The Threshold, Burden and Usefulness of Financial Reporting for Small and Medium-Sized Entities in KwaZulu-Natal

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Abstract

A subject of debate by standard setters is whether there should be one set of standards for all entities or different standards for different entities (i.e. differential reporting). The aim of this exploratory study is to examine the impact of International Financial Reporting Standards (IFRSs) on Small and Medium-sized Entities (SMEs) by reporting the results of a questionnaire survey which ascertained the perspectives of users of SMEs' financial statements and accounting practitioners in KwaZulu-Natal in three areas: firstly, the threshold (or cut-off) used in the definition of an SME, secondly, whether compliance with IFRSs places a burden on SMEs, and thirdly, the usefulness of SMEs' financial statements to their users.

This study provides evidence that the respondents to this survey were of the opinion that quantitative size criteria are an appropriate element in determining the threshold for differential reporting, that the costs of preparing financial statements by SMEs using IFRSs outweigh any benefits and that users are of the opinion that the financial statements of SMEs are useful mainly to the South African Revenue Service, followed by financial institutions.

Keywords: Differential reporting, SMEs, IFRSs, cost/ benefit constraint.

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Introduction

Prior to the enactment of the Corporate Laws Amendment Act (DTI 2006) on 14 December 2007, all private and public companies in South Africa were required to comply with South African Generally Accepted Accounting Practice (SA GAAP) or International Financial Reporting Standards (IFRSs). The International Accounting Standard Board (IASB) developed IFRSs for listed and multinational companies and did not initially consider the possible impact of IFRSs on small and medium-size enterprises (SMEs) (McBride & Fearnley 1999:71). The objective of IFRSs is to ensure comparability, reliability and the full disclosure of all relevant information to users and more recently, to prevent accounting abuse. However, this has placed a burden on SMEs' financial reporting obligations due to the complex and voluminous nature of these standards. South Africa had been seeking a solution to the increasing complexities of IFRSs on SMEs for some time and in 2007, in anticipation of the enactment of the Corporate Laws Amendment Act which effectively introduced differential corporate reporting, the South African Institute of Chartered Accountants (SAICA) early adopted the Exposure Draft (ED) of an *IFRS for SMEs* (IASB 2007a) developed by the IASB (SAICA 2007).

Problem Statement and Research Questions

SMEs or unlisted entities represent the majority of entities preparing financial statements in all countries (Schiebel 2008:1). Despite the importance of SMEs in a country's economy, SMEs face a number of problems such as access to capital (Luetkenhorst 2004) and compliance with IFRSs. William (2004:16) comments that traditionally standard setters have concentrated on getting it right for listed companies who represent less than 1% of all enterprises while full IFRSs may not be entirely applicable to SMEs.

While studies (Holmes, Kent & Downey 1991; Hattingh 2002; Van Wyk 2005; Wells 2005; Maingot & Zeghal 2006) support the need for differential reporting, there is little consistency in the recommendations as to the appropriate threshold (or cut-off) to be used in the definition of an SME. There is also increasing concern with regards to the high cost of compliance with IFRSs by SMEs (Van Wyk 2005:4; Warren 2004:47; Eurochambres

2004:2; Sealy-Fisher 2005:14). Furthermore, users of SMEs's financial statements are seldom consulted as to the kind of information they require (Schiebel 2008).

This study thus seeks to answer the following research questions:

- What are the perceptions of users of SMEs' financial statements and accounting practitioners on the threshold (or cut off) to be used in the definition of an SME?
- What are the perceptions of users of SMEs' financial statements and accounting practitioners regarding the burden that full IFRSs places on SMEs with emphasis on the cost of complying with IFRSs?
- What are the perceptions of users of SMEs' financial statements and accounting practitioners regarding the usefulness of SMEs' financial statements to certain user groups?

To answer the research questions, the IASB and South African differential corporate reporting requirements are discussed next followed by significant prior research regarding the threshold to be used for differential reporting, the burden of IFRSs on SMEs and the usefulness of SMEs' financial statements to various user groups. The research methodology is then presented followed by the results of the study. Finally, the conclusions, limitations and recommendations for further research are presented.

Differential Reporting Requirements of the IASB and SAICA

The objective of general-purpose financial statements is 'to provide information about the financial position, performance and the changes in financial position of an entity that is useful to a wide range of users in making economic decisions' (IASCF 1989:12). Thus 'IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-orientated entities. Profit-orientated entities include those engaged in commercial, industrial, financial and similar activities, whether organised in corporate or in other forms' (IASB 2007b:para 9). Although the IASB has the preliminary view that the objectives of general-purpose financial statements are the same for all entities, it acknowledges that the types and needs of users of SMEs' financial statements may be different to those of users of financial statements of larger entities (IASB 2004:15).

The preliminary view of the IASB was that the objectives of a set of financial reporting standards for SMEs should:

(a) Provide high quality, understandable and enforceable accounting standards suitable for SMEs globally;
(b) Focus on meeting the needs of users of SME financial statements;
(c) Be built on the same conceptual framework as IFRSs;
(d) Reduce the financial reporting burden on SMEs that want to use global standards; and
(e) Allow easy transition to full IFRSs for those SMEs that become publicly accountable or choose to switch to full IFRSs (IASB 2004:5).

While the IASB did not prescribe a quantitative size test, and rather focused on public accountability, preferring that national jurisdictions would determine which entities would be required or allowed to use IFRSs for SMEs (IASB 2004:21), the IASB focused on a typical entity with about 50 employees. This was not used as a quantitative size test for defining SMEs but rather to help the IASB decide on the kinds of transactions, events and conditions that should be explicitly addressed in the proposed *IFRS for SMEs*.

The South African Department of Trade and Industry (DTI) addressed the issue of differential reporting in its corporate law reform program, which began in 2004 (DTI 2004a). The Corporate Laws Amendment Act, No. 24 of 2006 (DTI 2006) which represents Phase 1 of a two-phase process in reforming corporate law in South Africa provided interim amendments to the current Companies Act and introduced two types of companies for purposes of financial reporting, the widely held company and the limited interest company. As part of Phase 2 of the corporate law process in South Africa, the DTI subsequently issued the Companies Bill, 2007 (DTI 2007). This was superseded by the Companies Bill 2008 (DTI 2008), which has now been issued as the Companies Act, No. 71 of 2008 (DTI 2009).

The Corporate Laws Amendment Act distinguished between widely held and limited interest companies and introduced differential reporting by requiring compliance with different financial reporting standards for the two different types of companies. Because accounting standards had not yet been developed for limited interest companies, section 56(3)(a) of the Corporate Laws Amendment Act provided a transitional provision which, according to SAICA, meant that limited interest companies without public accountability could, in the interim period, either continue to comply with IFRSs, or early adopt the IASB's Exposure Draft (ED) of a proposed *IFRS for SMEs* which SAICA adopted in 2007 as *Statement of Generally Accepted Accounting Practice for SMEs* (SAICA 2007).

The Companies Bill, 2007 (DTI 2007) proposed the following cut-off totals to differentiate between closely held versus widely held for profit companies.

Criteria threshold	**Closely held for profit companies**
Asset value	< R25 000 000
Annual turnover	<R50 000 000
Employees	< 200 employees
Source: Companies Bill, 2007 (DTI 2007).	

Table 1: Proposed threshold for closely held versus widely held for profit companies in South Africa

The above table shows the proposed threshold for distinguishing between closely held and widely held for profit companies in South Africa. A further condition attached to the above thresholds shown in Table 1 was that widely held for profit companies should also satisfy any two of the following three criteria:

- Average asset value over preceding three years exceeds the threshold asset value.
- Average annual turnover over preceding three years exceeds the threshold annual turnover.
- Average number of employees over preceding three years exceeds threshold employees (DTI 2007).

Companies which do not meet these criteria would not have to be audited and the financial reporting framework would be less onerous.

These quantitative size tests are not in the subsequent Companies Bill, 2008 (DTI 2008) nor in the Companies Act, No. 71 of 2008 which superseded the Companies Bill 2008. Instead two types of companies are identified, namely profit companies and non-profit companies. Profit companies can be a state-owned company, a private company or a public company (DTI 2009: Section 8). Section 29 (5) (c) (ii) allows the Minister, after consulting with the Financial Reporting Standards Council, to establish different standards applicable to different categories of profit companies. However, the Companies Act, No. 71 of 2008 does allow some exemption from the audit requirement for companies based on their annual turnover, the size of its workforce or the nature and extent of its activities (DTI 2009: Sec 30(2)(b)(i)). This may indicate that quantitative size criteria are important.

Literature Review

This literature review discusses three areas relevant to this study: the threshold for differential reporting; the burden of IFRSs on SMEs (i.e. the cost/benefit constraint), and the usefulness of SMEs' financial statements to the users of those financial statements.

The Threshold for Differential Reporting

A number of countries define an SME using quantitative size criteria. For example, the European Commission (2003:2) used a combination of staff head count, turnover, and total assets to determine whether an entity is large, medium, small or micro. These are shown in Table 2.

There are considerable differences in opinion regarding the relevant quantitative cut-off points. While the Czech Republic, Germany, Hungary and Poland agree with the EU recommendations of quantitative size criteria for micro entities, Denmark uses lower cut-off points with 10m DKK (€1,270,000) for turnover, but only 4m DKK (€526,000) for total assets. Estonia uses even lower cut-offs of €639,000 and €319,500 for turnover and balance sheet total respectively (IFAC 2006:25). New Zealand, Australia

Enterprise category	**Head count**	**Turnover**	**Balance sheet total**
Large	< 250	< €50million	<€43million
Medium	> 250	> €50million	> €43million
Small	> 50	> €10million	> €10million
Micro	> 10	> €2million	> €2million
Source: European Commission (2003:2) **Legend:** < greater than/ more than; > less than/ fewer than			

Table 2: European Commission classification of SMEs

and China also use size criteria in the definition of SMEs. These cut-off points could also be compared to the criteria referred to in the National Small Business Amendment Act, No. 15 of 2004 (DTI 2004b) (and contained in the National Small Business Amendment Act, No. 26 of 2003) (DTI 2003) which uses the full-time equivalent of paid employees, total turnover, and total gross asset value excluding fixed property to determine whether the size of an enterprise is micro, very small, small or medium. These criteria differ according to the sector or subsectors in accordance with the Standard Industrial Classification.

The disadvantages of using quantitative criteria are that firstly, there is no uniformity because turnover or balance sheet cut-off totals vary between countries rendering comparability difficult. Secondly, there is a need to constantly revise the amounts to meet the growing pace of the economy. Curran and Blackburn (2001:22) also comment that the number of employees can be distorted by the increasing use of part-time employees, casual workers and outsourcing, while balance sheet figures depend upon the specific rules used.

The advantage of using quantitative criteria is that standards may be set for larger and more complex entities, and do not have to take into consideration small entities. These small entities will have their own standards such as *IFRS for SMEs*.

What should be the threshold for differential corporate reporting has been a continuous debate in many countries (Martin 2005:4).

According to Heymans (2000:para 2), the threshold is an issue not only in South Africa but also in leading countries such as the United Kingdom (UK), Australia, New Zealand and Hong Kong. These countries have addressed differential reporting using size criteria (Martin 2005:1). Size has been described by many as a moving target which is not a measure for differentiation. Wells (2005:106) and Holmes *et al*. (1991:128) identify size criteria and also legal structure as an important element in the definition of differential reporting. Wells (2005) concludes that SA GAAP is appropriate for big entities with users with the rate of acceptability being lower where big entities have a narrow user base or a less regulated entity form. Barker and Noonan (1996) use size and ownership structure as elements to be used for the differentiation of big and small entities. A distinction should be made between the 'small entities staying small' and 'small companies growing'. Entities that have ambition to grow are more willing to accept regulations. These entities see the financial statements as a means of attracting investors. Growing companies always look for outside investors and they would continue to prepare their financial statements in accordance with IFRSs.

An alternative to using quantitative size tests is to define SMEs by identifying who are the users of the financial statements.

The Burden of IFRSs on SMEs

The benefits derived from information should exceed the costs of providing the information. SAICA (2003:Par18) concluded that benefits usually decrease with a decrease in the number and diversity of users and their information needs.

Small companies with limited staff and resources might incur significant incremental costs when required to comply with accounting standards. These full standards place a burden on all companies but the cost for large companies with the advantages of economies of scale may not be significant (Upton & Ostergaard 1985:96). Crains, Hosp and Martins (2006:24) comment that it was probably very complex for listed companies too, but they had the necessary resources to bear the costs. According to Crains *et al*. (2006), the three main areas of cost are audit cost at 40%, increased technology cost at 56% and personnel cost at 4%.

Carsberg, Page, Sindall and Waring (1985:18) outline the different types of costs incurred as a result of compliance as follows:

(a) Direct costs paid to auditors and external accountants.

(b) The cost of disclosure of sensitive information to competitors where larger organizations can usually conceal such details in group financial statements.

(c) Opportunity costs. Companies might miss other profitable opportunities because of the extra work required to comply with standards.

(d) The cost of credibility with clients and fee write-off. This is when accountants are required to produce pages of reports which require explanation and for which the clients are reluctant to pay.

(e) The costs of complying with legal requirements.

Cleminson and Rabin (2002) conclude that SA GAAP is a significant problem for SMEs due to complexity of standards and the costs of compliance. Research conducted by Kruger in 2004 as reported by Van Wyk (2005:11) indicates that compliance with SA GAAP is the price to be paid for limited liability and that small entities should have a separate set of accounting standards in order to release these entities from the burden of complying with the SA GAAP.

Carsberg *et al.* (1985) provide some evidence on the burden of GAAP on SMEs from a study on small company financial reporting in the UK. The sampled population comprised directors of SMEs and partners in accounting firms where interviews were done based on questionnaires. They found that small entity directors have little knowledge of the impact of financial reporting on SMEs. Only 4% of these directors thought of financial reporting as a main problem. This was because their financial statements were mostly prepared by the accounting practitioners. Auditors, on the other hand, viewed the burden of financial reporting as serious. Costs identified include:

- the cost of producing financial accounting information, including the direct costs of preparing the information (either from within the business or by hiring an accountant), printing and publishing the information and possibly auditing the information;

- the direct cost, that is the fee paid to the auditors/external accountants;

- opportunity costs which are the loss of profitable opportunities through the burden of compliance; and

- the potential cost of disclosing information to a competitor.

Despite the different costs mentioned in Carsberg *et al.'s* (1985) study as a result of compliance with GAAP by small entities, very little evidence exists to suggest that there is a high burden imposed by the standards on SMEs because a high percentage of the respondents seemed to be unaware of any compliance burden with financial reporting by SMEs.

Eleven years later, Barker and Noonan (1996:13) concluded that the costs of preparing financial statements and audit fees were the most expensive elements of accounting. Practitioners therefore, chose to comply with standards only when these standards are material. Eighty-three percent of the respondents acknowledged that there is a great burden in complying with full GAAP.

Providing a different point of view are Joshi and Ramadhan (2002:438) who examined the relevance of the International Accounting Standards (IASs) (i.e. IFRSs) to small and closely held companies in Bahrain. Joshi and Ramadhan's study examined the attitudes of professional accountants working in these companies. Many of the selected companies had limited liability. The results of the study revealed that 86% of the professional accountants acknowledged that their staff are capable of preparing financial statements based on IASs. Eighty-five percent of the respondents had no difficulties in interpreting these standards. Eighty-five percent of the respondents said IASs are not costly to apply and 86% confirmed that adopting these standards improves the efficiency and effectiveness of financial reporting. It was therefore concluded that IASs were not costly to adopt by SMEs and that these standards help to achieve the objectives and improve the effectiveness of financial reporting.

In 2005, the American Institute of Certified Public Accountants (AICPA) (2005:18) issued the Private Company Financial Reporting Task Force Report in the United States of America (USA). This study targeted external stakeholders, business owners, financial managers and accounting practitioners. All groups, especially the practitioners, perceived it extremely challenging to keep current and up-to-date with GAAP. Most of the external stakeholders rated GAAP as complex in terms of understanding and usage. The majority of the entities surveyed hired external accountants to prepare their accounts due to the complex nature of GAAP. Comparing the benefits of using GAAP with its cost, all respondent groups, especially the practitioners, rated the benefits of preparing or using the standards compared to the cost as being low.

A survey conducted in Canada by Maingot and Zeghal (2006:522) analysed the responses of 162 CAs and Certified General Accountants (CGA) concerning financial reporting of Small Business Entities (SBEs) in Canada. Respondents were asked to rank the weaknesses of GAAP. 'Time consuming' was ranked as the main burden encountered by SBEs as a result of compliance with full GAAP. 'Too complex', 'too costly' and 'lack of relevance' were equally ranked as reporting problems suffered by SBEs. To reduce the burden of reporting by SBEs, computerization of the accounting system was ranked highest. Several recommendations were made such as the setting of special standards and the reduction of regulations and accounting standards. There was very little support for the complete exemption of accounting standards by the respondents.

The Users of SMEs' Financial Statements and their Information Needs

In Australia, the 'the users of financial statements' is an important characteristic in defining an SME (SAICA 2002:3). SAICA (2001) identifies small entities as those entities with a limited number of users and whose users do not rely solely on the financial statements for financial information. Studies have concluded that the users of small entities' financial statements are financial institutions, creditors and the revenue collection service (Van

Wyk 2005:7; Hepp & McRae 1982:56; Anderson 1999; Maingot & Zeghal 2006:525).

The IASB's conceptual framework identifies the key users of financial statements as investors, lenders, suppliers and other trade creditors, employees, customers, government (and their agencies) and the public (IASCF 1989). The main problem faced by the preparers of financial statements is the identification of the needs of users of both private and public companies. Therefore, for financial statements to be useful, it must meet the needs of different users. The information provided should (SAICA 2003:3):

- fulfil the needs of the users;
- be presented in an easy to understand manner to the users;
- enhance comparability over time and also between entities; and
- enable an assessment of the balance between benefit and cost.

SAICA (2003:para14) identifies the users of Limited Purpose Financial Statements (LPFS) as owners, the South African Revenue Service (SARS) and anyone else entitled to receive the financial statements and who has the right to demand extra information if desired.

Riahi-Belkaoui (2004:50) differentiates between the primary users of financial statements of public companies who are financial analysts and public shareholders as opposed to private companies whose primary users are the owner managers and creditors. These different groups of users are perceived to have different information needs. However, in the conceptual framework, investors are the defining class of users since it is thought that if the contents of financial statements are drawn up with the needs of investors in mind, the various needs of other potential and current users will also be satisfied (IASCF 1989).

Crains *et al*. (2006) analysed the differences between investors in large listed companies and small entities. Investors in large companies need relevant information to buy, hold or sell shares and also to make future decisions over their holdings while investors in SMEs do not have the ability to increase or dispose of their holdings except in the long run.

Although the IASB's preliminary view is that full IFRSs are suitable for all entities, the IASB noted that the users of SMEs' financial statements may have less interest in some information in financial statements compared to the users of financial statements of entities that have public accountability (IASB 2004:14). For example, the IASB considers that users of SMEs' financial statements may have more interest in short-term cash flows rather than long-term cash flows. The IASB conclude that any differences in full IFRSs and *IFRS for SMEs* will thus be determined on the basis of user needs and cost-benefit analyses. This has led to some criticism of the IASB as it has been contended that the IASB has not considered two vital questions:

1. Who are the external users of SMEs' general purpose financial statements worldwide?
2. What kind of information do those external users need from SMEs? (Schiebel 2008:17).

The AICPA found that there are few users of small company financial statements (Mosso 1983:18). Sixty five percent of small private companies studied by the AICPA have eight or fewer owners and many were owner managers. This was in contrast to large companies which often had more than 300 shareholders. The number of creditors for small entities is also very small when compared to large companies (Mosso 1983:18). Users of small entities' financial reports are predominantly different kinds of people with different kinds of needs from the users of large companies' financial reports, and consequently no practical need exists for comparability.

Unlike public companies, private companies' financial statements are not public documents. They are used only by the managers, tax authorities and creditors. These users have the right to demand additional information.

There has been little research into identifying who are the users of SMEs' financial statements and what their information needs are (Schiebel 2008). Schiebel is of the opinion that this should be the starting point for developing accounting standards for SMEs. To substantiate his position, Schiebel (2008:11) examines the literature on common information needs of external users of SMEs' financial statements and concludes that the research so far has focused on 'one group of external users and one region or country at a time', and that '[n]o information is available about the common information needs of various external groups on a national or international level.' He argues furthermore that the IASB failed to determine the information needs of external users of SMEs financial statements and the kind of information those external users require from SMEs, and instead has relied on the responses by the accounting regulators, profession and academics when the IASB should have focused on the users and preparers of SMEs' financial statements (2008:18). Literature quoted by Schiebel (2008) includes Evans, Gebhardt, Hoogendoorn, Marton, di Pietra, Mora, Thinggård, Vehmanen, and Wagenhofer (2005) who identified significant gaps in the research literature on SMEs findings and concluded that relatively little is known about the actual views and needs of owner-managers and other users, and Anacoreta and Silva (2005) who note that 12% of the commentators to the IASB's *Discussion Paper* request the IASB to do detailed research into the common information needs of external users of SMEs' financial statements. Evans *et al.* (2005) recommend that the IASB initiate in-depth research to determine to what extent the needs of owner-managers and other users of SME financial statements differ between larger versus the smaller SMEs, and to what extent they may differ internationally. Schiebel (2008) also referred to Sinnett and de Mesa Graziano whose study for the Financial Executives Research Foundation (FERF) in 2006 identified that commercial and investment bankers and equity investors want audited annual US GAAP financial statements, and in fact want more information from unlisted entities than is provided under US GAAP.

The literature survey of Botosan, Ashbaugh-Skaife, Beatty, Davis-Friday, Hopkins, Nelson, Ramesh, Uhl, Venkatachalam, and Vrana (2006) concludes that the major users of unlisted entities' financial statements do not see a need for differential financial reporting and prefer US GAAP. They recommend the IASB to respond cautiously to requests for GAAP exceptions supported primarily by complexity arguments.

Research Methodology

This exploratory study, which provides descriptive data only, examines the perceptions of users of SMEs' financial statements and accounting practitioners (as the preparers of SMEs' financial statements) towards the threshold (or cut-off) to be used for differential reporting, the costs associated with complying with IFRSs and the usefulness of SMEs' financials statements to its user groups.

To represent the target group of users of SMEs' financial statements, Masters in Business Administration (MBA) students were chosen. This group was characterized by all respondents having a minimum of five years work experience of which three years were either at a supervisory or management level. This respondent group had all completed a module in financial accounting and were all aware of differential reporting. Further-more, they were either employees or owner-managers. As such, this target group was used as a surrogate for the users of SMEs' financial statements.

Liyanarachchi (2007) reviews and syntheses research in this area and finds that accounting students may be adequate surrogates for practitioners in many decision-making experiments. Elliot, Hodge, Kennedy and Pronk's (2009) results indicate that MBA students can be used as proxies for non-professional investors (i.e. users of information) provided that the task is aligned to their appropriate level. In the current study the research task involved answering a questionnaire on a topic of which they had some knowledge and experience. The MBA students were therefore considered suitable to express an opinion on the impact of IFRSs on SMEs.

The choice of the accounting practitioners stems from the fact that they are all chartered accountants (CAs) and thus more knowledgeable or better informed on IFRSs. A background question revealed that 44% of the practitioners had less than four years experience, 22% of the practitioners had between four and twelve years experience and 26% of the respondents had more than twelve years experience. Two practitioners (8%) did not answer this question. Although the respondents had a range of years of experience, the prevalence of more respondents with less experience has also been documented in other South African studies. For example, in the Wells' (2005) study, 30% of his target group had less than 10 years experience.

With regards to size of practice, 15% of the respondents indicated that they belonged to a large practice; 37% belonged to a medium-sized practice and 37% belonged to a small practice. Three respondents (11%) did not answer this question. This analysis shows that the respondents had varying amounts of experience and belonged to different sizes of practices.

However, because the number of respondents in each background demographic is low, experience and size of practice was not used in the analysis of the results which follow.

The target groups were not chosen by statistical sampling but conveniently from the MBA class at the University of KwaZulu-Natal (UKZN) and the population of chartered accountants in KZN. A total of 45 questionnaires were handed out to the MBA students and only 14 (31%) completed questionnaires were returned.

To distribute the questionnaires to the accounting practitioners' target group, three visits and three meetings were held with the Regional Director of SAICA in KZN. As an attempt to e-mail the questionnaire to sixty accounting firms resulted in few replies, accounting firms in Durban were visited and copies of the questionnaire were left for later collection. Out of 161 questionnaires that were administered to the accounting practitioners, only 31 (19%) were returned.

To ensure the reliability and validity of the data, methods of measuring reliability were not used as the target groups were sophisticated sub-populations of all MBA students at UKZN or all chartered accountants at selected accounting firms in Durban. Therefore, reliability was expected. With regards to validity, in view of the straightforwardness of the questionnaire, and the reasonableness of the responses, it was concluded that the questionnaire possessed validity and other methods of approaching validity were not pursued.

Discussion of the Results

Although the theoretical justification of differential reporting lies in the consideration of the cost/benefit constraint and the objective of financial statements, the questionnaire first set out to establish from the respondents whether IFRSs are suitable for all entities irrespective of size, type and nature of the entity. The reason for this question is to establish whether or not the respondent groups are of the opinion that different entities may require different reporting standards and if so, they would then have an opinion on the various matters which were being investigated in this study. The results of this question are shown in Table 3.

	Users		Practitioners		Total	
	No.	**%**	**No.**	**%**	**No.**	**%**
Agree	7	50	4	15	11	24
Disagree	7	50	23	85	30	76
Total	**14**	**100**	**27**	**100**	**41**	**100**

Table 3: Are full IFRSs suitable for all entities irrespective of size, type and nature?

An inspection of the total responses presented in Table 3 suggests that full IFRSs should not be considered suitable for all entities. However, the users were split evenly on this issue. This is not true of the practitioners since 85% of the practitioners disagree with this assertion. The support for full IFRSs by users of SMEs may be because their annual financial statements are prepared by experts or CAs hired by their entities or, the MBA students as surrogates for the user group, are not as aware as the practitioners of the issues surrounding the use of full IFRSs. Practitioners may be in a better position to assess the burden of IFRSs on SMEs, hence their lower support.

Reasons given by those respondents who consider full IFRSs suitable for SMEs are that it enhances comparability within entities and countries; that all entities should apply the same standards; that these standards are important enough to be maintained; that small businesses will have the opportunity to do business with large companies and obtain loans from banks; that there should be common standards which all entities should follow irrespective of their size; and that financial statements will be reliable as a result of using full IFRSs. They also perceived that the global application of a one-tier system will lead to harmonization of accounting standards.

On the other hand, respondents who did not perceive full IFRSs to be suitable for SMEs stated that it is too costly; that the standards lack relevance; that much time is needed in the preparation of the financial statements; that the standards are constantly being revised; and that they are very complex. Some other arguments against full IFRSs are that IFRSs are designed for large listed entities; certain aspects of IFRSs provides no value to small entities; certain aspects of IFRSs are not applicable to small entities and should be discarded; clients resist the high fee which arises as a result of lengthy reports; and there is the need to keep records simple for small entities because detailed disclosures add little value to the entity.

Overall, these results confirm the findings by Holmes *et al*. (1991), Hattingh (2002) and Wells (2005) that there is support for differential reporting, although in this current study, the users are neutral in their response.

The Threshold for Differential Reporting

One of the key issues to be addressed in the context of differential reporting is the use of quantitative size criteria in the definition of SMEs. Respondents were first asked whether size is considered an appropriate element in the definition of SMEs. The results of this question are shown in Table 4.

	Users		**Practitioners**		**Total**	
	No.	**%**	**No.**	**%**	**No.**	**%**
Yes	11	79	17	63	28	68
No	3	21	10	37	13	32
Total	**14**	**100**	**27**	**100**	**41**	**100**

Table 4: Are quantitative size criteria an appropriate element in the definition of SMEs?

The aggregate responses presented in Table 4 suggest that a quantitative size criterion is considered to be a suitable element in the definition of SMEs with 68% of all respondents in agreement. Size is considered an appropriate criterion in the definition of SMEs by 79% of the users. Only 63% of the practitioners perceived size as being important. This result supports the current situation in the UK, Australia and New Zealand where quantitative size criteria are used as a distinguishing factor for small and large entities.

In order to identify the cut-off values for a suitable size threshold in the definition of SMEs, respondents were asked to suggest suitable amounts for total assets, turnover and number of employers. This question was directed only to those who perceived quantitative size criterion to be an important element in the definition of SMEs. These results are shown in Table 5.

Table 5 shows that all the respondents who considered size to be an appropriate criterion in the definition of SME proposed an amount for the three elements. Users prefer total assets up to R5 million, revenue up to R5 million and total employees of between 20 and 30. The practitioners, on the

		Users		**Practitioners**		**Total**	
		No.	**%**	**No.**	**%**	**No.**	**%**
Total assets	R0-R5m	7	64	5	29	12	43
	R5m-R10m	0	0	3	18	3	11
	R10m-R15m	0	0	3	18	3	11
	R15m-R20m	3	27	1	6	4	13
	R20m-R25m	1	9	2	12	3	11
	R25m and >	0	0	3	17	3	11
	Total	**11**	**100**	**17**	**100**	**28**	**100**
Revenue	R0 -R5m	7	64	1	6	8	29
	R5 m– 10m	0	0	3	18	3	11
	R15m-R20m	2	18	0	0	2	7
	R20m-R25m	2	18	0	0	2	7
	R25m and >	0	0	13	76	13	46
	Total	**11**	**100**	**17**	**100**	**28**	**100**
Number of employees	1-10	2	18	0	0	2	7
	10-20	0	0	0	0	0	0
	20-30	5	46	1	6	6	21
	30-40	1	9	7	41	8	29
	40-50	3	27	1	6	4	14
	50 and >	0	0	8	47	8	29
	Total	**11**	**100**	**17**	**100**	**28**	**100**
Note: Total responses correspond to ‘yes’ in Table 4.							

Table 5: Amounts considered suitable in the definition of SMEs

other hand, showed no clear preference with respect to total assets, but preferred revenue of more than R25 million and total employees of more than 50 (with the majority of the practitioners preferring total employees exceeding 30). Table 5 indicates that even though a majority of the respondents support size as an appropriate element in the definition of SMEs, choosing the value of total assets, revenue and number of employees to be used for the threshold of differential reporting is a debatable issue especially for the user group, with the practitioners applying much higher parameters than the user group.

Apart from size, all respondents were asked to identify any other elements that should be taken into account in the definition of SMEs. Table 6 shows the perceptions of respondents concerning other elements that should be used in the definition of SMEs.

	Users (n=14)		**Practi-tioners (n=27)**		**Total (n=41)**		**Rank**
	No.	%	No.	%	No.	%	
Users of financial statements	10	71	22	81	32	71	**=1**
Public versus non-public accountability	5	36	19	70	24	53	**=2**
Reliance on registered accountants and auditors	10	71	14	52	24	53	**=2**
Lack of board structure	9	64	8	30	17	38	**3**
Owner-managed business	9	64	23	85	32	71	**=1**
Number of owners/shareholders	0	0	16	59	16	36	**4**

Table 6: Other elements that could be used in the definition of SMEs

Overall, the respondents consider the users of financial statements and whether the SME is an owner-managed business as the most important elements in the definition of SMEs. Accounting versus non-accounting accountability and reliance on registered accountants and auditors was ranked second overall. Lack of board structure, although poorly rated by practitioners, was considered important by the users. The number of owners/shareholders was rated higher by the practitioners. These results show some support for the IASB where public versus non-public accountability is considered an important element in the definition of SMEs.

Table 6 also shows that users find reliance on registered accountants and auditors to be an important element to be used in the definition of SMEs. A possible reason for support for reliance on registered accountants and auditors as an element to be used in the definition by users could be that most of these respondents rely highly on the registered accountants and auditors for the preparation of their financial statements.

The preference of public versus non-public accountability by practitioners may stem from the fact that practitioners are probably more up-to-date with the deliberations of the IASB which may have influenced their perceptions. However, owner-managed business is ranked first by practitioners (85%). This may be because most owner-managed businesses are usually small in size and the owners are the primary users of the financial statements.

The results in Table 6 may indicate that more than one element could be used in the definition of SMEs.

The Burden of IFRSs on SMEs

Respondents were asked to evaluate IFRSs in terms of the cost of complying with IFRSs, and its volume and complexity. These results are shown in Table 7.

The results presented in Table 7 indicate that IFRSs are perceived by the respondents to be costly, voluminous and complex. This result confirms the findings in Table 5 that full IFRSs are not suitable for all entities. ‘Costly’ is ranked highest (80%) by the total respondents and ‘complex’ and ‘voluminous’ are ranked equal second (78%).

The users considered IFRSs less costly, less complex and less voluminous than the practitioner group. As users of SMEs’ financial statements, they are unaware of the complex and voluminous nature of IFRSs.

The practitioners perceive that full IFRS is very costly, too voluminous and too complex for SMEs. As the practitioners are also CAs,

		Very Costly	**Costly**	**Less Costly**	**Moderate**	**Total**	**Very costly and costly No.** [1]	**%**	**Rank**
1	2	3	4	5	6	7	8	9	10
Evaluation of IFRS in terms of cost	Combined	17	16	3	5	41	33	80	2
	Users Pracs.	1 16	7 9	2 1	4 1	14 27	8 25	57 93	1 1
		Too voluminous	**Voluminous**	**Less voluminous**	**Moderate**	**Total**	**Too voluminous**	**%**	**Rank**
Evaluation of IFRS in terms of volume	Combined	17	15	4	5	41	32	8	2
	Users Pracs.	3 14	4 11	3 1	4 1	14 27	7 25	0 93	2 1
		Too complex	**Complex**	**Less complex**	**Moderate**	**Total**	**Too complex and**	**%**	**Rank**
Evaluation of IFRS in terms of complexity	Combined	20	11	6	3	40	31	78	2
	Users Pracs.	3 17	4 7	4 2	2 1	13 27	7 24	50 89	2 2

[1]The numbers in column 8 are derived from the summation of the first two columns.

Table 7: Evaluation of IFRSs in terms of cost, volume and complexity

they are in a better position to assess the burden of IFRSs since they use these standards to prepare financial statements.

Respondents were asked to list the different ways through which costs are incurred by SMEs as a result of complying with full IFRSs. The majority of the practitioners listed audit fees and accounting fees. Other costs incurred as a result of complying with IFRSs were perceived to be revaluation costs, increased personnel expenses, the possibility of misinterpreting information by employees due to their limited knowledge of IFRSs, payments to IT specialists for a system change, software costs, cost of extra time, additional costs of disclosure, outsourcing of services, the lack of professionals to assist in compliance with IFRSs by SMEs, costs of keeping up-to-date with changing standards, and the cost of hiring experts to provide reliable information.

Many of the users of SMEs did not answer this question possibly because they consider complying with IFRSs suitable for all entities (see Table 3).

Apart from cost, respondents were asked to identify other factors considered to be a burden on SMEs as a result of complying with IFRSs. The factors indicated by the respondents include that IFRSs requires technically complex record keeping, requires constant revision of standards, is too complex for users and preparers to understand, is too complex for a layman to understand, is time consuming, is too voluminous, involves accounting standards that are unnecessarily onerous, and brings about employees' dissatisfaction due to increased workload.

Table 8 shows the results of a question which asked respondents to rank the difficulties faced by SMEs.

An examination of the combined results shows that the problem of obtaining finance is perceived to be the main difficulty faced by SMEs (68%), followed by compliance with legislation (62%). There is limited support for the burden of preparing financial statements and competition (51%), high audit fee (36%) and black economic empowerment (34%).

The break down of the results indicates a difference in the responses of the users and the practitioners. Users see the burden of preparing financial statements and audit fees to be the most significant problem (71%), followed by compliance with legislation (64%) and then the problem of obtaining finance (57%).

		Too heavy	Heavy	Neutral	Less heavy	Not heavy	Total	Too heavy and heavy		Rank
		No	**No**	**No**	**No**	**No**	**No**	**No[1]**	**%**	
1	2	3	4	5	6	7	8	9	10	11
Compliance with legislation	Combined	11	14	4	6	6	41	25	62	2
	Users	5	4	0	3	2	14	9	64	2
	Pracs.	6	10	4	3	4	27	16	59	2
Black economic empowerment (BEE)	Combined	6	8	3	14	10	41	14	34	6
	Users	2	3	0	4	5	14	5	36	4
	Pracs.	4	5	3	10	5	27	9	33	5
Problem of obtaining finance	Combined	19	9	4	3	6	41	28	68	1
	Users	5	3	1	2	3	14	8	57	3
	Pracs.	14	6	3	1	3	27	20	74	1
Burden of preparing financial statements	Combined	12	9	2	7	11	41	21	51	3
	Users	6	4	0	3	1	14	10	71	1
	Pracs.	6	5	2	4	10	27	11	40	4
High audit fee	Combined	4	12	1	5	19	41	16	36	5
	Users	2	8	0	2	2	14	10	71	1
	Pracs.	2	4	1	3	17	27	6	22	6
Competition	Combined	10	10	2	7	11	41	20	50	4
	Users	3	0	0	4	6	14	3	21	5
	Pracs.	7	10	2	3	5	27	17	63	3

[1]The numbers below are derived from the summation of the first two columns.

Table 8: Ranking of difficulties faced by SMEs

Practitioners on the other hand identify the problem of obtaining finance as the main significant difficulty faced by SMEs. The burden of preparing financial statements by SMEs does not seem to be a prime issue especially to the practitioners because only 40% of the practitioners rated it as a difficulty faced by SMEs. Although difficulties such as raising finance, legislation, competition and BEE might be a problem to most small entities, the use of IFRSs by SMEs has led to a heavier burden due to the increase in the audit fees, and the complex nature of preparing financial statements.

Due to the complex standards developed by the IASB, SMEs rely on external accountants or accounting experts in the preparation of their annual financial statements (Carsberg *et al.* 1985:33). Table 9 summarises the results of the question asking who mostly prepares the annual financial statements of SMEs.

The aggregate responses in Table 9 suggest that external accountants or experts mostly prepare the financial statements of SMEs. This may be because IFRSs are too complex and technical for the directors and account-

	Users			**Practitioners**			**Total**		
	No	**%**	**Rank**	**No**	**%**	**Rank**	**No**	**%**	**Rank**
Accountants employed by SMEs	4	28	**3**	6	22	**2**	10	24	**2**
External accountants or experts	5	36	**1**	18	66	**1**	23	56	**1**
The director and the accountants	4	29	**2**	1	4	**3**	5	12	**3**
Managers only	0	0	**5**	1	4	**3**	1	3	**5**
Did not respond	1	7	**4**	1	4	**3**	2	5	**4**
TOTAL	**14**	**100**		**27**	**100**		**41**	**100**	

Table 9: Preparation of the annual financial statements of SMEs

ants of SMEs. By implication, extra money is required to hire external accountants or experts to prepare the financial statements of SMEs which leads to increased costs. This result shows little support for accountants employed by SMEs, the directors and the accountants of SMEs and managers as preparers of the annual financial statements.

The result of the current study is similar to Carsberg *et al*. (1985:33) as both respondent groups rank external accountants or experts highest.

The Usefulness of Financial Statements to Users

The results of the question asking respondents for their opinion on the usefulness of SMEs' financial statements to certain users are summarized in Table 10.

The aggregate responses presented in Table 10 indicate high overall support for the usefulness of the financial statements of SMEs to SARS (98%) and financial institutions (95%). The degree of support is lower for shareholders, analysts and managers. This overall response is consistent with those of the individual respondent groups since both users and practitioners favour SARS and financial institutions as important users of financial statements of SMEs. According to the users of SMEs, all five categories of users of financial statements of SMEs are considered important although SARS and financial institutions are ranked highest. Practitioners did not consider analysts, managers and shareholders/owners as the main users of the financial statements of SMEs. The low ranking of analysts could be justified by the fact that they are mostly concerned with public companies. The poor support for shareholders is surprising because prior research indicates strong support for shareholders/owners since the financial statements are used in decision making by this user group.

The results of this study are slightly different from those conducted by Barker and Noonan (1996:19) in which there was majority support for directors/owners, financial institutions and revenue (tax) respectively. Suppliers, customers and employees were perceived to be less important users.

		Very useful	**Useful**	**Neutral**	**Less useful**	**Not useful**	**Total**	**Very useful plus useful No**[1]	**%**	**Rank**
1	2	3	4	5	6	7	8	9	10	11
Financial institutions	Com-bined	27	12	1	1	0	41	39	95	2
	Users	11	1	1	1	0	14	12	86	2
	Pracs.	16	11	0	0	0	27	27	100	1
South African Revenue Service (SARS)	Com-bined	29	11	1	0	0	41	40	98	1
	Users	11	2	1	0	0	14	13	93	1
	Pracs.	18	9	0	0	0	27	27	100	1
Managers	Combi ned	14	9	5	9	4	41	23	56	4
	Users	8	4	1	0	1	14	12	86	2
	Pracs.	6	5	4	9	3	27	11	41	3
Shareholde rs/ owners	Combi ned	16	9	3	12	1	41	25	61	3
	Users	10	3	0	1	0	14	13	93	1
	Pracs.	6	6	3	11	1	27	12	44	2
Analysts	Combi ned	14	9	7	7	4	41	23	56	4
	Users	8	3	0	2	1	14	11	79	3
	Pracs.	6	6	7	5	3	27	12	44	2
[1]The numbers in column 9 are derived from the summation of the first two columns.										

Table 10: The usefulness of SMEs' financial statements to certain user groups

Conclusions, Limitations and Recommendations for Further Research

This study provides evidence that there is support for differential reporting as overall the respondents did not consider IFRSs suitable for all entities irrespective of size, type and nature.

This study provides evidence that there is support for the use of quantitative size criteria as an appropriate element in the definition of SMEs. However, there was no clear preference on the appropriate value for total assets, revenue and number of employees to be used in the definition of SMEs. It is interesting to note that the Companies Act, No. 71 of 2008 indicates that quantitative thresholds may be used to determine whether or not a non-public company is audited.

The users of financial statements and whether it was an owner-managed business were identified as important elements in the definition of SMEs. Public versus non-public accountability and the reliance on registered accountants and auditors were other important variables considered relevant in the definition of SMEs.

With regards to the evaluation of IFRSs in terms of cost, volume and complexity, the practitioners were more in agreement than the users that IFRSs were costly, voluminous and complex (see Table 7). A reason advanced for this is that the practitioners are in a better position than the users to have an informed opinion on this matter. The difficulties faced by SMEs are not only financial statement preparation, but also such matters as obtaining finance and complying with legislation. External accountants or experts were found to be the preparers of the financial statements, and with respect to the users, SMEs' financial statements were seen as most useful to SARS.

While this study also provides support for the theoretical justification for differential reporting with respect to the cost/benefits of complying with IFRSs, less clear is whether financial statements prepared using *IFRS for SMEs* will indeed satisfy the needs of the users. All the users listed in the question on the usefulness of SMEs' financial statements, with the exception of the analysts, can demand additional information from the SMEs (see Table 10). The main user, SARS, may prefer the financial statements prepared on a tax basis.

This study does have some limitations. Firstly, the choice of KwaZulu-Natal for both target groups means that the results cannot be generalized to different target groups or to the rest of South Africa. Secondly, the response rate was low with a consequent low level of statistical tests. However, despite these limitations, this exploratory study provides useful and relevant information and extends the research in this area.

Future studies could focus on different user groups such as actual SME owners and provide a better understanding of who are the users of SMEs' financial statements and what are their needs for information and whether *IFRS for SMEs* satisfies this need. This could be done through structured interviews to solve the problem of low response rates. This would provide confirmatory evidence for SAICA and the IASB that *IFRS for SMEs* does meet the different needs for information by the users of SMEs' financial statements.

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