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

Dinuja Perera, Parmod Chand

Department of Accounting and Corporate Governance, Macquarie University, North Ryde, NSW 2109, Australia

Abstract

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

1. Introduction

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

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

This movement towards the convergence of IFRS for SMEs still seems to be controversial for a number of reasons. Interestingly, the degree to which IFRS for SMEs have been adopted or rejected by countries creates several arguments. Deloitte Touche Tohmatsu reports that “many countries are moving towards adoption of the IFRS for SMEs, although it appears those countries may not have required IFRS accounting ‘across the board’ prior to moving to implementation” (AASB, 2010a, 1). In contrast, more prominent developed countries that have adopted the full set of IFRS, such as Australia, the United Kingdom, and European Union member states, have not yet adopted IFRS for SMEs. Many countries including Australia are of the view that IFRS for SMEs still appear to be complex in recognition and measurement principles (AASB, 2010a). Moreover, the European Commission (EC) is of the view that the objectives of simplification and reduction of administrative burden for SMEs has not yet been served by the IFRS for SMEs (European Commission (EC) Explanatory Memorandum, 2011). Such
concerns raised by prominent countries or regions highlight several issues for IFRS for SMEs and their implementation. The entities (non-publicly accountable entities) that are envisaged as being eligible to apply the IFRS for SMEs represent more than 95% of all companies globally (RSM International Association, 2009). The need to develop an appropriate regulatory framework and to enable comparable accounting information to be provided by SMEs is considered to be highly important. Therefore, it is vital to examine the conceptual and technical difficulties encountered by those countries that have rushed to adopt IFRS for SMEs. This paper attempts to provide extensive insights on the development and implementation process of IFRS for SMEs around the world. Such analyses and insights will assist in revising the IFRS for SMEs and will minimize future complications in the SME convergence process.

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

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

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

2. Accounting regulatory framework for SMEs

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

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

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

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

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

2 The IFC is the leading technical advisor to the G–20 Global Partnership for Financial Institutions’ (GPFIs) SME Finance sub-group and is a member of the World Bank group, which prepares the SME Finance Policy Guide for the World Bank.
3. Definitions for small and medium-sized enterprises

It is generally claimed that there is no universally accepted definition for SMEs. In fact, it is difficult to adopt a universal definition for SMEs due to differences in firm size, sectors, culture and the development status of economies in which SMEs operate (Kushnir, 2010; UNCTAD, 2007b). Gibson and Vaart (2008) propose a new quantitative formula for defining SMEs that takes into account the revenue of a company and the country-specific economic context in which the SME operates.\(^3\)

The economic considerations (Gross National Income and Purchasing Power Parity) incorporated into this formula would ensure a consistent approach for defining SMEs in USD terms across countries and would improve the comparability between different SMEs operating in the global market, thereby overcoming the difficulties of adopting a one-size-fits-all approach (Gibson & Vaart, 2008). However, some definitions specific to international organizations (for example, the European Commission, World Bank, and United Nations Development Programme) and country-specific definitions for SMEs remain prominent and are often based on size-thresholds such as employee headcount, annual turnover and total asset values.

The European Commission (EC) adopted the Commission Recommendation 2003/361/EC of 6th May 2003 on the new definition of SME with effect from 1st January 2005 (EC, 2003). The EC is of the view that “it is essential that measures in favour of SMEs are based on a common definition to improve their consistency and effectiveness and to limit distortions of competition” (EC, 2003, 6).

As shown in Table 1, EC has three distinct categories of SMEs. In the largest category, medium-sized enterprises consists of enterprises that employ less than 250 employees with an annual turnover of less than or equal to 50 million Euros and an annual balance sheet total of less than or equal to 43 million Euros. Secondly, small enterprises are defined as enterprises which employ less than 50 employees and whose annual turnover or annual balance sheet total does not exceed 10 million Euros. Thirdly, micro enterprises are defined as enterprises which employ less than 10 employees and whose annual turnover or annual balance sheet total does not exceed 2 million Euros. The employee headcount threshold is compulsory; however it is not mandatory to meet both turnover and balance sheet thresholds concurrently (EC, 2003). This ensures that SMEs engaged in different types of economic activity are treated fairly, given that their financial information is by nature different. In accordance with the definition, an entity needs to be an “enterprise” to qualify as an SME, defined as any entity engaged in an economic activity, irrespective of its legal form (EC, 2003).

It is worthwhile to note that the criteria defined in the EC definition are the key conditions for treating an enterprise as an SME. An enterprise will be treated differently depending on whether the enterprise has any relationships, partnerships or links with other enterprises. The EC has affirmed that the use of the definition is voluntary for its Member States, though the Commission, together with the European Investment Bank and the European Investment Fund, urges them to apply it as widely as possible (EC, 2003).

The World Bank identifies only the maximum threshold for defining SMEs, with no classification made between micro, small and medium enterprises to reflect the size of the enterprise. As defined by the World Bank, the maximum threshold for the number of employees is 300, with maximum revenue (turnover) and assets value of 15 million US dollars each (Gibson & Vaart, 2008).

There is no common definition for SMEs in Asia Pacific Economic Corporation (APEC) economies (see Table 1 for examples). In Australia, for example, the Australian Bureau of Statistics (ABS) defines a micro enterprise for statistical purposes as an enterprise that has less than 4 employees. A small enterprise is defined as an actively trading business that has less than 19 employees, and a medium enterprise as an actively trading business that has between 20 to 199 employees (DIISR, 2011).\(^4\)

Australian SME financial reporting is based on the Reporting Entity Concept as defined by the Statement of Accounting Concepts (SAC 1) (Public Sector Accounting Standards Board, 1990).\(^5\)

In Canada, the Public Works and Government Services of Canada (PWGSC) defines SMEs as enterprises whose employee count is less than 500. The threshold for small manufacturing enterprises is less than 100 employees and for service enterprises are less than 50 employees (PWGSC, 2011). In Korea, the Small Business Corporation (SBC) of Korea defines SMEs as enterprises that have less than 300 employees with a capital worth of $8 million or less for manufacturing enterprises. They categorize micro and small manufacturing enterprises as those that employ 10 and 50 employees respectively (SBC, 2009).

Singapore adopted a new definition for SMEs with effect from 1st April 2011, whereby an SME is defined as a company whose annual sales turnover is not more than $5100 million or who employs not more than 200 workers (The Standards, Productivity, & Innovation Board Singapore, 2011). In Japan, the Ministry of Economy, Trade and Industry (METI) defines SMEs in four industry categories; manufacturing, wholesale, retail and services, and a Japanese SME is defined as an enterprise which employees 300 or less people and whose capital size is ¥ 300 million or less (EU, 2010).

The Asian Development Bank (ADB) has not introduced a formal definition for SMEs; however, ADB relies on country-specific definition in its place. There is no common definition for SMEs among South Asian countries; instead, different countries adopt different definitions for SMEs decided by their own parameters (see Table 1 for South Asian country-specific SME definitions).

The United States of America (US) takes a different approach to defining SMEs. The Small Business Administration (SBA) has established “Size Standards” for small businesses (SBA, 2012).\(^6\) A size standard is stated in the number of employees or average annual receipts, and is set for each individual North American Industry Classification System (NAICS) coded industry.\(^7\) Based on these criteria, SBA has established a standard of 500 employees for most manufacturing and mining industries and US$7 million in average annual receipts for most non-manufacturing industries (SBA, 2012).\(^8\) The US definition for small businesses seems complex in nature, but variations in size standards are assumed to depict industry differences better than any other definitions discussed so far.

The IASB adopted a definition for SMEs when IFRS for SMEs came into effect in July 2009. According to the standard, SMEs are entities that:

a) do not have public accountability, and

b) publish general purpose financial statements for external users.

Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies (IASB, 2009a, 10).

An entity has public accountability if:

a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public

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\(^3\) The proposed formula is expressed as Annual Turnover between USD minimum 10–maximum 1000 + mean per capita gross national income at purchasing power parity of the country in which the SME operates.

\(^4\) Actively Trading Businesses are businesses that have an Australian Business Number (ABN).

\(^5\) A Reporting Entity is defined as follows: “an entity in respect of which it is reasonable to expect the existence of users who rely on the entity’s general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprised of a parent and all of its subsidiaries” (AASB, 2011, 10).

\(^6\) The SBA is a US government agency that provides a wide range of financial and counselling support to entrepreneurs and small businesses.

\(^7\) NAICS is the standard used by Federal statistical agencies to classify business establishments for the purpose of collecting, analyzing and publishing statistical data related to the US business economy.

\(^8\) See http://www.dbas.gov/content/summary-size-standards-industry for a summary of size standards by industry.
Table 1
Size threshold for SMEs worldwide.

<table>
<thead>
<tr>
<th>Region/country</th>
<th>Micro enterprise</th>
<th>Small enterprise</th>
<th>Medium enterprise</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Employee headcount</td>
<td>Total assets/total annual turnover</td>
<td>Employee headcount</td>
<td>Total assets/total annual turnover</td>
</tr>
<tr>
<td>European union</td>
<td>&lt; 10</td>
<td>≤ €2 million and ≤ €2 million Employee headcount</td>
<td>&lt; 50</td>
<td>≤ €10 million and ≤ €10 million Employee headcount</td>
</tr>
<tr>
<td>APTC</td>
<td>&lt; 4</td>
<td>&lt; 19 employees for manufacturing</td>
<td>&lt; 19</td>
<td>≤ 100 employees for manufacturing</td>
</tr>
<tr>
<td>Australia</td>
<td></td>
<td>≤ 10 employees for manufacturing</td>
<td>&lt; 50</td>
<td>≤ 50 employees for manufacturing</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td>≤ 10 employees for manufacturing</td>
<td>&lt; 300</td>
<td>≤ 100 employees for manufacturing</td>
</tr>
<tr>
<td>Japan</td>
<td>Manufacturing &amp; others</td>
<td>Wholesale</td>
<td>≤ 100</td>
<td>Capital size ≤ $100 million Employee headcount</td>
</tr>
<tr>
<td>South Asia</td>
<td>India</td>
<td>≤ 300</td>
<td>≤ 100</td>
<td>Capital size ≤ $100 million Employee headcount</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>10–24 or less</td>
<td>Assets worth Tk 5–50 lakh</td>
<td>25–99</td>
<td>Assets worth Tk 50 lakh to Tk 10 crore Employee headcount</td>
</tr>
<tr>
<td>Bhutan</td>
<td>10 or less</td>
<td>Assets worth Tk 5 lakh or less</td>
<td>10–25</td>
<td>Assets worth Tk 5 lakh to Tk 1 crore Employee headcount</td>
</tr>
<tr>
<td>Nepal</td>
<td>&lt; 5</td>
<td>Investment capital less than NU 1 million</td>
<td>5–19</td>
<td>Investment capital between NU 1–10 million Employee headcount</td>
</tr>
<tr>
<td>Maldives</td>
<td>Up to 5</td>
<td>Annual income of MRF 500,000</td>
<td>6–30</td>
<td>Annual income between MRF 500,001–5,000,000 Employee headcount</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>SMEs are defined as enterprises with a capital investment of less than Rs. 5 million which employ fewer than 50 employees</td>
<td>SMEs are defined as enterprises with a capital investment of less than Rs. 20 million in plant, machinery and equipment excluding land and buildings, an annual turnover not exceeding Rs. 40 million, and a total annual turnover not exceeding Rs. 100 million</td>
<td>SMEs are defined as enterprises with an annual sales value up to Rs. 250 million</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>SMEs are defined as enterprises whose employment size is up to 250, with paid up capital to Rs. 25 million and an annual sales</td>
<td>SMEs are defined as enterprises whose</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources:
market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks (IASB, 2009a, 10).

The IASB’s definition of SMEs is more loosely defined than the typical SME definitions adopted by various jurisdictions. The RSM International Association indicates that:

This definition avoids a quantified size test and, instead, adopts a public accountability principle. The IFRS for SMEs has been designed using a 50-employee typical entity guideline, not as a quantified size test for defining SMEs but rather to assist the Board in determining the types of transactions that the standard should address... (RSM International Association, 2009, 5).

Revelations of the various SME definitions illustrates that there is inconsistency in the definitions of SMEs across the globe. In particular, the definition of an SME in the context of IFRS for SMEs is significantly different to that of most other countries and is based on the listed status of an entity rather than on its size-threshold. Authorities at the individual jurisdiction level are permitted to decide what constitutes an eligible entity, entitled to apply the IFRS for SMEs (IASB, 2009a). However, the inconsistency between general definitions of an SME and IASB’s definition is problematic in terms of the implementation of IFRS for SMEs, as will be explained later.

4. Importance of SMEs across the globe

SMEs play a vital role in economic and social development in developed and developing economies. It has been recognized that the SME sector is the largest employment provider in many countries, particularly in terms of new job creation. Furthermore, the contribution of SMEs to the economic output, technology and innovation has also been widely identified (Chen, 2006; OECD, 2005; Reddy, 2007).

In many APEC economies, SMEs hold a major share of businesses and employment and contribute significantly to economic output (APEC, 2009). For example, in Australia, SMEs accounted for 99.7% of actively trading businesses in June 2009 (DIISR, 2011). Importantly, the majority of Australian SMEs function as the resource providers for large manufacturing firms. In terms of employment, SMEs accounted for 70.5% of total industry employment in 2009–2010 (DIISR, 2011).

In other countries and regions, the contributions made by SMEs are also significant. For example, SMEs in China play a significant role in economic development, accounting for a GDP contribution of 60% in 2009. Chinese SMEs created around 80% of urban job opportunities in 2009 (Zhu, Wittmann, & Peng, 2012). More importantly, the role of SMEs in the field of technology innovation is regarded as remarkable. Since economic reform, more than 65% of invention patents, 75% of high-quality technological innovation, and 80% of new product development have been recorded by Chinese SMEs (APEC, 2008). In Japan, almost 90% of businesses are considered to be SMEs, representing the majority of the employed population and accounting for a significant proportion of the economic output (EUI, 2010).

The economic and social contribution by SMEs in a number of developing countries has also received increased attention. SMEs in Sri Lanka provide a growing contribution to the GDP (52% in 2011) particularly in agriculture, plantations, construction, manufacturing and trade sectors (Department of Development Finance, 2011). The SME Chamber of India (2012) reports that around 45% of industrial output, 40% of exports and 42 million people in employment are contributed by SMEs. In South Africa, SMEs, which account for around 91% of formal business entities, had contributed around 57% and 60% to the GDP and employment respectively by the end of 2009 (Kongolo, 2010).

In Europe, SMEs accounted for a 67% share of the total employment in 2010 (EIM Business and Policy Research, 2011). In the period 2002–2010, SMEs created 85% of net new jobs in the EU, of which micro firms (by definition having fewer than 10 employees) accounted for the highest percentage of 58% (EIM Business and Policy Research, 2011). This figure also indicates a significant growth of micro firms in the EU during the last few years.

The United States Trade Representative (USTR) (2010) reports that SMEs in manufacturing and services sectors have entered into ‘direct exports’, by contrast with large multinational firms, which trade mostly through foreign affiliates. During the period 2005–2009, 73% of foreign sales were committed by their exporting SMEs through direct exports. Importantly, those direct exports have led to the creation of nearly 2 million jobs (USTR, 2010).

The above facts confirm that the SME sector has been positioned as the most crucial sector and the backbone of many developed and developing economies around the world. Therefore, the accounting information presented by these focal entities is equally important. It is envisaged that the global convergence of the financial reporting practices of SMEs will possibly open access to international finance through high quality, comparable financial information (IASB, 2009a).

5. IFRS for SMEs at a glance

The IFRS for SMEs are a simplified version of the full IFRS which is primarily based on the fundamental principles of the full IFRS (IASB, 2009b). However, IFRS for SMEs is a stand-alone document—logically structured into 35 sections by topic. The IFRS for SMEs approaches with significantly reduced disclosures of around 300, compared to the full IFRS of 3000 disclosures, and with reduced guidance. The standard is based on simplified recognition and measurement principles and several easy accounting policies. Several topics have been omitted from the IFRS for SMEs which are not relevant to SMEs (e.g. earnings per share, interim financial reporting, segment reporting, and special accounting for assets held for sale), and extra considerations specific to SMEs (e.g. combined financial statements, original issue of shares or other equity instruments, sale of options, rights and warrants, and capitalization or bonus issue of shares and share splits) have been incorporated (IASB, 2009b).

The main simplifications of recognition and measurement principles of the IFRS for SMEs compared to the full IFRS are contrasted in several sections of the IFRS for SMEs (the key differences between the IFRS for SMEs and the full IFRS are shown in Table 2). The accounting treatment under Section 19 Business Combinations and Goodwill in the IFRS for SMEs is significantly different to IFRS 3 Business Combinations. Under IFRS 3, goodwill and other intangible assets with definite useful life are reviewed for impairment and not amortized. In contrast, goodwill and intangible assets are amortized over their useful life in the IFRS for SMEs. If a reliable estimate of the useful life cannot be made, “life” is presumed to be 10 years (Ernst & Young, 2010; IASB, 2009a).

Section 15 of the IFRS for SMEs, Investments in Joint Ventures, permits interest in jointly controlled entities to be accounted for using the cost model (if a published price quotation is not available), the equity method and the fair value model. In contrast, International Accounting Standard (IAS) 31 Interests in Joint Ventures, permits only either the proportionate consolidation method or the equity method to be used in the consolidated accounts (Ernst & Young, 2010; IASB, 2009a).

9 In the Exposure Draft on the proposed amendments to the IFRS for SMEs issued in October 2013, the IASB has proposed to amend the definition in paragraph 1.3 (b) as ‘it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. Most banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks will meet this second criterion” (IASB, 2013, 16).

10 A study on the impact of SMEs on the EU labour market was conducted by EIM Research & Business Policy—Netherlands on behalf of the EC in 2011.
Table 2
Major Differences Between IFRS for SMEs and Full IFRS.

<table>
<thead>
<tr>
<th>IFRS for SMEs</th>
<th>IFRS Equivalent</th>
<th>Key areas of differences between IFRS for SMEs and IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of changes in equity and statement of income and retained earnings</td>
<td>IAS 1 Presentation of financial statements</td>
<td>“Statement of Income &amp; Retained Earnings” is a new statement incorporated into the IFRS for SMEs. A statement of income and retained income may be presented in place of the statement of comprehensive income and statement of changes in equity, if the only changes to equity comprise profit or loss, payment of dividends, corrections of prior year errors and changes in accounting policy.</td>
</tr>
<tr>
<td>10 Accounting policies, estimates and errors</td>
<td>IAS 8 Accounting policies, changes in accounting estimates and errors</td>
<td>If the IFRS for SMEs does not specifically address a transaction, other event or condition, an entity’s management shall use its judgement in developing and applying an accounting policy. In making the judgement, management shall refer to, and consider the applicability of: (a) the requirements and guidance in the IFRS for SMEs dealing with similar and related issues; and (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 Concepts and Pervasive Principles. Management may also consider the requirements and guidance in full IFRS dealing with similar and related issues, but not mandatory.</td>
</tr>
<tr>
<td>Basic Financial instruments other financial instruments issues</td>
<td>IAS 39 Financial Instruments: recognition and measurement</td>
<td>An embedded derivative is separated from the host contract and accounted for as a derivative under IAS 39 under certain conditions. There is no concept of embedded derivatives under the IFRS for SMEs. Derecognition and Hedging requirements have been simplified.</td>
</tr>
<tr>
<td>Investments in associates and investments in joint ventures</td>
<td>IAS 28 &amp; 31 Investments in associates and interest in joint ventures</td>
<td>A venturer shall account for all of its interests in jointly controlled entities using either: (a) the cost model; (b) the equity method; or (c) the fair value model. However, the IFRS for SMEs permits the use of the cost model only if a published price quotation is not available, otherwise use of the fair value is permitted. Under subsequent measurement, investment property whose fair value can be measured reliably without undue cost or effort must be measured at fair value at each reporting date with changes in fair value recognized in profit or loss. An entity accounts for all other investment property as property, plant and equipment using the cost-depreciation-impairment model in Section 17. An entity must measure all items of property, plant and equipment after initial recognition at cost less any accumulated depreciation and any accumulated impairment losses. Only the historical cost method is permitted, no revaluations.</td>
</tr>
<tr>
<td>18-19 Intangible assets other than goodwill and business combinations &amp; goodwill</td>
<td>IAS 38 Intangible assets</td>
<td>Under IFRS for SMEs, in subsequent measurement, intangible assets are measured at cost less accumulated amortization and impairment losses. It does not permit the application of the revaluation model to intangible assets. Goodwill and intangible assets are amortized over its useful life. If a reliable estimate of the useful life cannot be made, the life is presumed to be 10 years.</td>
</tr>
<tr>
<td>20 Leases</td>
<td>IAS 17 Leases</td>
<td>An entity shall recognize government grants according to the nature of the grant as follows:</td>
</tr>
<tr>
<td>25 Borrowing costs</td>
<td>IAS 23 Borrowing costs</td>
<td>All borrowing costs are expensed in profit or loss in the period in which they are incurred.</td>
</tr>
<tr>
<td>26 Share-based payments</td>
<td>IFRS 2 Share-based payments</td>
<td>The IFRS for SMEs uses a hierarchy to determine the fair value of shares issued based on:</td>
</tr>
<tr>
<td>Employee benefits</td>
<td>IAS 19 Employee benefits</td>
<td>Grants are measured at the fair value of the asset received or receivable.</td>
</tr>
<tr>
<td>Income tax</td>
<td>IAS 12 Income taxes</td>
<td>Deferred tax assets have to be recorded under the IFRS for SMEs with offsetting valuation allowances (this is not included in IAS 12). “Uncertain tax positions” recognition and measurement have been incorporated in the IFRS for SMEs. Exchange differences on monetary items are recognized in profit or loss for the period except for those differences arising on a monetary investment in a foreign entity (subject to strict criteria of what qualifies as net investment). In the consolidated financial statements, such exchange differences are recognized in other comprehensive income and reported as a component of equity.</td>
</tr>
<tr>
<td>Foreign currency translations</td>
<td>IAS 21 The effects of changes in foreign exchange rates</td>
<td></td>
</tr>
</tbody>
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Recognition and measurement of “uncertain tax positions” have been incorporated into the IFRS for SMEs (Sections 29 Income Tax) and deferred tax assets have to be recorded under the IFRS for SMEs with offsetting valuation allowances, which is not covered by IFRS (IAS 12 Income Tax) (Ernst & Young, 2010; IASB, 2009a).

The IASB has issued the Exposure Draft on the proposed amendments to the IFRS for SMEs in October 2013 which has resulted from the initial comprehensive review of the standard. The IASB has proposed amendments only on some clarifications to the existing requirements or supportive guidance. However, no amendments are proposed in changes to the underlying requirements in the IFRS for SMEs. Based on the comments received from different jurisdictions on minimizing the diversity in recognition and measurement of deferred tax in Section 29 Income Tax of the IFRS for SMEs, the IASB has proposed to align the recognition and measurement principles in Section 29 with IAS 12 Income Taxes whilst retaining some of the presentation and disclosure simplifications from the original version of Section 29 (IASB, 2013). This is the most significant change being proposed to the IFRS for SMEs in this ED.

6. Adoption of IFRS for SMEs across the world

It is now nearly five years since the IFRS for SMEs was first issued. The recent statistics show that nearly 70 jurisdictions have either adopted the IFRS for SMEs or made a public announcement of their intention to apply the standard in the future (IFRS Foundation, 2014). Some countries in South America, Central America, the Caribbean, Africa, Asia, Middle East and European regions have adopted the IFRS for SMEs (see Table 3) (IFRS Foundation, 2014).

South Africa was an early respondent to the IFRS for SMEs, having adopted the standard with no modifications when the ED of the IFRS for SMEs was issued by the IASB in October 2007 (IFRS Foundation, 2012a). However, the South African Institute of Chartered Accountants (SAICA) had been working on developing a third tier financial reporting framework for micro entities (Micro GAAP) as they believed that the ED of the IFRS for SMEs was burdensome for micro entities (SAICA, 2012). Later, SAICA withdrew the proposed Micro GAAP as the IFRS for SMEs was issued in 2009 with a more simplified version than the ED. Nevertheless, the SAICA has developed a separate electronic guide for micro entities on applying the IFRS for SMEs, comprising of more practical examples, illustrative financial statements and user and disclosure checklists (SAICA, 2012).

Hong Kong on the other hand has also adopted the IFRS for SMEs, but with few modifications made to the standard—referring to them as the Hong Kong Financial Reporting Standards (HKFRS) for Private Entities. Their standard is primarily based on the IFRS for SMEs, but refers to “Private Entities” rather than “SMEs”. However, the same definition as applied by the IASB to define eligible entities for the IFRS for SMEs has been adopted. The standard setters believe that the national criteria used to define SMEs often refer to smaller entities irrespective of whether they prepare GPFs for external users. Therefore, based on this argument, the Hong Kong Institute of Certified Public Accountants (HKICPA) has replaced the term “SMEs” with “Private Entities”: All other smaller entities which do not come under the “Private Entities” definition are therefore eligible to apply the locally developed SME Financial Reporting Framework and Financial Reporting Standard (SME-FRF & FRS). Furthermore, HKFRS for Private Entities has replaced certain income tax recognition and measurement principles in Section 29 of the IFRS for SMEs with certain tax requirements in the extended version of HKAS (Hong Kong Accounting Standards) 12 Income Tax. These changes ensure the appropriateness of HKFRS for Private Entities, and ease the changeover from the existing HKFRS to HKFRS for Private Entities (HKICPA, 2011, 2012).

For SMEs in Brazil, the Brazilian Accounting Pronouncement Committee has introduced CPCs for SMEs (new Brazilian GAAP for SMEs) which is a translation (Portuguese version) of the IFRS for SMEs. However, in addition to the IASB definition for SMEs (non-publicly accountable entities), a Brazilian SME also needs to meet certain “size criteria” to qualify for the application of the standard (PriceWaterhouseCoopers (PWC), 2012). Brazil has also made few modifications to IFRS for SMEs by requiring SMEs to use the equity method to account for investments in subsidiaries in separate financial statements (IFRS Foundation, 2014).

Countries such as Argentina, Bahamas and Cambodia have also adopted the IFRS for SMEs as published by the IASB with no amendments to the standard. These countries have kept the use of the standard optional whereby SMEs may use the national GAAP or alternatively the full IFRS, according to their requirements (see Fig. 1 for the application status of the IFRS for SMEs).

It is important to note that major developed and developing countries such as Australia, the United Kingdom, France, Germany and Canada have not adopted the IFRS for SMEs. There are several reasons for a number of prominent countries choosing not to adopt the IFRS for SMEs, which are revealed in section seven.

7. Problems posed by the IFRS for SMEs

The discussions on issues in the financial reporting convergence process have been motivated since the inception of the implementation process of the full set of IFRS. There have been several functional complications reported in the convergence process of IFRS by countries that have adopted IFRS (Alp & Ustundag, 2009; UNCTAD, 2007a; Wong, 2004). Conversely, due to the recent publication of the IFRS for SMEs and the slow take-up of the new standard by various jurisdictions across the globe, the consequences of adopting the IFRS for SMEs are still presumed to be impending. Diverse complications and controversial issues in adopting the IFRS for SMEs have been reported by many jurisdictions, especially from the developed countries. Taking examples from the implementation of the full set of IFRS and the IFRS for SMEs context, the next section provides a holistic view on the problems experienced and the possible challenges in implementing IFRS for SMEs across the globe. To evaluate the problems posed by the implementation of IFRS

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11 Size criteria include: Revenue <R$300 million and total assets <R$240 million.

Please cite this article as: Perera, D., & Chand, P., Issues in the adoption of international financial reporting standards (IFRS) for small and..., Advances in Accounting, incorporating Advances in International Accounting (2015), http://dx.doi.org/10.1016/j.jadiac.2015.03.012
for SMEs, this discussion applies where relevant, decision useful theory and pecking order theory.

7.1. Issues with IASB's development process of the IFRS for SMEs

The IASB has set meeting the needs of users of SME financial statements as one of the primary objectives of introducing IFRS for SMEs. The IASB (2009b) points out that the differences between full IFRS and IFRS for SMEs should be established based on the accounting information needs of the users and cost–benefit considerations. Such views show that the accounting information needs of the users have been an important benchmark in the differential reporting framework introduced by the IASB.

As explained by the decision usefulness theory, assessing the decision usefulness of the users is a primary test for defining the generally acceptable principles of accounting regulations. However, Schiebel (2008) demonstrates that IASB has given less consideration to users’ participation in the consultation process during the development of the new standard because the major commentators were represented by auditors, accountants and standard setters. Additionally, the European Union consultation on the IFRS for SMEs by German Cooperative and Raiffeisen Confederation (DGRV) (2010) reports that the IASB Board members do not represent any member with SME background or from SME working group. Therefore, it is unlikely that the concerns of SMEs are adequately addressed in the standard setting process of IFRS for SMEs. If the IFRS for SMEs does not reflect the information needs of external users, the perceived benefits of published information of SMEs for external users become uncertain. In particular, this situation would be more distressing for small and micro entities.

The IASB’s objective of allowing SMEs to access international competitive funds by producing high quality, comparable financial statements is a remote objective. This objective is coincided with the pecking order theory, which explains that an entity’s choice of finance between internal and external sources vary with the level of information asymmetry of financial information. Regardless of reducing the information asymmetry, SMEs in general are hesitant in seeking external sources of capital because of several external constraints such as the complex procedures involved in granting loans, collateral requirements and the associated high capital cost (Hyz, 2011). Rather, majority of SMEs still rely on owner financial resources and retained earnings as suggested by the pecking order theory. Kauffmann (2005) confirms that there is limited access to formal financial sources as a result of the high default risk among SMEs in Africa. Furthermore, the development stage of the entity, creditworthiness, liquidity position and delinquency of SMEs are also found to be the barriers in accessing external funds. Therefore, preparation of high quality financial statements may not be the exclusive solution for accessing external funds, particularly accessing the international funds.

A narrow definition of non-publicly accountable entities has made it confusing for eligible entities to apply the eventual standard. As previously outlined, the IASB (2009a) defines an SME as an entity that does not have public accountability but prepares general purpose financial statements for external users. However, there appears to be an inconsistency in this definition between the criterion used to define an SME – “non-publicly accountable entities” and the intended users of the standard – “SMEs”. Whilst conveying the importance of introducing the IFRS for SMEs, the IASB stresses that SMEs are estimated to represent more than 95% of all companies around the world (IFRS Foundation, 2012b). However, that estimation is based on those SMEs that were categorized according to size-thresholds, not necessarily based on the criterion of non-publicly accountable entities envisaged by the IASB.

The history of the development of the project and implementing the IFRS for SMEs provides evidence that the IASB has been confused in selecting an appropriate title, with changes made to the title several times. The title “IFRS for SMEs” was finally agreed a few months before the release of the standard in July 2009 (RSM International Association, 2009). This may pose issues in implementing the standard due to the inconsistency between the IASB definition of SMEs and the various different definitions adopted by other countries and regions to define SMEs.

It is worth mentioning that the majority of SME definitions include "micro" enterprises, though the abbreviation “SME” refers only to small and medium enterprises. For this reason, the abbreviation

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12 The IASB engaged in a long consultation process before releasing the IFRS for SMEs in July 2009. They published a discussion paper for public comments in June 2004 to gather preliminary views on the new standard.

13 Other names suggested: IFRS for Private Entities, IFRS for Non-publicly accountable entities, IFRS for non-public-interest entities, IFRS for private companies, IFRS for smaller entities, IFRS for unlisted entities, and IFRS for limited interest entities.
"MSME" (Micro, Small and Medium-sized Enterprises) is becoming popular in place of "SME" for definitions adopted by different economies. For example, South Asian economies such as India, Bhutan, and Maldives are currently using the abbreviation MSME. However, there appears to be an injustice in discussing these three categories of enterprises together, because microenterprises and SMEs are distinctly dissimilar in their business scope. The question may again be posed as to whether micro firms should be treated as SMEs according to the definition adopted by IASB for defining small and medium entities in the IFRS for SMEs. Certainly, differently defined SMEs would be a challenge when making comparisons of businesses across the globe.

7.2. National legislations and enforcement issues

One of the major issues that need to be discussed during the implementation process of IFRS is the extent to which the fragmented regulatory authorities at individual jurisdiction level hinder the effective and efficient implementation of international standards (Alp & Ustundag, 2009; UNCTAD, 2007a). Using examples from countries such as Pakistan, South Africa and Turkey to demonstrate, UNCTAD expounds this divergence issue as “the practical implementation issue that arises in this context is the extent to which IFRS-based general-purpose financial statements could be used for prudential regulation. Such an arrangement would require clear understanding to be reached among the different regulators” (UNCTAD, 2007a, 10).

A number of countries have been pressured to establish new institutions or to reinforce the roles of existing institutions to strengthen the regulatory framework and the legal backing of IFRS. Within this context, the implementation of the IFRS for SMEs would be confronted with national legislation requirements. In many countries, SMEs are required to prepare financial statements in compliance with certain tax legislation, especially for the purpose of filing tax returns. Countries such as Lebanon, Slovakia, Austria, and Russia believe that SMEs are in favour of preparing financial statements for tax purposes only (IFRS Foundation, 2011). Therefore, the IFRS for SMEs is believed to be a burden and too difficult for their SMEs to adopt. For example, in Germany, financial statements usually serve a multi-purpose function and therefore, SMEs prefer to prepare a single set of financial statements which also satisfies taxation purposes (Evans et al., 2005). France on the other hand rejected IFRS for SMEs as it does not adequately fit with their integrated tax and accounting framework (PWC, 2010). Evans et al. (2005) also points out that the preparation of separate financial and tax accounts would be costly and a burden for small entities.

There are several incidences in which the issue of adopting IFRS for SMEs arises due to inconsistencies in reporting frameworks determined by individual jurisdictions (locally developed GAAPs) and the IFRS for SMEs. Countries such as Japan, Austria, Germany, Belgium, Indonesia, India and several other jurisdictions emphasize their requirement for compliance with national laws and other local GAAPs for SMEs, rather than adopting the IFRS for SMEs (IFRS Foundation, 2011). There are also countries that do not apply GAAP at present for their SMEs. The United Arab Emirates (UAE), for instance, currently do not have national GAAP for SMEs in their reporting framework and are therefore uncertain in adopting the IFRS for SMEs for all the business entities due to their immaturity in applying a financial reporting framework and due to potential knowledge shortfall (ICAEW, 2010). The UAE economy is substantially represented by family owned businesses. These family businesses have generally not opted for the use of IFRS for SMEs (IFRS Foundation, 2014). Japan, on the other hand, has still not formally adopted full IFRS in their reporting framework and therefore is not considering adopting the IFRS for SMEs at this stage (IFRS Foundation, 2011).

7.3. Complexity and other difficulties in implementing IFRS for SMEs

The issue of the complexity of the international standards has been persistently discussed since the inception of the IFRS implementation process. A number of studies have identified that the complex nature of the full set of IFRS poses several practical difficulties, particularly in developing economies (Alp & Ustundag, 2009; UNCTAD, 2007a; Wong, 2004). Moreover, lack of technical expertise in the accounting and auditing professions and the potential knowledge shortfall in dealing with international standards has been widely articulated (Alp & Ustundag, 2009; UNCTAD, 2007a). The IFRS for SMEs are deemed to be a less complex and simplified version of the full set of IFRS, but as far as the intended users of the new standard are concerned, several arguments have been made about the incongruity and the burden of IFRS for SMEs. For example, having experienced several difficulties in adopting full IFRS in 2005, Australia is more concerned about the possible transition issues that may arise during the implementation process of the IFRS for SMEs (AASB, 2010a). The transition process from local GAAP/full IFRS to the IFRS for SMEs may impose certain difficulties on business practices, processes and systems, which often turn out to be costly, complex and prolonged for small entities to take on.

Australia is of the view that the IFRS for SMEs still appear to be complex in the recognition and measurement requirements (AASB, 2010a). Deloitte Touche Tohmatsu (Australia) reports that:

The approach of effectively adopting IFRS for all entities in Australia from 2005, albeit with an overlaid ‘reporting entity’ concept, has meant that a lot of the ‘pain’ of adopting IFRS has already been incurred in the Australian context. Compared with IFRS, the IFRS for SMEs does not result in a substantial reduction in complexity in the recognition and measurement requirements – and in fact many ‘simplifications’ may be more onerous in practice (e.g. introduction of ‘uncertain tax position’ accounting for income taxes), be counter-intuitive (e.g. mandatory amortization of goodwill over a 10 year period) or may ultimately be adopted in ‘IFRS proper’ (e.g. rewrite of financial instruments requirements). Furthermore, there are as yet no widely accepted interpretations of contentious issues under the IFRS for SMEs, a position similar to the original IFRS transition in 2005, with all the uncertainty this brought on transition (AASB, 2010a, 1).

Difficulties in implementing an international standard because of the lack of widespread technical expertise in the accounting environment are also a concern. Australia is also of the view that coexistence of opposing IFRS recognition and measurement principles for identical circumstances harms the standards and also the practitioners. For these reasons, Australia has so far not adopted the IFRS for SMEs. Instead, the AASB has adopted the Reduced Disclosure Regime (RDR) implemented under the revised differential reporting framework for issuing new accounting standards—AASB 1053 Application of Tier of Australian Accounting Standards and AASB 2010–2 Amendments to Australian Accounting Standards arising from Reduced Disclosure Requirements in 2010. This has made amendments to the existing Australian Accounting Standards, including the Interpretations. The publicly accountable entities are required to apply full IFRS as adopted in Australia under Tier 1, whereas all other preparers of GPFSs which fall into Tier 2 are required to apply IFRS recognition, measurement and presentation requirements with substantially reduced disclosures (AASB, 2010b).14

Similarly, the European Commission has kept the adoption of the IFRS for SMEs within the European Union optional. There appears to be no strong objection to adopting the new standard; however, the
The proposal has introduced a specific regime for small companies that will considerably reduce the administrative burden currently borne by small companies when they prepare their financial statements. It has reduced the disclosures by way of notes to the accounts to:

(i) accounting policies;
(ii) guarantees, commitments, contingencies and arrangements that are not recognized in the balance sheet;
(iii) post-balance sheet events not recognized in the balance sheet;
(iv) long-term and secured debts; and
(v) related party transactions. It should be noted that mandating the disclosure of items (iii) and (v) will result in new obligations imposed for small companies, as a majority of Member States have provided for exemptions from these disclosures for such companies.

The proposed directive also aims:

(i) to harmonize thresholds to ensure that the administrative burden reduction actually reaches all small companies in the EU. Currently many companies that are small under EU definitions enter the medium-sized or large company category; and
(ii) to improve the comparability and clarity of financial statements prepared by medium-sized and large companies, and by small companies to a limited extent. General principles such as “substance over form” become mandatory so as to increase the clarity of financial statements.

The EC has recommended small companies to:

(i) impose no requirements for a statutory audit; and
(ii) exempt small groups from preparing consolidated financial statements.

EC is of the view that the objectives of simplification and reduction of administrative burden would not be served by the IFRS for SMEs (European Commission (EC) Explanatory Memorandum, 2011). The European Financial Reporting Advisory Group (EFRAG) reports that the IFRS for SMEs’ conventions are incompatible with EU Directives (Fourth & Seventh) in several ways (EFRAG, 2010).15 This will result in financial statements prepared under IFRS for SMEs are neither comparable with financial statements prepared according to EU Accounting Directives nor with full IFRS financial statements (DGRV, 2010). In addition to the issues mentioned above, complexities arising with future changes to full IFRS and additional difficulties encountered by subsidiaries and companies planning transition to full IFRS are major concerns in Europe for not adopting IFRS for SMEs.

For these reasons, after certain review processes of the adoption of the IFRS for SMEs and EU Accounting Directives, the European Commission published a Proposed Directive on 25th October 2011 which is a specific regime for small companies and replaces the Fourth (78/660/ECC) and Seventh (83/349/ECC) Company Law Directives (Treaty on the annual accounts of certain types of companies and Treaty on consolidated accounts respectively) (European Commission (EC) Explanatory Memorandum, 2011). The aims of this Proposed Directive are to reduce the administrative burden on small companies and increase the comparability of the financial statements. The main simplification effects are outlined in Table 4.

The principal modification to the existing provisions is the introduction of general principles of “materiality” and “substance over form” to increase the clarity of the financial statements (European Commission (EC) Explanatory Memorandum, 2011).

Canada has also opted for developing an independent set of standards for their private entities rather than choosing IFRS for SMEs. KPMG (2009, 2) states that “some requirements of IFRS for SMEs, such as consolidation; componentization of property, plant and equipment; and deferred income tax accounting do not recognize the needs of and inappropriate for Canada’s private businesses and the users of their financial statements.” Followed by a “made-in-Canada” approach, the Canadian Accounting Standards Board has published a simplified set of accounting standards for private enterprises which is called “Accounting Standards for Private Enterprises (ASPE)” in 2009.

7.4. Technical difficulties inherent in IFRS for SMEs

With respect to the technical matters that persist with the implementation of the full set of IFRS, the UNCTAD argues that “practical implementation of IFRS requires adequate technical capacity among preparers, auditors, users and regulatory authorities. Countries that implement IFRS face a variety of capacity-related issues; depending on the approach they take” (UNCTAD, 2007a, 11).

The practical implementation of IFRS for SMEs would also be challenging, because the capacity limitations of financial markets, institutions and regulatory authorities vary across the globe. The prominent professional accounting networks such as PWC (2011), Ernst and Young (2010) and KPMG (2010) demonstrate the possible problematic sections of the IFRS for SMEs that could develop with so-called capacity limitation issues.

As specified by Section 26 Share Based Payments of the IFRS for SMEs, if the fair value of shares in equity-settled share-based payments is not observable, and obtaining entity specific market data is impracticable, the directors should use their judgement to apply the most appropriate valuation methodology (see Table 2). Since the full IFRS (IFRS 2 Share Based Payments) allows using “Intrinsic Value” in the absence of a reliable estimate of fair value, the IASB believes that the simplified valuation of share-based payments would be appropriate for SMEs. However, PWC (2011) points out that only in rare situations it is unable to estimate the reliable fair value. Furthermore, the Institute of Chartered Accountants Australia (ICAA) (2012, 3) points out that “an intrinsic value model would require a valuation to be conducted on the SME’s shares in any event. It is difficult to see any simplifications here”. Therefore, ICAA (2012) suggests that it is necessary to specify valuation models for SMEs to determine the fair value. The technical challenges in fair value-based measurement requirements in IFRS have, however, been a major issue of concern. More specifically, differences in the liquidity of capital markets and the lack of availability of recent capital market information of different economies would be challenging issues, for which practitioners need to seek alternative sources of measurement. The accurate estimation and consistent application of those alternative measurements would nevertheless be a confronting issue (Alp & Ustundag, 2009; Mala & Chand, 2012; UNCTAD, 2007a).

Accounting for Borrowing Costs (Section 25) of the IFRS for SMEs will be another area where technical implementation difficulties may occur. Section 25 allows an SME to expense all borrowing costs to profit or loss in the period in which they are incurred. However, Ernst and Young (2010) points out that this recognition may be a significant burden for

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Table 4
Proposed directive simplification — European Commission.
Source: European Commission (EC) Explanatory Memorandum (2011, 6–7)

The proposal has introduced a specific regime for small companies that will considerably reduce the administrative burden currently borne by small companies when they prepare their financial statements. It has reduced the disclosures by way of notes to the accounts to:

(i) accounting policies;
(ii) guarantees, commitments, contingencies and arrangements that are not recognized in the balance sheet;
(iii) post-balance sheet events not recognized in the balance sheet;
(iv) long-term and secured debts; and
(v) related party transactions. It should be noted that mandating the disclosure of items (iii) and (v) will result in new obligations imposed for small companies, as a majority of Member States have provided for exemptions from these disclosures for such companies.

The proposed directive also aims:

(i) to harmonize thresholds to ensure that the administrative burden reduction actually reaches all small companies in the EU. Currently many companies that are small under EU definitions enter the medium-sized or large company category; and
(ii) to improve the comparability and clarity of financial statements prepared by medium-sized and large companies, and by small companies to a limited extent. General principles such as “substance over form” become mandatory so as to increase the clarity of financial statements.

The EC has recommended small companies to:

(i) impose no requirements for a statutory audit; and
(ii) exempt small groups from preparing consolidated financial statements.

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15 EFRAG carried out this compatibility study on behalf of the European Commission in 2010.
certain industries, such as ‘construction’, because it would affect the profit or loss with a considerable cost being charged to income statement.

Deferred tax assets (Section 29), which have to be recorded with offsetting valuation allowances, and recognition and measurement under “uncertain tax positions”, have been newly incorporated into the IFRS for SMEs. ICAA (2012) and Ernst and Young (2010) believe that these two new requirements will be difficult for small entities to apply in practice and that the incomprehensible nature of them will lead to interpretation issues for the preparers of financial statements. Similarly, the insufficiency of available guidance on the foreign currency translation (Section 30), which may result in different interpretations being adopted by different entities, is also a concern (Ernst & Young, 2010).

Section 17 of the IFRS for SMEs has prohibited the revaluation option of accounting for Property, Plant and Equipment (PPE) believing that the revaluation of PPE is one of the complex accounting policy options in full IFRS. Considering this as a significant barrier to the adoption of IFRS for SMEs in jurisdictions where SMEs commonly revalue their PPEs, many accounting regulatory bodies around the world have made representations to the IASB to reconsider incorporating the revaluation option in IFRS for SMEs. Revaluation of PPE has been a common practice among unlisted companies in many countries, particularly where there has been a history of inflation (ACCA, 2012). Many jurisdictions are of the view that revaluation option does not add significant complexity; rather the fair value measurement in PPE would enhance the relevance and reliability of financial statements for users of SMEs. It would also facilitate access to capital, as in many cases the carrying value of PPE can be a significant portion of an entity’s assets (Chartered Accountants of Sri Lanka, 2014; EFRAG, 2014). Hence, the inclusion of revaluation option would offer an opportunity for different jurisdictions to select a measurement option which suits their circumstances (EFRAG, 2014). The EFRAG (2014) also signifies that the negative effects of the application of complex accounting policy options could be outweighed by the increased usefulness of the financial information provided by SMEs.

ACCA (2010) and KPMG (2010) have raised concerns about issues arising from the effect of changes in recognition and measurement principles of the IFRS for SMEs on tax and the distributable profits of SMEs. KPMG (2010) points out that the changes in amount of taxes payable (which is either affected by changes in net profit or tax law based on the accounting treatment), the ability to pay dividends; and management compensation (which is based on either net profit or other financial metrics) are the possible impacts of changes in recognition and measurement principles of the IFRS for SMEs. Therefore, KPMG (2010) urges the need for sufficient forward planning to control the adverse impacts of adopting the IFRS for SMEs.

Furthermore, when developing the IFRS for SMEs, some key concepts and application guidance have been dropped in certain sections of the IFRS for SMEs. For example, under intangible assets acquired in a business combination, there is an absence of guidance on the types of intangibles that might be recognized, as well as no detail on fair value measurement considerations. Further, recognition requirements of financial guarantees are not mentioned (ICAA, 2012). Nevertheless, even within the framework of principles-based standards, reduced guidance of IFRS for SMEs may pose certain difficulties when accountants exercise the professional judgement.

It is argued that the absence of specific guidance on a particular accounting issue leads the users of the standards (specifically the accountants) to a tiered hierarchy to allow the selection of an appropriate accounting policy. This hierarchy flows from the SME’s own accounting framework (IFRS for SMEs) of pervasive concepts, to the application of judgement in consultation with the full set of IFRS (ICAA, 2012). For an example, IFRS Foundation (2012c, 1) reports that:

In the absence of specific requirements for transactions, events or conditions, paragraph 10.4 of the IFRS for SMEs requires management to use its judgement in developing an accounting policy that is reliable and results in information that is relevant to the economic decision-making needs of users. Paragraph 10.5 establishes the following hierarchy for an entity to follow in deciding on the appropriate accounting policy:

a) the requirements and guidance in the IFRS for SMEs dealing with similar and related issues; and
b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 Concepts and Pervasive Principles.

Paragraph 10.6 notes that in making the judgement described in paragraph 10.4, management may also consider the requirements and guidance in full IFRS dealing with similar and related issues. When following paragraphs 10.4 and 10.5, the full IFRS principles may be used in the absence of specific guidance in the IFRS for SMEs. Since paragraph 10.4 and Section 2 are based on full IFRSs, using requirements in full IFRSs will result in an appropriate accounting treatment.

The Hong Kong Institute of Certified Public Accountants (HKICPA) (2011, 3) also points out that:

If full IFRS is to be used as a fallback, it should first of all not conflict with the requirements and guidance in the IFRS for SMEs dealing with similar and related issues and secondly it should not conflict with the pervasive principles in Section 2 of the IFRS for SMEs.

Moreover, they are concerned that circumstances may arise, or already exist, where new IFRSs are issued and these new IFRSs are based on principles other than the older IFRS standards on which the IFRS for SMEs is based. The specific guidance in the new IFRS could then be applied even when it is inconsistent with guidance provided in the IFRS for SMEs on related issues. Furthermore, Singapore Accounting Standards Council (2011, 2) points out that:

As requirements and guidance in the full IFRS may not always be consistent with those in the IFRS for SMEs, applying the full IFRS guidance could result in non-compliance with paragraph 10.5(a), and hence the standard itself. Application of this hierarchy is also problematic in countries those who adopt IFRS for SMEs for their non-publicly accountable entities without converging with full IFRS.

In addition to the technical difficulties discussed above, criticisms have been made against differential reporting for SMEs that could lead to different “true and fair views”. Evans et al. (2005) argue that the “true and fair view” principle would not be consistent between entities in the same jurisdiction if different entities are subject to different reporting requirements as specified by full IFRS and the IFRS for SMEs. Moreover, Association of Chartered Certified Accountants (ACCA) (2010) points out that the “true and fair view” becomes subjective when the fair presentation is viewed against differential reporting regimes rather than a single reporting framework common to all entities. Therefore, a number of researchers have suggested giving consideration to reduced or different disclosure requirements for SMEs (compared to full IFRS), rather than different recognition and measurement principles which could lead to different “true and fair views” (Evans et al., 2005).

As evidenced by the developed economies such as Australia, New Zealand and the United Kingdom, the major reason for the reluctance to adopt IFRS for SMEs has been the negative perception towards the “two different true and fair views”. For an example, Australia is of a strong view that “the development of two separate and unrelated suites of accounting principles operating in one economic environment is undesirable” (ICAA, 2014, 2). Australian regulators also assert that the IASB’s over emphasis on simplifications of accounting principles would lead to divergence in reporting needs between non-publicly and publicly accountable entities. They further stress the existence of inconsistency in “true and fair view” principle among entities in the same
jurisdiction if different reporting requirements as specified by full IFRS and IFRS for SMEs are applied.

The self-contained nature and the stable platform for IFRS for SMEs prevent SMEs departing from the standard and choosing accounting policies from the full IFRS (ICAA, 2014; Kemp, 2010). The ICAA and prominent accounting regulatory bodies in Australia have raised concerns that the rapid major changes which have taken place on full IFRS would have to be appropriately embedded into IFRS for SMEs in order to minimize the divergence between IFRS for SMEs and full IFRS. Australia is not in favour of the IASB’s decision on IFRS for SMEs to maintain a stable platform without opting for regular updates with recurring changes in full IFRS. This complexity has been articulated by the ICAA and AASB in all their correspondences with the IASB. This has been further articulated in their response to the IASB’s recent Request for Information on the ED for SMEs and they emphasize that the IASB needs to reconsider its decisions regarding the simplification of accounting principles in order to make the IFRS for SMEs more reasonable and appealing to the users (see AASB, 2014; ICAA, 2014 for a review).

The recent comment letter sent by the ICAA to the IASB on ED for IFRS for SMEs acknowledges that:

One possible consequence of an IFRS for SMEs standard diverging in this way is that the reporting needs of many non-publicly accountable entities will not be effectively addressed. The decisions of different jurisdictions worldwide on the adoption of IFRS for SMEs may already be evidence of that. Jurisdictions such as Australia and the UK have used some of its principles in developing local standards for use by non-publicly accountable entities, rather than adopting IFRS for SMEs standard as is. Other jurisdictions have chosen to retain local Generally Accepted Accounting Principles (GAAP) and full IFRS alternatives in preference (ICAA, 2014, 2).

Due to complexities and disagreements cited above, records indicate that amongst the countries who opted for IFRS for SMEs, many jurisdictions have given SMEs a choice between the full IFRS and the local GAAP instead of IFRS for SMEs (see Fig. 1) (IFRS Foundation, 2014). For example, Israel has decided not to make the use of IFRS for SMEs mandatory due to the differences in measurement requirements between IFRS for SMEs and full IFRS. However, Israel intends to reconsider the mandatory adoption after the first revision of IFRS for SMEs which would come into effect in future (IFRS Foundation, 2014; UNCTAD, 2013). The Singapore Accounting Standards Council (ASC) has issued additional guidance to Singapore Financial Reporting Standards (SFRS) equivalent to IFRIC 15 Agreements for the Construction of Real Estate. This guidance has been made as an integral part of the SFRS for Small Entities and intended to be consistent with the requirements of IFRIC 15 of the full IFRS (IFRS Foundation, 2014).

As the IFRS for SMEs is not appealing in its current state, some jurisdictions have decided to make significant modifications to the standard in order to conform to the requirements of the full IFRS. For example countries such as the United Kingdom and Ireland have modified the standard by adding (1) the revaluation option to revalue PPE and intangible assets, (2) an option to capitalize borrowing costs on qualifying assets, (3) timing difference approach to deferred income taxes rather than temporary difference approach, etc. in order to mitigate the significant differences between the non-listed and listed entities (IFRS Foundation, 2014). Pakistan is currently considering the adoption of IFRS for SMEs. However, Pakistan authorities will only consider adopting the standard by removing the differences in some recognition and measurement criteria such as capitalization of borrowing cost on qualifying assets, revaluation option on PPE and valuation allowance of deferred tax assets (UNCTAD, 2013).

As evidenced by the existing literature on international reporting standards for SMEs, the implementation and adoption of IFRS for SMEs still seems to be controversial. The problems associated with the transformation process to a common set of international accounting standards, and the technical issues inherent in the recognition and measurement principles of the new standard, are expected to be a continuing challenge in achieving comparable global financial information produced by SMEs worldwide.

8. Conclusions and implications

The objective of this paper was to critically review IFRS for SMEs, including their development and implementation processes. Using the decision usefulness theory and the pecking order theory, the viability of the IASB’s focus on enhancing decision usefulness and reducing the information asymmetry of financial information of SMEs was appraised in this paper. As suggested by the decision usefulness theory, an accounting regulatory framework needs to be derived through the financial information needs of the users at large. However, the analyses revealed that the user orientation have not been adequately addressed by the IASB during the standard setting process of IFRS for SMEs. This infers that the IASB has followed an indeterminate basis for modifying and simplifying the full IFRS principles and disclosure requirements for SMEs. In light of the cost–benefit considerations, SMEs may be hesitant in choosing IFRS for SMEs, if IFRS for SMEs do not clearly represent the user information needs.

In accordance with the pecking order theory, internal sources of funding still appears to be the primary in the hierarchy of funding of SMEs and certain barriers to access external sources of capital move beyond the information asymmetry of financial information provided by SMEs. The analyses suggests that a proper mechanism would be required at individual jurisdiction level to safeguard the SMEs, before they are being exposed to global comparisons for accessing international competitive funds as envisaged by the IASB.

Whilst many countries have adopted IFRS for SMEs, with or without modifications, there are still a number of prominent countries who have yet to adopt this set of standards. This study provides evidences that countries supposed to adoption have identified many problems with IFRS for SMEs, including the perceived burden for small and micro entities, inconsistencies with reporting frameworks at national level and difficulties in the adoption process. Furthermore, technical difficulties inherent in certain sections of the IFRS for SMEs and their potential complexity in the preparation of financial statements were also outlined. Countries have also highlighted the existence of inconsistency in “true and fair view” principle among entities in the same jurisdiction if different reporting requirements as specified by full IFRS and IFRS for SMEs are applied. Therefore, adopting IFRS for SMEs appears to be challenging, with several practical difficulties in their implementation.

Though it is obvious that the IFRS for SMEs are a simplified version of the full IFRS, the application of this set of standards still seems to be burdensome for small and micro entities, especially micro entities. Countries that adopt locally developed GAAP, in particular, seem reluctant at present to accept the IFRS for SMEs for this specific reason. The necessity of enforced international reporting standards for smaller and micro entities still remains uncertain, and there may be a need for further simplification or for a fully simplified set of new standards which address the modest financial accounting needs of micro entities.16

The interpretation of the eligibility of entities to adopt IFRS for SMEs and the title of the new standard itself has also created controversy. If the “size-threshold” is used as a common indicator to separate small and medium-sized entities from large enterprises, embarrassment might be created among entities regarding their eligibility to apply this set of standards. A controversial issue would be that large private entities with no public interest could also apply the IFRS for SMEs though they do not yet belong to the SME category. Therefore, it may be necessary to create an alignment between the quantitative and qualitative criteria—the “size” and “non-listed status” of an entity (as

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16 The IASB is currently considering the introduction of a simplified guideline on IFRS for SMEs, particularly for micro entities.
decided in Brazil), to minimize the difficulties associated with the interpretation of which entities are eligible to apply the IFRS for SMEs. Furthermore, a single set of reporting standards would be difficult to implement across all SMEs, which are defined differently across the globe. As far as the cost implications in adopting IFRS for SMEs are concerned, the preparation of financial statements under the new standard is said to be cost-effective, with the IFRS for SMEs having significantly reduced disclosure requirements compared to the full IFRS. This might be true if a transition is made from the full IFRS to the IFRS for SMEs. At present, SMEs in many countries prepare their financial statements based on local GAAP requirements, so the transition from local GAAP to the IFRS for SMEs may therefore increase the cost of preparation of financial statements. Costs associated with training, changes to the existing systems/packages, the re-establishment of financial statements, extra consultation, and so on would also be onerous for SMEs adopting the IFRS for SMEs. Thus, the precise effect on the cost–benefit considerations of such simplifications in the recognition and measurement requirements of the IFRS for SMEs is uncertain.

The implementation of two versions of international financial reporting standards (the full IFRS and the IFRS for SMEs) in the same jurisdiction may present certain difficulties for entities. The differential reporting may also pose difficulties as an entity that has adopted the IFRS for SMEs wishes to shift to full IFRS. Some countries are more concerned with the issue of compatibility of international standards with local legislation, because offering an option to adopt the full IFRS, local GAAP or the IFRS for SMEs according to requirement or discretion would create future complications in terms of the comparability of financial statements across various business categories. These complications present challenges to the implementation of IFRS for SMEs given the many national and cultural differences around the world. Certain limitations of this study need to be acknowledged. The discussion on the implementation issues of the IFRS for SMEs was based on prior studies that reported the transformation of the full set of IFRS, the IFRS for SMEs, and recent information published by the IFRS Foundation and prominent professional accounting bodies on the implementation of IFRS for SMEs. This may limit the scope of the study; however, based on the conceptual and practical issues identified, future research could be undertaken in various jurisdictions to reveal the actual implementation difficulties and issues encountered at the country and/or regional level in the adoption of IFRS for SMEs. From the perspective of those countries that have already adopted the new standard, future studies could also investigate the cost–benefit considerations of IFRS for SMEs.

References


