes held during 2006. Discussion and our conclusions are set out in section six.

Context and literature review

Background to the IASB and the changeover to IFRS

The International Accounting Standards Committee (IASC) was formed in 1973, but it was not until 2000, after a lengthy process, that the International Organization of Securities Commissions recommended that its members permit the use of International Accounting Standards (IAS) (as the standards were then named) for transnational listings and issues of shares. Widespread adoption of IAS was encouraged by a number of influential bodies such as the World Bank (Accountancy, 1998) after the South East Asian economic crisis.

The IASC was reformed as the IASB in 2001 following a structural review. There is little representation within this organisation from the non-listed sector and it receives most of its funding from large accounting firms, multinational companies, banks (including central banks) and other international organisations (International Accounting Standards Committee Foundation, 2004). The focus of IASB from the
outset was to set standards for application in global capital markets, not for application by non-listed entities.

In June, the European Commission (2000) proposed that all EU companies listed on a regulated market should prepare their consolidated accounts in accordance with IAS. The justification was to ensure a high degree of transparency and comparability of financial statements and an efficient functioning of the community capital market and of the internal market, with the ultimate objective of achieving a single set of global accounting standards.

In 2002, in the post Enron environment, when US Accounting Standards were subject to criticism, the “Norwalk” agreement (FASB/IASB, 2002) was reached between the IASB and the US FASB to converge IFRS with US GAAP. This raised concerns that rule-based regulation (seen as a US defence against litigation) may dominate the standards (Jopson, 2005). FASB sets standards for listed companies and in the USA, unlike Europe, there is no legal requirement for all companies to prepare GAAP compliant accounts. Thus, the objective of setting standards companies listed on global capital markets was reinforced.

In June, the IASB (2004) published a Discussion Paper on proposals for accounting standards tailored to the needs of SMEs. In contrast with the UK FRSSE, the IASB ignores definitions based on size and defines an SME as an entity that does not have public accountability (e.g. to a securities regulator), although it assumes that the entity has external users for their financial statements (e.g. credit rating agencies, creditors, customers). The IASB (2006) reports that the responses showed a clear demand for such a standard, but scope of application would be a matter for national jurisdictions. IASB (2006) claims that IFRS is suitable for all entities, but recognises national GAAP is still a permitted option for SMEs and attempts are being in various countries to align GAAP with IFRS. The IASB is concerned that such developments could lead to multiple adaptations of IFRS some of which may be weakly aligned. The needs of external users might be ignored, transition to full IFRS might be difficult and there would be a lack of comparability across different jurisdictions.

The “Exposure draft of proposed international financial reporting standard for small and medium-sized entities” (IASB, 2007) was finally issued in February 2007, with a comment period running up to 1 October 2007. It broadly follows the path laid down in the Discussion Paper (IASB, 2004). In terms of the word count, it is approximately 15 per cent of the size of full IFRS, and is a “stand alone document” (i.e. there is no requirement for preparers to refer back to full IFRS). It contains some recognition and measurement simplifications (e.g. all research and development expenditure is to be expensed), with substantially reduced disclosure requirements. Some accounting options available under full IFRS (e.g. capitalisation of some borrowing costs) are excluded in the quest for simplicity. The IASB claims that the proposed standard would be suitable for SMEs of any size required to produce general purpose financial statements presenting an entity’s financial position, results of operations, and cash flows (IASB, 2007).

Entities not covered by the regulation: the UK debate
Each member state within the EU (2002) can choose whether to permit or require the use of IAS for unlisted companies and subsidiaries who are members of listed groups. In the UK, the Department of Trade and Industry (DTI) consulted widely (DTI, 2002).
Following this process, it was announced that all British companies would be permitted to use IAS as an alternative to UK GAAP from 1 January 2005, with a further review around 2008 to consider whether application of IAS should become mandatory (DTI, 2003).

The UK ASB has been working to narrow the gap between IFRS and UK GAAP for a number of years, so initially they believed that there was no case for two sets of standards (i.e. IFRS and UK GAAP) in the medium term (ASB, 2004). In a draft Policy Statement the ASB (2005) proposed to:

- bring about convergence between UK standards and IFRS;
- to seek to issue accounting standards that are appropriate for the entities that have to apply them; and in particular that the burden of the requirements of accounting standards is proportionate to the benefits they provide; and
- use a phased approach to bring UK standards fully into line within a period of three to four years.

Criticism of the strategy quickly emerged. Representatives of the SME sector urged the ASB to abandon its convergence programme with IFRS (Grant, 2005) in order to prevent small companies being burdened with an IFRS version of UK GAAP. Shearer (2005) asserts that IFRS are unashamedly written to meet the needs of users in the world’s capital markets and argues that a different solution is needed for SMEs.

ASB (2006a) then published a paper which suggested dropping the third proposal (above) and replacing it with the revised proposal that while it would still issue new IFRS based standards, these would not be mandatory before a single future date (currently estimated to be financial years beginning on or after 1 January 2009). The paper proposed two tiers of accounting standards:

1. Full IFRS should be applied to entities that have public accountability (but be available for use by all entities).
2. IASB standards for SMEs should be applicable for entities that do not have public accountability (broadly the same group currently applying the FRSSE).

The paper recognises that while a “two size fits all” regime is the ideal solution, there are a number of entities that do not fit neatly into either category and that it is only achievable if a satisfactory dividing line between the two categories can be established. It suggests that (depending on the outcome of the IASB’s SME project) the appropriate solution could be either “IFRS minus” (i.e. full IFRS with certain exemptions) or “SME plus” (i.e. based on IASB’s Standards for SMEs). By May 2006 (following discussions at a public meeting), when it launched its consultation process, the ASB had refined its proposals slightly suggesting that UK subsidiaries of groups which are required to apply IFRS, should also report under IFRS but with reduced disclosure requirements. The use of the ASB’s (2006d) FRSSE could be extended to medium-sized entities. The position can therefore only be regarded as confused and uncertain.

The implications of the IASB’s (2007) new exposure draft for UK financial reporting are still being digested and debated. The ASB (2007) has issued its own invitation to comment on the standard to gauge the views of UK constituents.
Financial reporting, proportionality and smaller companies

Reporting, consistent and dependable accounting information is a prerequisite to effective communication (Solomons, 1991). Effective communication underpins many uses for published accounts of public companies such as: defining and applying contracts (Whittington, 1993); reducing search costs (Meeks and Meeks, 2002); and countering information asymmetry between owners and managers of companies and between buyers and sellers of shares. Information asymmetry may inhibit smooth running of capital markets, so the provision of reliable standard information to capital providers could be expected to reduce the cost of capital (Healy et al., 1999; Shaomin and Pinsker, 2005) and serve stakeholder interests (Day, 2001).

However, this model of listed company accounting has limited relevance to non-listed entities where shares are not publicly traded. Many of these entities are owner managed (Carsberg et al., 1985) thus removing the problem of information asymmetry and the agency problems as identified in Jensen and Meckling’s (1976) seminal paper. Carsberg et al. (1985) and Keasey and Short (1990) also find that the main uses of annual accounts for smaller companies is the provision of information to management, to the bank and other lenders. Collis and Jarvis (2000, p. 43) discover that directors find accounts useful in providing independent confirmation of their company’s results. POBA (2006, p. 23) find that companies with turnover of less than £1m did not regularly supply their accounts to external stakeholders and POBA also find that banks use mechanisms other than annual accounts to make lending decisions. A further interesting finding from POBA (pp. 25-6) is that there is a disturbing level of inaccuracy in accounts of small companies filed on public record at Companies House. This would suggest that increasing the complexity of reporting requirements for small companies would not necessarily lead to more accurate reporting.

While debates about global accounting convergence have ignored the non-listed sector, the DTI’s (2005) Company Law Reform process which had led to the recent passing of the Companies Act 2006, is substantially based on the concept of “think small first”. The European Commission President, Barroso has also identified the need for SME friendly policy development (EC, 2006a).

The UK Government’s Better Regulation Task Force (2003) sets out five principles of good regulation which are particularly relevant to smaller entities. The five principles are defined as follows:

(1) **Proportionality.** Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and cost identified and minimised.

(2) **Accountability.** Regulators must be able to justify decisions and be subject to public scrutiny.

(3) **Consistency.** Government rules and standards must be joined up and implemented fairly.

(4) **Transparency.** Regulators should be open and keep regulations simple and user friendly.

(5) **Targeting.** Regulation should be focussed on the problem and minimise side effects.

The literature identifies a dilemma for UK accounting going forward. The drive for global convergence of standards for the benefit of capital markets is well advanced
internationally and has not been opposed by government in the UK, yet the UK’s own models of best practice and company law support a strategy of “think small first” and “proportionality”.

Research methodology
Our empirical data comprises a set of interviews with regulators, company directors and audit firm partners based in the UK carried out before IFRS was introduced. As a point of comparison, we have drawn on responses to the ASB's public consultation processes about the future for non-listed entities which took place during 2006.

Interviews
The interviews were carried out between November 2003 and January 2004 following approval of the Regulation (EU, 2002) introducing IFRS into the EU. This was a period when the implications of the 2005 deadline were becoming apparent. The interviewees were drawn from practitioners and regulators who would have been expected to have had some knowledge about IFRS at the time of the interviews. Two of the interviewees are company directors with accounting qualifications, one from a top 100 (FTSE 100) UK listed company (designated C1), and the other (C2) from a recently delisted top 350 (FTSE 350) company with overseas subsidiaries which prepared accounts under IFRS. Four are audit firm partners being: one technical partner from a Big Four[3] firm (designated P1); one Big Four audit partner (P2); one mid-tier firm audit partner (P3); and one small firm partner (P4). Six regulators (designated R1-R6) were also interviewed, therefore a total of 12 interviews were carried out.

A semi-structured format was used which gave us sufficient flexibility to adapt questions in response to different circumstances and perspectives. We report here the key comments relevant to this paper.

All the interviews were recorded in full and subsequently transcribed (Jones, 1985). Content analysis was conducted with the assistance of the QSR-NVivo software, which facilitates analysis of interview material for the purposes of qualitative research. A coding scheme was developed from the data based on identified themes which emerged from repeated reading of the material. Coding was checked for consistency by two researchers and input into the software, from which the analysis was carried out.

Public consultations
During 2006 the ASB launched two public consultation processes with a view to finalising its future strategy. First a public meeting on the future role of the ASB (2006b) was held in January and a report of the discussion published. Subsequently, views were sought on the future application of reporting requirements for UK companies and this feedback was published (ASB, 2006c). The responses relevant to the above questions have been analysed to provide an indication of how attitudes on the issues have continued to develop in response to a changing environment.

Interview evidence
A summary of interviewee responses is provided in Table I and key comments are set out below.
Options available to companies outside the regulation

When the interviews took place, the DTI (2003), following consultation, had announced that companies not covered by the Regulation would be given the option of staying on UK GAAP or transferring over to IFRS. Even then some interviewees noted that not everything had been clarified:

An interesting question is that if one adopts, can one go back if one doesn’t have to? And nobody’s answered that question yet (P4).

One interviewee noted that the choice open to companies outside the regulation might be driven by economic factors:

I guess there might be some tax drivers if companies can see they can get a one off tax benefit for moving to IAS, that might be a reason for doing it (R3).

Another view was that since the examinations of the professional accountancy bodies had largely moved over to IFRS, UK GAAP would have a finite life:

I suspect that people will keep going with UK GAAP until actually you can’t any more, because there’s less and less people who knew what that was about (P2).
Individual companies within a listed group
The least controversial aspect of the problem was the suitability of IFRS for subsidiaries belonging to a listed group:

Many of us presumed that all the subsidiaries of listed companies would automatically convert to adopted IAS, which actually absorbs quite a lot of the bigger unlisted companies in the UK (R1).

Such companies were more likely to have the necessary support and expertise to successfully apply IFRS. Also using IFRS for individual company accounts within a group would avoid the cost of reconciling from UK GAAP to IFRS when consolidated accounts were being prepared.

Unlisted companies
There was much more caution expressed regarding the suitability of such a complex set of standards as IFRS for unlisted companies. Even enthusiasts of the project for listed companies were dubious that the principle of harmonisation was relevant for such companies or their users.

Despite such concerns there also remained a general desire for UK financial reporting to have internal consistency, especially as the ASB had already expressed its intention to converge UK GAAP with IFRS:

We don’t want three sets of standards. We don’t want listed IAS, big GAAP for UK but not listed and little GAAP. We want a set of standards for companies which are complex entities and little GAAP. And I think that is where we’ve got to go ... By 2010 I would expect UK standards to have essentially become IAS standards, apart from small GAAP (P1).

There was some enthusiasm from regulators (e.g. R1, R4) for the idea that the IASB should develop a FRSSE based on international standards for small companies. The proposal had existed for some time and little progress had been made at the time of the interviews, although one regulator expressed optimism that the IASB would pick up the project:

Despite certain members of the Board, whose names again I won’t mention, being opposed to the idea (R5).

The practitioners with the greatest experience of applying the existing UK FRSSE (i.e. P3 and P4) were of the opinion that it saved little preparation time compared with full UK GAAP, but it was popular with clients who generally wished to disclose as little as possible. They could therefore see the merit of an IFRS version.

The view was also expressed that some larger companies could be brought within the scope of the FRSSE:

I am saying more companies would be able to use FRSSE GAAP, be it a UK FRSSE or an international FRSSE, wherever things have got to by then (2010). And then everything else above that would effectively be using one set of accounting standards (R1).

However, there was also a view that the needs of medium companies were different from small ones:

Medium sized companies are going to be different because they may be subsidiaries of bigger companies, they may have more significant trading links with international companies who want their subsidiaries to prepare on the same basis, their associates/trading partners to
prepare on the same basis. The majority of small businesses do not have any international
business other than direct links of selling to a few people. Medium sized businesses can have
more European links and therefore more reason for maybe, wanting to prepare accounts that
somebody else can look at on a comparative basis (P4).

Although it remained a preferred small company solution for many interviewees, one
regulator expressed a doubt that the needs of the smallest companies would be met by
an IFRS based FRSSE:

The UK perception is that you have a FRSSE and the FRSSE says you retain the
measurement principles and you reduce the disclosures. But the measurement principles, as
I said earlier, are getting more and more technically pure but perhaps slightly impractical. So
there must be questions about how sensible it is to require two sweet shops merging to
identify goodwill and all the other things they are obliged to do (R3).

One regulator, concerned by the increased complexity of financial reporting, developed
this line of argument further:

Small companies are going to be less and less proficient in terms of the quality of information
they are putting on the public record and so there comes a point where the information is
so useless there is no point in having it any more. Or you reduce it to a very basic file
document (R5).

Responses made in 2006 to the ASB’s consultation processes
At the public meeting while the ASB’s (2006b) aim of converged principles was broadly
supported, concern was expressed that sometimes IFRS did not appear to be based on
clear or sound principles. The overriding view was that ASB should produce standards
that best suited the UK market taking into account costs and benefits and user needs,
an issue linked to concerns about the complexity of IFRS. The relevance of IFRS to non
listed and non-publicly accountable companies was questioned. It was noted that many
companies which were subsidiaries of listed groups were continuing to report under
UK GAAP because their distributable profits were adversely affected by IFRS.

Regarding which standards should apply to each entity, many preferred the model
in which full IFRS should be applied by all other than FRSSE entities because:

It was consistent with the ideal of having a set of consistent, convergent standards applicable
to as wide a spectrum of entities as possible (ASB, 2006a, p. 4).

The view was expressed that any other solution would imply that the ASB had given
up on influencing the IASB.

There was also considerable support for a model in which the IASB’s SME standards
would apply to all other than listed companies (a larger group than the IASB intended to
use them), thereby avoiding the complexity of IFRS (which some thought might increase
further over time). Others thought they should apply to large private companies. It was
suggested that IFRS was the price of listing that should not be foisted on other entities.
Some went further and suggested that because IFRS was converging with US GAAP
with the objective of eliminating the reconciliation statement for companies listed in the
USA, application of IFRS should be confined to them.

The accounts of wholly owned subsidiaries were not thought to be of great interest
and it was proposed that the financial information they should be required to produce
could be minimised.
It was suggested that completion of the IASB’s SME project could be some way off and that the ASB should press ahead with the development of “IFRS minus” standards probably suitable for the middle tier of companies. Some had doubts the IASB’s SME standards would in any case be appropriate for the middle tier of companies and believed that a three tier regulatory system was inevitable. It was noted that the IASB had been reluctant to take on the project and there were fears that the result would be “big GAAP” based. Some decisions would have to be deferred until it had been completed.

The feedback to PN 289 (ASB, 2006c) produced a majority in favour of all publicly accountable companies being required to apply full IFRS to enhance transparency of reporting, given a reasonable transition timetable. Dissenters preferred a voluntary solution, arguing that the distributable reserves problem needed to be resolved.

A majority also believed that the FRSSE (and perhaps ultimately the IASB SME standards) should be extended to medium-sized companies to allow them to take advantage of simplified requirements (although a minority feared that the needs of medium-sized companies would then drive the FRSSE). The proposition that UK subsidiaries within groups applying full IFRS should also apply full IFRS, but with reduced disclosure requirements, was supported by a majority who did not wish to maintain two sets of books. Those that disagreed again cited problems of distributable profits[4] and excessive disclosure.

The issue that produced the most fragmented response was the issue of what should happen to entities not included in any other category (e.g. large unlisted companies). While the majority favoured a two tier structure for UK financial reporting (with more opting for the FRSSE than full IFRS) some clearly thought some form of third tier (e.g. a continuation of UK GAAP) was worth the additional cost.

Discussion and conclusion
At first sight it would appear that the debate regarding the appropriate form of regulation for entities excluded from the Regulation (EU, 2002) has progressed remarkably little over the last four years. It is evident that when the decision to adopt IFRS for the group accounts of listed companies was made, no plan was in place for the future of financial reporting for the majority of UK entities, who are required to file GAAP compliant accounts. The EU delegated the issue to member states. In the UK, the DTI (2003) left many options open when it concluded that such entities could choose to adopt IFRS or UK GAAP. This effectively further delegated the problem to the ASB who had to decide the extent to which UK GAAP would be a clone of IFRS, which entities should apply the FRSSE and whether a two or three tier structure was appropriate. The difficulty in obtaining a satisfactory solution is illustrated by the way in which the convergence strategy proposed in 2005 (ASB, 2005) needed to be revisited in 2006 (ASB, 2006a), and in the diversity of responses to consultation processes (ASB, 2006b, c).

While the debate may have progressed only very slowly (and it certainly has not been resolved) it has evolved. In our interviews, no significant impediment was seen to companies, who were part of a listed group, adopting full IFRS. By 2006 there were issues with the calculation of distributable profits and excessive and unnecessary disclosure.

There has been relatively little change in the preferred treatment of small companies, but declining confidence that it can be achieved. At the interviews it was
agreed that full IFRS would be excessively complex and ultimately pointless for such companies, and that a FRSSE (preferably developed by the IASB and based on the measurement and recognition requirements of full IFRS) was probably the best solution (although one interviewee expressed doubts as to whether IFRS measurement principles were appropriate for small companies). By 2006 there was less confidence that the IASB, which was now widely perceived as a body primarily geared to the needs of multinational companies and their stakeholders, would deliver an appropriate set of standards for small companies. Predictably, the initial response to the IASB’s SME standard appears to be that this is not a direct replacement for the FRSSE as it is more complex. In designing it, the IASB actually had in mind a typical SME with about 50 employees, which would place it at the top end the small company category under existing law (Shearer, 2007).

The debate has shifted most regarding the broad range of entities which do not fit into the previous categories. At the interviews the view expressed was that it was important for UK financial reporting to have an internal consistency; that it was important not to erect barriers between listed and non-listed companies; and therefore full IFRS, after an appropriate transition period, would be appropriate. However, by 2006 (i.e. after IFRS had been implemented), perceptions about its complexity had changed thinking, so that many respondents no longer considered IFRS appropriate for medium-sized entities. Even the ASB (2006d) has accepted such arguments by proposing that medium-sized entities should be permitted to use the FRSSE. Concerns have been expressed that this might cause the needs of medium companies to drive the contents of the FRSSE. While the ASB would like essentially two tier regulation (IFRS and FRSSE) there are real difficulties in finding a tractable solution on that model. The proposed dividing line between “big GAAP” and “little GAAP” has shifted so that more companies are now perceived to be in the “little GAAP” category. There is also support for giving larger companies relief from full IFRS, either by extending the scope of the FRSSE or keeping some form of UK GAAP based on a lighter touch IFRS (possibly the IASB’s standard for SMEs). The cost and complication of a three tier model (full IFRS for listed companies, the IFRS SME standard for large private and maybe medium companies and the FRSSE for small companies) may be unavoidable. All this leaves SMEs and the smaller firms of accountants who advise them operating in great uncertainty as to what reporting will be required of them in the medium term.

It is the perceived growing complexity of IFRS that has complicated the debate. This has to some extent been driven by the “Norwalk Agreement” (FASB/IASB, 2002) with fears that IFRS will be pulled towards rule-based solutions to satisfy the American market. Fair value accounting (the source of much of the complexity) is integral to the decision usefulness model of financial reporting which is proposed in the joint conceptual framework being developed up by the two standard setters (FASB, 2006). There is plenty of evidence to suggest that the decision usefulness model is not suitable for smaller companies. They have few users of their accounts (Carsberg et al., 1985; Keasey and Short, 1990), may be owner managed (Jensen and Meckling, 1976) and lack the accounting expertise to deal with complexity (POBA, 2006). Arguably a model of reporting based around the concept of stewardship, using simpler historical cost accounting would be more appropriate.

It is always difficult to design a system of financial reporting regulation which meets the needs of large multinational corporations without imposing excessive
burdens on smaller companies. However, under UK GAAP a reasonable compromise was established. The UK model of accounting regulation has traditionally paid attention to a “think small first” model as all companies had to prepare GAAP compliant accounts. This regulatory model has been reinforced by proportionality and targeting principles of the Better Regulation Task Force (2003). The decision to adopt IFRS throughout the EU has turned this on its head into a “top down strategy” exacerbated by the “Norwalk Agreement” (FASB/IASB, 2002).

One reasonably coherent system of accounting regulation for all companies will be much harder to achieve under IFRS. Few now consider full IFRS suitable for small companies; the majority would question its value for medium companies; and there are doubts about its applicability to larger entities. As far as most companies are concerned, the IFRS project would appear unlikely to meet the Better Regulation Task Force’s (2003) principles of proportionality (few would argue that IFRS is simple and user friendly) and targeting (the whole question of accounting for unlisted companies is treated as a side effect of the main project). That potentially leaves a large number of diverse organisations outside the scope of full IFRS.

We recommend that the reporting needs of each group of entities outside the Regulation (EU, 2002) should be given full and separate consideration rather than trying to fit a diverse group of companies into a reporting model which is inappropriate and costly. It may be impossible to obtain a satisfactory solution with just two tiers of financial reporting, as the complexity of full IFRS makes it unsuitable for most unlisted entities. More radical solutions could be considered. For example, when audit became more complex and more expensive, the burden on small companies was lifted, by excluding them from the requirement to have an audit. Perhaps, it is time to consider relieving small companies of the requirement to prepare GAAP compliant accounts (a cash-based statement would suffice). The focus for the FRSSE (or SME IFRS) could then shift to larger entities (e.g. those currently included in the medium category). An alternative would be to recognise the impossibility of one accounting framework and retain UK GAAP, particularly in an environment where there is disquiet about the IFRS fair value model. The ASB faces a dilemma of the resources it should apply to protecting 1.1 million non-listed companies against over-regulation whilst at the same time supporting the UK’s position on accounting in global markets.

It is interesting that the EC (2006b) is now initiating a debate regarding how the accounting related administrative burdens for SMEs might be reduced. They have also taken the view that the IASB’s SME project will not meet the needs of many smaller companies. Proposed issues for discussion include a further increase in the audit exemption threshold and revision of accounting directives (e.g. to simplify accounting requirements, reduce the choice of available options and reduce disclosure requirements).

There is a need for much more research into the reporting needs of SMEs. Currently in a standard setting environment that is primarily focussed on global capital markets, the default assumption is that what is appropriate for multinational companies is appropriate for smaller unlisted companies, with perhaps some reduced disclosure requirements. The complexity of international business transactions and the related accounting rules are raising serious doubts about the feasibility of retaining one accounting model to fit all entities.
Notes
1. Under EU law companies are classified as small if they have turnover < £5.6m, assets < £2.8m and employees < 50. Small companies may be exempt from audit and may file small company abbreviated accounts. Medium companies have turnover < £22.8m assets < £11.4m and employees < 250 and may file medium company abbreviated accounts.
2. In 2002 and again in 2006 the IASB and the US FASB (whose prime role is to set standards for listed companies) announced plans to converge their standards.
3. The Big Four currently comprise: PricewaterhouseCoopers, KPMG, Deloitte and Ernst & Young.
4. Distributable reserves tend to be eliminated under IFRS due to the treatment of pre-acquisition dividends.

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**Corresponding author**

Tony Hines can be contacted at: tony.hines@port.ac.uk

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