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SME Reporting in Australia: Where to Now for Decision-usefulness?

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This paper develops recommendations for simplified decision-useful SME financial reporting in Australia – a country that has traditionally allowed a wide range of reporting standards to be used by these entities. Drawing on interviews and comment letters from a number of stakeholders, and data from a survey of users of financial statements of non-publicly accountable unlisted entities, we analyse stakeholder arguments for and against SMEs providing less detailed reports, and identify the line items that might be most useful to users for decision making.

There is broad support for the contention that financial reports need to be decision-useful. For example, Lennard (2007: 55) states, '. . . if financial reporting cannot influence decisions, it would seem that it would serve no purpose'. However, understanding exactly what makes reports decision-useful is less straightforward (Gassen and Schwedler 2010), and the academic literature contains no clear answers to this question. Although reports need to satisfy the decision-making needs of users (Financial Markets Authority 2014), those needs may not be homogeneous.

User decision-making requirements from financial reports can vary from one entity to another for a variety of reasons, some of which arise from differences in entity size, structure and purpose. This diversity in the size, structure and purpose of entities serves to exacerbate the general problem of how to ensure that reports meet users' needs and are decision-useful. This paper is concerned with user requirements for unlisted entities and, in particular, unlisted small and medium-sized entities (referred to as SMEs for the remainder of this paper). We focus on SMEs for two main reasons.

1. There are a large number of SMEs in Australia (around 96% of Australian businesses employ fewer than 200 employees (ABS 2015)). Their contribution to the Australian economy is, therefore, important. In addition, they are the incubators for larger entities.
2. The burden of preparing financial reports is not cost-neutral for smaller entities and they are less able to bear this burden than larger entities. Sian and Roberts (2009) suggest that the cost of provision of accounting services is one of the greatest concerns for SMEs. This elevates the importance of understanding whether financial reports are actually being used for decision making after they are produced.

In the context of the preparation of international and local financial accounting standards for entities not covered by International Financial Reporting Standards (IFRS), we contribute to the discussion of user reporting needs for SMEs with a focus on Australia, a country in which many entities (including most SMEs) are not required to produce fully-IFRS-compliant financial reports, but are allowed to use a wide range of reporting standards.[1] We respond to calls in the literature from Potter (2013) and others (Christie et al. 2010; Group of 100 2009; Spencer 2014) to address the potential burden of adding IFRS measurement and recognition and additional line items to SME financial reports.

This study is also motivated by concerns expressed by authors that stakeholders' financial information needs have not been canvassed sufficiently when determining SME financial reporting requirements (Deaconu et al. 2009; Jonas and Young 1998; Schiebel 2008; Young 2006). In response to the interest of regulators, standard setters and researchers in the area of users' perspectives, and in the absence of prior empirical research, we present evidence on stakeholder requirements from SME reports. The shortage of prior empirical research is identified by Devi and Samujh (2015: 24) as having 'impeded the

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development of the IFRS for SME's'.[2] Our empirical evidence may help to guide the future development of simplified reporting standards for SMEs in Australia and elsewhere.

After documenting the evolution of reporting requirements in this sector in Australia, we provide evidence about how much financial information is useful, and what particular line items are most useful, for users of SME financial reports in their decision making. The evidence suggests that some elements of SME financial reports may be unused, which supports a more simplified format to reduce the reporting burden.

This paper makes three contributions to the literature on financial reporting by SMEs in Australia. First, it solicits and categorises the perspectives of actual users of SME financial reports, which are often absent from the existing literature. Second, it provides an assessment of these perspectives, concluding that a reduction in the volume of financial reporting by SMEs is both feasible and justified. This contribution may guide the future development of simplified reporting standards for relevant entities in Australia and other countries. Third, it highlights the difficulty of identifying SME reporting issues within the broader context of reporting by unlisted entities in Australia.

Background

There is an inherent tension in discussions of the implementation of a financial reporting standard for unlisted entities in Australia. Because of a decision in 1990 to create a tiered approach to financial reporting based on a contentious country-specific definition of a 'reporting entity',[3] some unlisted entities in Australia adopted IFRS entirely for their reporting (Walker 2007). Lobbying for a reduction in the reporting burden for these entities often confuses or muddies discussion regarding the decision-usefulness of financial reporting, making it difficult to identify user requirements specifically for SMEs.

This confusion is also evident in the development of IFRS for SMEs prior to its release in 2009. Standard setters at the International Accounting Standards Board (IASB) at various times referred to the developing standard as IFRS for SMEs, IFRS for Non-publicly Accountable Entities and IFRS for Private Entities (McCann 2009). The working title 'IFRS for Non-publicly Accountable Entities' was discarded by the IASB because it was 'not easily translatable' and most entities ('even a hot dog stand') have some form of public accountability (Pacter quoted in McCann 2009). IFRS for Private Entities was rejected because entities that are partly owned by the government are considered public entities, but may not be listed (as is common practice in China, France, Sweden and several Latin American countries) (McCann 2009).

At its release in 2009, the IASB would not define the terms of application or a test for company size in the IFRS for SMEs standard, rather preferring this to be interpreted in a country-specific way (Epstein and Jermakowicz 2007). When the Australian Accounting Standards Board (AASB) introduced the Reduced Disclosure Requirements standard (RDR) in 2010, they specified that its application was for non-publicly accountable entities. This confusion about the scope of application of IFRS for SMEs and the RDR forms a critical part of the context in which this study is situated, and is discussed further in this paper.

The study also responds to many concerns in the literature about the impact of full IFRS if applied to SMEs in particular. There has been much discussion of the burden on SMEs for financial statement preparation and additional statutory financial reporting (including Spencer 2014; Group of 100 2009; Collis and Jarvis 2000; Keasey and Short 1990). For example, the Group of 100 (G100) underlined concerns about the 'potentially negative impact' of excessive disclosure that is a distraction for users 'from the information that is relevant to their decision making' (Group of 100 2009: 2). The United Kingdom's (UK) Financial Reporting Council (FRC) has a focus on 'less complex and more relevant' financial reports (Spencer 2014) and is concerned about the obscuring 'clutter' complicating users' analysis of company performance (UK FRC 2009; UK FRC 2011: 5). Collis (2012: 463) also identifies concerns about disclosing turnover as a 'powerful determinant' for non-micro small companies to file full accounts, 'followed by the belief that the accounts they file at Companies House are useful to users'. Citing a survey of Australian accounting practitioners, Holmes et al. (1991: 131) reported 'an obvious demand for differential reporting requirements associated with business size and legal structure', with 97% of the respondents agreeing to the need for differential reporting standards.

Another concern about the impact of IFRS is the cost burden of applying IFRS recognition and measurement approaches (Christie et al. 2010; Potter 2013). For example, Potter (2013: 2) reminds us that 'financial reporting is costly. For some entities, while the extra costs involved with disclosing an additional line item in financial reports may be small, the costs of applying IFRS recognition and measurement approaches in accounting standards for the first time may be significant'.

Concern about the lack of user involvement in the development of accounting standards generally has been raised in the literature by Jonas and Young (1998) and Young (2006). Deaconu et al. (2009) and Potter (2013) are specifically concerned about the lack of attention to stakeholders' financial information needs in SME reporting. The inherent tension in the case of IFRS for SMEs is highlighted by Ram and Newberry (2013), who describe it as a standard for entities that do not engage with capital markets, based on standards that are designed to meet the needs of capital markets users. This wry observation highlights the lack of involvement by users of SME financial reports in setting those standards. Ram and Newberry (2013: 13) explicitly state that 'in reality, there was little or no serious consideration of users' needs'. Potter (2013: 2) succinctly expresses the problem: 'What needs to be established is whether the information being reported is meeting the needs of the preparers and users of financial reports, in light of the costs involved'.

In summary, the lack of empirical research, unspecified guidelines relating to the application of IFRS for SMEs, concerns about the burden of financial reporting for SMEs and the absence of user involvement in the development of the SME standard give rise to our research questions: how much financial information is needed by SME report users, and what particular financial statement line items are most useful? By addressing these questions, this paper contributes to the policy debate over the best approach to SME reporting in Australia because we find that there is both scope and justification for a reduction in the volume of financial reporting by unlisted entities, particularly SMEs.

As Carsberg et al. (1985) suggest, a simplified standard will have the best impact if (i) it is targeted at the actual users of financial reports of SMEs, (ii) it does not increase the burden for SMEs to report beyond the benefits offered, (iii) the cost of exposing confidential information to competitors is not too high, and (iv) there is a high level of compliance with the standard. In a later section, we return to these criteria to evaluate the evidence presented in this paper.

First, we describe the reporting requirements for SMEs in Australia to provide context for our analysis and conclusions. Then we present the arguments for and against reductions in the scope of financial reporting for SMEs, based on the contents of comments letters written to the standard setter in response to a policy suggestion, and a series of interviews with accounting practitioners, standard setters and representatives of professional bodies. From a survey of self-identified users of non-publicly accountable financial reports, we then present findings about which particular line items would be most useful to users. Our analysis of this evidence supports further reductions in the scope of financial reporting for SMEs, and we provide suggestions to legislators and standard setters for future SME reporting.

SMEs in Australia and their Reporting Requirements

As confirmed by Allee and Yohn (2009: 3) in their study of United States (US) small privately held businesses, there is a positive relationship between the size of a firm and the demand for its financial statements. Firm growth is also noted as a 'driver of the production and use of financial statements'. Similarly, Collis et al. (2004) identify size (specifically, turnover) as an important factor in voluntary decisions to audit financial statements for SMEs. In an Australian study, Holmes and Nicholls (1989) suggest that business size is also a factor in the demand for externally prepared accounting data. Although SMEs are different from large corporations in terms of the scope of their operations, they may need to report externally because of their links with larger businesses through trade, acquisition and ownership, because of their relationships with lenders (Collis et al. 2004) and because of their potential to grow beyond the application of SME reporting requirements.

Of course, not all SMEs in Australia are or will ever be large enough to produce General Purpose Financial Statements (GPFS), nor do they have stakeholders or other interested parties who would require them. Using classifications defined by the Australian Bureau of Statistics (ABS), the Australian Government Department of Industry, Innovation, Science, Research and Tertiary Education's 2012 report identifies that the overwhelming majority of SMEs are wholly Australian owned (97%), only have domestic operations (86%), and contribute significantly to employment (70% of private sector employment) (Australian Government Department of Industry, Innovation, Science, Research and Tertiary Education 2012). In 2015, the ABS classified small business as actively trading businesses with zero to 19 employees, whereas medium businesses are actively trading businesses with between 20 and 199 employees (ABS 2015).

In Australia, the IASB/AASB *Framework for the Preparation and Presentation of Financial Statements* guides the formulation of accounting standards for all entities, including SMEs. There are two classifications of financial reports in Australia: GPFS produced by 'reporting entities' and some 'non-reporting entities', and Special Purpose Financial Statements (SPFS) produced by other 'non-reporting entities'.

Since 2005, reporting entities incorporated under the *Corporations Act 2001* produce GPFS using IFRS or a subset of IFRS. The focus of the definition of reporting entities (in SAC 1 *Definition of the Reporting Entity* of the Australian Accounting Standard) is 'the existence of users dependent on general purpose financial reports for information that will be useful to them for making and evaluating decisions about the allocation of scarce resources' (AASB 2009). As well as entities listed on the Australian Securities Exchange (ASX), reporting entities include unlisted entities, and entities in the not-for-profit and government sectors which, by nature of their size and influence, are of interest to the Australian Securities and Investments Commission (ASIC) (ASIC 2014). Any incorporated entity that is not defined as a

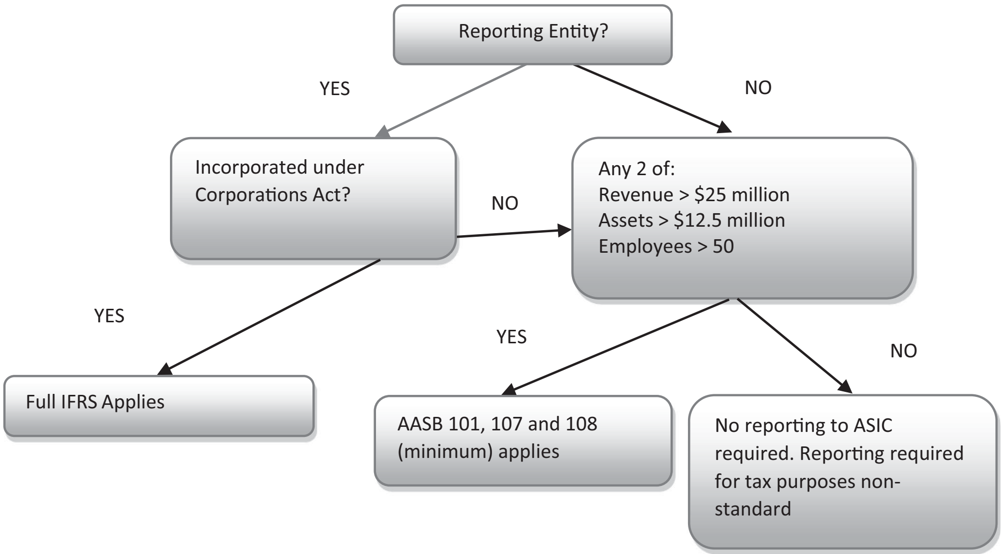

Figure 1 **Reporting in Australia prior to the introduction of phase 1 of the RDR**

reporting entity under the SAC 1 definition is referred to as a non-reporting entity.

Certain non-reporting entities are also required to report to ASIC using a subset of IFRS if they exceed a size threshold that is determined by ASIC. These non-reporting entities need to produce special purpose reports that comply with at least AASB 101 *Presentation of Financial Statements,* AASB 107 *Cash Flow Statements* and AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (ICAA et al. 2007).

The subset of unlisted entities required to submit financial statements to ASIC can be classified as private for-profit entities, foreign controlled entities, unlisted public entities (financial and insurance companies) or public companies limited by guarantee (Carey et al. 2014). Each of these classifications contains large, medium and small entities.

Other non-reporting entities can produce SPFS. The reporting standard used for SPFS is not legislated, although ASIC has provided guidelines stating that SPFS should use IFRS measurement and recognition. As a minimum requirement, SPFS need to conform to AASB 101, AASB 107 and AASB 108 (ICAA et al. 2007). These entities are not large enough to fall within the size criteria specified by ASIC for reporting.

According to the ASIC 2015/16 annual report, 23 047 public companies reported to ASIC, of which 20 971 were unlisted. This number includes registered schemes, foreign companies, emerging mining and resources companies (ASIC 2016). The various types of entities and the legislation each had to comply with prior to 2010 are summarised in Figure 1.

Australia is one of the few countries that did not adopt IFRS for SMEs when the IASB issued it in July 2009. Instead, the AASB opted for the RDR as a second-tier reporting standard, using IFRS measurement and recognition standards (AASB 2010a), but omitting certain disclosures.[4,5] Table 1 summarises the differences between RDR, IFRS for SMEs and IFRS (AASB 2009).

In July 2010, the AASB introduced Stage 1 of the RDR to be implemented for reporting periods after 1 July 2013.[6] The AASB anticipated that Stage 1 of the RDR would lead to a reduction in costs for financial report preparers, a reduction in red tape and a lower volume of information more oriented to users' needs (AASB 2010a). It is important to note that prior to the introduction of Stage 1 of the RDR, including at the time of the release of the *Exposure Draft 192: Revised Differential Reporting Framework* (ED 192), the scope of application of the standard was not clearly known, and confusion existed because of the AASB's concurrent attempts to remove the reporting entity concept. When it was announced, Stage 1 application was limited to larger for-profit proprietary entities (publicly accountable) already using full IFRS measurement and recognition, not smaller ones. The implementation of Stage 2, which will widen the application of the RDR to entities not currently using full IFRS, has been delayed (AASB 2015). It is anticipated that there will be further changes to this approach following the results of academic research into reporting requirements for SMEs in Australia (AASB 2013; Carey et al. 2014; Potter et al. 2013). Figure 2 provides a timeline summary of the development of the RDR.

There are two key differences between Australia and other countries in terms of IFRS. First, although IFRS were targeted initially at listed, for-profit entities (Fearnley and Hines 2007), they have been applied more widely in Australia: 'Other countries such as the United Kingdom (UK) adopted them (i.e. IFRS) for listed

Table 1 Differences between IFRS, IFRS for SMEs and the Reduced Disclosure Reporting Standard (RDR) (AASB 2009)

	Measurement	Recognition	Disclosure	Drafting	Application in Australia
IFRS	IFRS	IFRS	IFRS	IFRS	Listed entities, some not-for-profit and government entities, other non-listeds meeting ASIC's size threshold
IFRS for SMEs	Different to IFRS	Different to IFRS	Fewer and differences[24]	Shorter than IFRS and simplified	Not available for use in Australia
RDR	IFRS	IFRS	Fewer[25]	Shorter than IFRS	Phase 1 (from FYE June 2010): Unlisted reporting entities

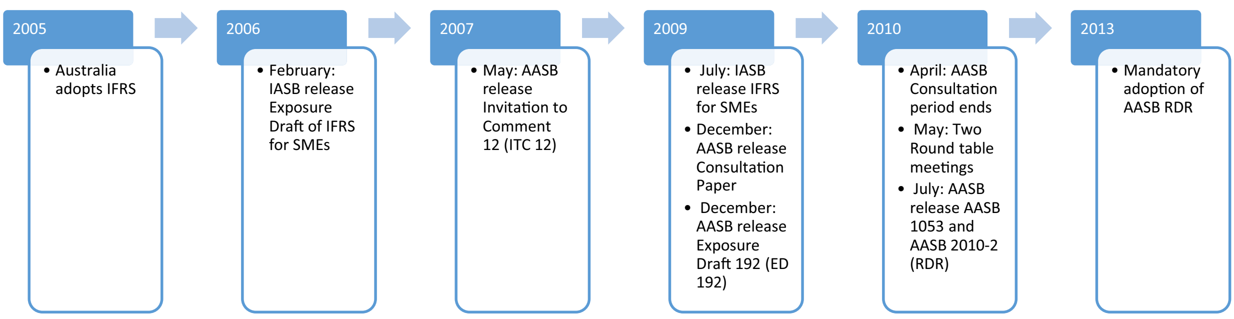

Figure 2 **Timeline of the development of the RDR [Colour figure can be viewed at wileyonlinelibrary.com]**

groups but retained local generally accepted accounting practice (GAAP) for individual companies and other entities', leaving Australia with its own 'set of challenges' relating to unlisted entities required to use full IFRS (ICAA 2007: 5).

The second key difference is that the extension of IFRS to non-reporting entities in Australia depends on the entity assessing whether or not it is a reporting entity, which is acknowledged to be subjective and has been criticised for mixed interpretation and inconsistent application (ASIC 2000). According to Boymal (2007: 108):[7] 'To avoid classification as reporting entities, companies state that they are preparing special purpose reports for the purpose of lodging with ASIC or for the purpose of conforming to their constitution or for the purpose of conducting an annual meeting. I regard these as devices to avoid reporting obligations'.

The post-2010 reduction in the application of IFRS responds to earlier calls for a reduction in the reporting burden on unlisted entities, most of which are relatively small with limited resources (CPA Australia and Rankin 2007; Durkin 2009; ICAA 2007; Reilly 2009). The release of the IASB *Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities* in February 2006 gave Australia a 'wake-up call' to resolve differential reporting (Evans and Cummings 2007), and heralded a fierce debate on SME reporting requirements amongst academics, practitioners, member bodies and regulators.

Determining Financial Report Users' Information Needs

The IASB/AASB *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*) states that the objective of financial statements is to 'provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions' (AASB 2010b para 12). These users include 'present and potential investors, suppliers and other trade creditors, customers, governments and their agencies and the public' (AASB 2010b para 9)[8] and extend to a variety of information needs. *Statement of Accounting Concepts SAC 1: Definition of the Reporting Entity* explains that GPFS are to be prepared for existing users who 'cannot command the preparation of information to satisfy their individual information needs' (AASB 2010b SAC 1 para 8) and guidance is provided for entities that are unable to determine whether there are any such users (AASB 2010b SAC 1 para 19–22).

Although the importance of determining users' needs is a prominent theme in the literature and accounting conceptual frameworks, it is not clear that the standard setters know users' identities or needs in practice (Strouhal et al. 2010; Young 2006). Deaconu et al. (2009: 1, authors' emphasis) confirm that: 'One of the main observations which were [sic] made, especially from the European respondents, referred to the fact that the standard does not really take into account the *stakeholders specific to SMEs and their needs*'. Jonas and Young (1998: 155) argue that the production of accounting standards should begin with standard setters seeking information from potential users of the reports as users are the 'experts in the interpretation of information'. By acknowledging that they will 'be directed toward the common information needs of a wide range of users' when developing standards (AASB 2010b Framework para 6), the *Framework* recognises that users of financial statements are the foremost reason for producing them.

However, the literature also reports that the identity of users of financial statements in the SME sector is difficult to determine (Cole et al. 2012; Collis and Jarvis 2000; Jonas and Young 1998; Young 2006). Many of the types of users identified in the *Framework* could demand information directly from a smaller company. For example, creditors, banks and other types of lenders can require information to be provided to them as part of a loan agreement and regulatory or oversight agents can also request specifically tailored information. Compared with firms that do not produce financial reports, Allee and Yohn (2009) find that firms producing financial statements voluntarily have a higher debt to asset ratio, a need for external credit, more employees, growth in sales during the year, and/or ownership that includes limited liability of owners or a larger number of owners. Because of their relatively smaller size and market impact compared with larger entities, SMEs may not attract the attention of other GPFS users, for example, labour unions or the media. Finally, by virtue of owner-management or a close alignment between owners and managers, there may be no Type 1 agency issues (Allee and Yohn 2009; Watts 1977). For these reasons, SMEs might have no external investors who are unable to request internal reports. From the company's perspective, as suggested by Dang-Duc (2011: 102), 'the decision-usefulness theory might not apply to smaller firms since the external use of financial information provided by SME reporting practices is limited'.

During the formulation of accounting standards, standard setters usually seek opinions about the needs of external users of financial statements by exposing the proposed change to the discerning public and calling for comment letters in response to the ED. As a means of eliciting the views of users, these broad and unfocused invitations to participate rely on users initiating communication with the standard setters. Therefore, it is not surprising to find little involvement by report users in the activities of writing comment letters on EDs and discussion papers (Durocher et al. 2007; Durocher and Gendron 2011; Georgiou 2010; Gilfedder and Ó hÓgartaigh 2001; Jorissen et al. 2012; Katselas et al. 2011; Larson 2007). Georgiou (2002: 704) suggests that 'either the majority of parties use other methods of participation, or they do not participate at all in the process'.

The literature identifies several reasons for this inactivity in the process of standard setting. Jonas and Young (1998) attribute it to the future, elusive nature of benefits to users who are more focused on the present. They also suggest that aggressive participation in the standard-setting process by other constituents takes up the standard setters' time and diverts their focus away from other users' needs. Georgiou (2010) attributes an identified lack of influence by user groups to a belief that their involvement would not change the outcome of the standard-setting process. In the case of the IASB's public due process for its SME standard, such a belief is affirmed by Ram and Newberry (2013), who conclude that the process was closer to a public relations exercise than one designed to capture the will of the people.

Durocher and Gendron (2011: 236) suggest that 'docile', 'sophisticated' users have a 'propensity not to challenge standard setters' discourses, practices, and decisions'. The technical nature of accounting standards may intimidate some users (Jonas and Young 1998) and the technical language used in standards may be a barrier (Young 2003). Young (2003: 624) considers that only an expert could succeed 'in untangling the complicated phrasing and in using the highly specialized language of accounting'. For this reason, prominent among the participants in the standard-setting process are firms of accountants and auditors who claim to speak on behalf of smaller users.

In summary, prior research signals under-representation of users of SME financial statements in the standard-setting process and a consequent need for research that focuses on their information needs. In response, this study seeks to determine how much information and what information users need. The next section provides details of the research undertaken.

Research Method

We sought the views of users of financial statements for SMEs in Australia as part of a wider project about SME reporting. In 2011 we conducted semi-structured interviews with interested and informed participants in the SME reporting issue to identify the arguments for and against SMEs providing less detailed reports. In order to understand and rank their particular needs, an online survey to a comparable group of users was developed and administered.

Our interviewees were chosen to provide a range of views and relevant experience with SME reporting. We approached respondents to *Exposure Draft 192: Revised Differential Reporting Framework* (ED 192) and its accompanying Consultation Paper: *Differential Financial Reporting – Reducing Disclosure Requirements* (whom we contacted using email addresses provided in their comment letters),[9] members of the AASB and rural accountants. Our specific selection criteria included the level of detail in the comment letters, ease of practical access to the research team, a breadth of views and representation from a variety of institutions. Of the 17 interviewees approached, 14 agreed to be interviewed. They comprised one member of the AASB, two partners in Big 4 accounting firms (one of whom was also a member of the AASB), three partners in mid-tier accounting firms, two senior employees of major financing and insurance companies, four representatives of professional bodies and two other accounting practitioners who serve rural communities and were active in the SME sector. The interviews were recorded, transcribed and imported into NVivo. Lexicographical content analysis of the recorded interviews sorted the data into themes derived directly from the content. To preserve anonymity, and consistent with the ethics approval for this research, the interviewees are identified as P1 to P14 where they are quoted or referenced directly in this paper.

The timing of the study is relevant when considering how respondents would have viewed the scope of potential application of any changes to reporting requirements. As Figure 2 shows, when comments were submitted on ED 192, Stage 1 of the RDR had not yet been announced. The Stage 1 announcement in June 2010, with the application of the RDR to large publicly accountable unlisted for-profit proprietary entities and some publicly held entities, precedes the survey and interviews. Therefore, interviewees and survey respondents may have been aware of the AASB's need for additional information before making a decision on reduced reporting requirements for SMEs.

How Much Financial Information is Needed by SME Report Users?

From our analysis of this first research question using interview data, two opposing positions were evident: those in favour of no (or minimal) reduction in reporting content, and those advocating for a lower reporting burden for SMEs.

Arguments for no reduction

Arguments for no reduction in reporting content from full IFRS are sourced from our interviews when participants were aware of two sets of accounting standards for GPFS, and the somewhat *ad hoc* SPFS approach.

Provide for the needs of 'potential' users

Some interviewees conceptually supported the requirement to produce general purpose reports, citing this as an obligation to 'potential[10] users' (P7) arising from limited liability. The presumption is that potential users might need more detailed reports. This view was expressed by P8 and P12.

'It may not be possible to actually in practice find that there are users. But the . . . concept behind it is that there are a broad group of interested parties who may be users of the financial information' (P8); '. . . there should be a rebuttable presumption that if you're on public record there are users of your report' (P12).

A number of interviewees agreed that in the event of a default, it would be important to have generally available financial statements that were credibly prepared. Such a historical record of financial statements might be scrutinised by users who were previously uninterested, for example, minor creditors, solicitors and tax officials: 'I think the question that somebody might use them is probably a timeframe issue . . . you could quite conceivably go along for a number of periods and say nobody is going to use this . . . if something's not going so well in your business at the moment, now there probably will be users out there' (P7); 'We're looking at it cross-sectionally and saying this year nobody uses that information. But in the life of a company there are clearly times when that information is going to be needed . . . around distress' (P1); 'We still need GPFS because they are used in event of default. The users don't know they are users yet' (P9).

Need for consistent reporting

There was high regard for the need to have consistent reports between entities and over time so that the content of the reports could be compared. 'From a user perspective, using different measurement and recognition would mean that two sets of accounts can't be compared. You would have the same issue if you acquire a company using SPFS . . . You can't trust the accounts of small entities' (P5); '. . . there's got to be a minimum, and there's got to be a standard of accounts, and if members don't care, well, that's tough, they don't care, you've just got to still have a line in the sand, and that's what accounting is' (P13).

Concerns with SPFSs

The inconsistency and incomprehensibility of reports that were not prepared according to a well-defined set of accounting standards were a concern. 'Picking and choosing how you report, I think it's just disgraceful from a user perspective. How is a user going to understand that?' (P2); '. . . while I see that some individuals may . . . require some training or some learning, I think . . . that the special purpose financial statements are a mess at the moment' (P12).

Arguments for a simplified standard

Absence of identified users

The need for international comparability for SME reporting was first questioned in Invitation to Comment (ITC) 12, and ED 192 comment letters (see, e.g., CPA Australia and Rankin 2007). It is recognised that the majority of SMEs in Australia are wholly Australian owned. There is no SME market for international vendor financing or a need for international credit ratings for SMEs in Australia (CPA Australia and Rankin 2007). For the small number that do trade internationally, cross-border suppliers use financial guarantees and letters of credit to secure their business relationships, rather than relying on financial statements.

Comment letter writers believe that GPFS should include the three basic reports – income statement, balance sheet and statement of cash flow, as well as statements of accounting policies, and related party disclosure, modified for not-for-profit entities (BDO Kendalls (NSW) and Basford 2007). Some ITC 12 commentators specify that the current reporting standards for non-reporting entities (AASB 101;[11] AASB 107;[12] AASB 108;[13] AASB 1031;[14] AASB 1048[15]) would meet the needs of users (e.g., Commerce Queensland and Bidwell 2007). One would also include IAS 24[16] *Related Party Disclosures* on this list (Deloitte Touche Tohmatsu and Rundell 2007).

A number of interviewees echoed this view. P9 suggested smaller creditors might need the reports, but P6 felt that most creditors had their own 'mechanisms' to get the required information and 'don't rely on their accounts'. This was supported by the following comment from P14, a bank employee: 'We can demand information that we want. So from that perspective, we've got no sort of business or commercial requirement to impose a stricter reporting regime or requirement around financial statements on organisations we lend to because we're in a position where we can simply specify the format of the information that we need'.

Relevance of complex financial reports to SMEs

Similarly, interviewees elaborated on earlier calls expressed in comment letters for 'fewer mandatory disclosures in the Australian SME standard' and 'allowing an entity to select the "simple" measurement option of cost' (Australian Institute of Company Directors and Evans 2007). The view was expressed that owners and managers find the compliance burden of more complex financial reporting to be unnecessary and wasteful: 'They see their real role as running the companies, driving performance, and they do see this as a lot of technical stuff and a lot of compliance, and it's getting in the way of their performance ... they [managers/directors] feel swamped by compliance and conformance red tape' (P6); 'They don't want to do a balance sheet. Most clients don't use them. They just say this is a piece of paper ... They'll throw it in the corner. They'll just say, "How much tax?"' (P8).

Interviewees also commented that standards are 'failing' (P9) the needs of users because they produce 'reams and reams of more information' (P9) rather than satisfying users' real needs: '... their needs are probably for information that's summarised and categorised and presented in a far more digestible forum than it's actually currently presented in financial reports' (P9); [Directors and management] 'think it's so technical that they are driven to external experts and consultants, which really are expensive, they feel they lose control of it, they don't understand it, and it's changing all the time' (P6); '... what they really want is data rather than information ... to some extent the broad user that the reports are in theory provided for understands less and less of the information because there's more and more data going in ... if we define the users as the broad base of people who might be interested in financial information, I think that evidence would suggest that financial reporting's probably failing the objective of providing information to those users ... It's gone beyond most lay users' (P8).

Loss of confidential information to competitors

Disclosure of too much information to competitors threatens the sustainability of SMEs. However, they are willing to benefit from access to a competitor's information. 'We know that the reason that a lot of our clients are often reluctant about disclosing too much in the financial statements is that they know their competitors look. And they know that when their competitors file theirs, they immediately all go on the ASIC website and download and have a good read through' (P12); 'Some people think private companies should be private' (P11).

Challenges of report preparation

The increased cost of producing annual financial statements was of major concern, especially for smaller practitioners (see, e.g., Cornall 2007; Nuss 2007, QBE Insurance Group and Drabsch 2007).

This concern was explained by interviewees: 'None of this is cost free ... Large systems need to be put into place ... they haven't got deep pockets, and it is an issue of materiality and disproportion' (P6); 'It's very difficult to do a cost–benefit equation on financial information because the benefits go to the users, and the cost is borne by the preparers' (P8).

Also, the lack of access to qualified professionals regionally was seen as a threat to compliance, if the profession is unable to train and locate more suitably qualified accountants (Wilcher 2007; Beckingham 2007; Rutter 2007).

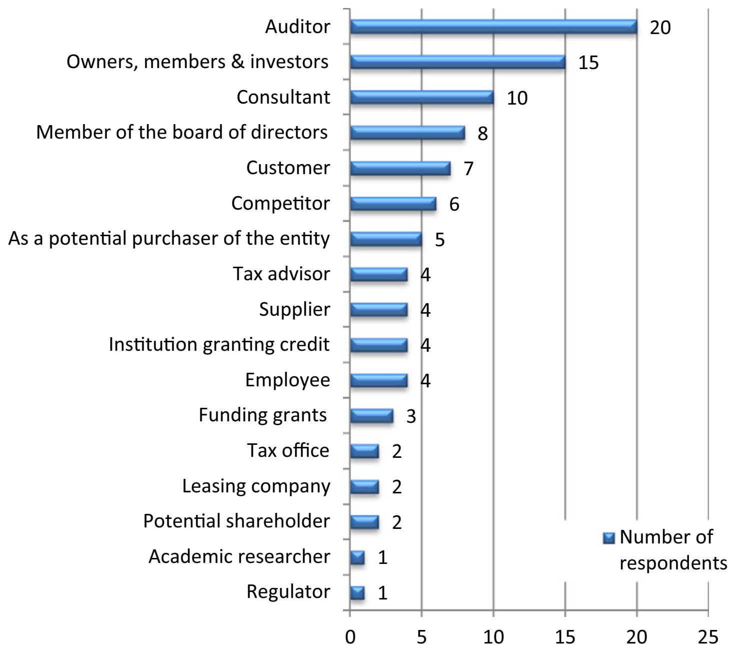

Figure 3 **Perspective taken when using financial statements (n = 98) [Colour figure can be viewed at wileyonlinelibrary.com]**

What Particular Financial Statement Line Items are Most Useful?

This second research question is analysed using data from an online survey of users of financial reports of non-publicly accountable entities. The survey was designed to seek users' views on the relative importance of 32 line items in financial statements.[17] The list is shown in Appendix A. The items were adapted from Cole et al. (2012), with small changes to the list after consultation with members of the accounting profession[18] and after pilot testing.[19]

A link to the online survey was distributed by two professional accounting member organisations in Australia, the (then) Institute of Chartered Accountants Australia (ICAA)[20] and the (then) National Institute of Accountants (NIA)[21], and the Australian Institute of Company Directors (AICD). Distribution was via a link in the newsletters of the ICAA and the AICD, and via Twitter and Facebook for the NIA, between 28 January 2011 and 8 March 2011. These newsletter links advertised the nature and objectives of the survey. This paper examines the 98 completed responses.[22]

Respondents to this survey are self-identified users of financial statements of Australian non-publicly accountable entities. We selected the term 'non-publicly accountable entities' rather than 'SMEs' because the RDR was initially targeted at the former, despite the application of Stage 1 to publicly accountable entities. Non-publicly accountable entities were defined in the survey as incorporated entities other than any 'listed entities on the ASX or other exchanges, and entities that control other people's money, for example, banks and mutual funds'.

Survey respondents completed the survey from the perspective of the last set of non-publicly accountable entity financial statements they had used: this is summarised in Figure 3. The most frequently selected perspective was from auditors and accountants (20), followed by owners, members or investors (15), consultants (10) and members of the board of directors (8). The remainder of the sample included a diverse range of user types, including customers, competitors, potential purchasers, lending and funding institutions, tax advisors, suppliers and government functions (e.g., regulators and the tax office).

The five most important financial reporting items as indicated by the respondents[23] are shown in Table 2.

When the scores for *Important* and *Very Important* are combined, the five most important items on the financial statements are Sales or revenue (92%), Operational profit (85%), Working capital (84%), Level of debt (83%) and the Cash flow statement (81%). The items selected most frequently as *Very Important* are Operational profit and Level of debt (both 56%). These items highlight the concerns of users, and mirror the AASB's view that users want information for assessing expected returns, establishing the nature and assessing the uncertainty of an entity's cash flows, and evaluating the success of management in discharging its responsibilities (AASB 2013). They are items that can be used to predict SMEs' future liquidity and profitability and to assess the success of management in translating revenue into profit.

Table 2 **Most important items used on financial statements (n = 98)**

	Item	Very unimportant (%)	Unimportant (%)	Neither important nor unimportant (%)	Important (%)	Very important (%)
Most important	Sales or revenue	2	2	4	38	54
	Operational profit	3	3	9	29	56
	Working capital	4	3	9	37	47
	Level of debt	7	4	6	27	56
	Cash flow statement	6	4	9	29	52

Table 3 **Reasons why information on reports was *Important* or *Very important* according to users of reports (n = 98)**

Reason	%
Comparison of the entity's performance to its performance in previous periods	53
Assurance of good management	51
To confirm the correctness of other financial statements or claims made by the entity	50
To assess performance trends	47
Making investment decisions	30
Comparison of the entity's performance to other Australian entities	28
To aid in auditing the entity	25
Comparison of the entity's performance to other entities in the same group	13
Comparison of the entity's performance to your own entity	12
Confirmation of credit risk (as a financial institution)	10
To aid in auditing a similar entity	10
Confirmation of credit risk (as a supplier or potential supplier)	9
To aid in auditing a competing entity	6
To calculate remuneration	4
Comparison of the entity's performance to other non-Australian entities	3

Untabulated results show that the five least important items are Dividend policy, Goodwill, Information about shares, Ratios and Notes to acquisitions. None of these items scored over 50% in the categories *Very Unimportant* and *Unimportant*.

Respondents were asked to identify how they use the information they indicated was *Important* or *Very Important*. The responses are shown in Table 3, listed from most frequently selected to least frequently selected.

The most common reason for using the financial statements of non-publicly accountable entities is to compare the ongoing performance of the entity with previous periods. The first four reasons indicate an assessment of stewardship from the perspective of an investor or potential investor as well as showing the use of the financial statements to make decisions regarding credit supply, analysis of credit risk and comparison with competitors and other similar entities. In addition, many users use the reports to confirm that the claims made by an entity in their financial statements are correct.

These responses confirm that users focus on expected returns, cash flows, financing and monitoring of management.

Analysis

That there are two conflicting views regarding the amount of accounting information required to be produced by SMEs is evident from the interviews. On the one hand were those who argue that SMEs have a duty to 'potential' users to report in such a way that is understandable and is comparable to the reports of other (larger) entities. This obligation arises in part from the protection provided by limited liability, and in part to allow for unforeseen circumstances, for example, potential default in payments to creditors.

The other side of the debate argues three main points: for SME reporting to be sustainable and to constitute value-for-money, the reports need to provide less complex information; SMEs need to avoid disclosing too much information to competitors; and SMEs need to be protected from excessive burden and costs associated with reporting.

Using the four criteria for a simplified standard from Carsberg et al. (1985) ((i) targeted at the actual users, (ii) does not increase the burden to report beyond the benefits offered, (iii) exposing confidential information to competitors is not too costly, and (iv) high level of compliance), we evaluate these arguments in the context of the interview and survey findings. We also note the (subsequent) Australian Financial Reporting Council's (FRC) findings from their consultation process into managing financial report complexity in October 2012, which reports:

> In particular, there was a view that the reporting requirements for not-for-profit (NFP) entities, smaller entities, and the public sector could be further explored to reduce the reporting burden on such entities. Suggestions were made to allow International Financial Reporting Standards (IFRS) for Small and Medium Entities (SMEs) in Australia, and/or revise the Reduced Disclosure Requirements (RDR) framework to lessen the reporting burden. Several respondents noted the low take-up rate of RDR and suggested that the Australian Accounting Standards Board (AASB) make it easier for entities to

> adopt RDR and consider further changes to RDR to ensure that the reporting burden for eligible entities is aligned to the benefit provided to users of their reports (FRC 2012: 2).

First, our survey shows that the needs of actual users of the financial reports of non-publicly accountable entities focus on comparative performance analysis over time, in order to predict expected returns, cash flows and future financing, and to monitor management. These needs could be met with reduced reporting, provided that key metrics from the income statement, the balance sheet and the statement of cash flows are reported consistently over time and between SMEs. Such metrics would include total revenue, net profit, total assets, total equity and cash flow from operations. Second, it is clear from the contrary views expressed through the interviews that many participants in SME reporting do not favour a high reporting burden for SMEs, because the costs impact the SMEs currently whereas the benefits are elusive and distant. This may motivate behaviour that results in lower compliance with complex and detailed SME financial reporting standards. Finally, the interviews elicited the trade-off between the level of compliance and the impact of exposing confidential information to competitors, which again may motivate entities to use SPFS rather than GPFS.

In summary, the evidence we have analysed supports the case for a reduction in reporting by SMEs. The reasons for SMEs to adopt the RDR are based on principles and the existence of potential future users rather than on the needs of actual users. We conclude that some information reported in GPFS for SMEs may be unused, thus burdening SMEs with unnecessary reporting costs.

We acknowledge that the context in which our study was conducted was the introduction of an accounting standard in Australia for all unlisted entities, not just SMEs. Although we made specific reference to SMEs in the interviews it is possible that some confusion may have arisen as a result of interviewees including larger entities in their thinking. The survey participants were asked to specifically position themselves as users of financial reports of non-publicly accountable entities when responding. As SMEs form a subset of non-publicly accountable entities, we can confidently make reference to the applicability of the survey findings to SMEs. However, this may explain why survey respondents were reluctant to classify any of the suggested line items as unimportant. A future survey targeted specifically at SMEs might identify further possible reductions in the number of line items.

The juxtaposition of the introduction of the RDR and discussions being conducted at the same time regarding repurposing of the reporting entity concept in Australia caused, and continues to cause, concern (see, e.g., West, 2015). This may also be the reason for the conflicting views presented in the interviews, particularly relating to complexity, comparability and the financial reporting obligations arising from limited liability.

Nevertheless, based on our research, we recommend that future revisions to SME reporting standards should consider further reporting reductions. This could be achieved by removing disclosures on ratios, superannuation, information about shares, and dividend policy, or by starting with the three basic reports and adding key disclosures such as working capital, EBIT or EBITDA and the level of debt.

Conclusion

This study addressed two research questions: How much financial information is needed by users of SME reporting, and what particular financial statement line items are most useful? The data include interviews with 10 writers of comment letters to ED 192, two members of the AASB, and two rural accounting practitioners, and survey responses from users of non-publicly accountable financial statements. We acknowledge the possibility of a self-selection bias in the survey respondents and possible bias towards protecting the disclosures of larger entities in ED 192 commentators and therefore our interviewees. However, we maintain that the respondents are informed and articulate users who represent the population of SME financial statement users.

In relation to the question of how much financial information is needed by users of SME reports, we conclude from the interviews that some users of SME financial statements would be satisfied with less complex reports that provide information regarding an entity's liquidity, profitability and solvency. Other users who favour reporting according to a comprehensive set of accounting standards are concerned about unspecified future needs for financial information, particularly in the event of financial distress. They are also concerned about the lack of consistency and comparability of SPFS.

From the survey, we find that the five most important items on the financial statements for users are Sales or revenue, Operational profit, Working capital, Level of debt and the Cash flow statement. These items can be used to predict SMEs' future liquidity and profitability and to assess the success of management in managing cash and in translating revenue into profit.

Overall, using Carsberg et al.'s (1985) criteria, this research supports the viewpoint that resistance to costly, complex and detailed financial reporting by SMEs is justified and is likely to continue. Our empirical evidence reinforces our recommendation for a reduction in disclosure requirements that will meet the decision-useful requirements specified by the five most useful items.

The Stage 1 implementation of the AASB's RDR in Australia only offers a reduction in disclosure and not a reduction in measurement and recognition for unlisted entities. It has been applied to a subset of unlisted entities, *viz.* publicly accountable for-profit private sector entities and some government entities (AASB 2010a). The research conducted to date in Stage 2 examines the reporting choices of reporting and non-reporting entities using size criteria specified in *SAC 1* (Carey et al. 2014; Hamidi-Ravari 2014). From the Stage 2 research emphasis, we conclude that the focus of the standard setter is still larger unlisted entities rather than smaller ones.

We contend that the standard-setting process for the RDR in Australia has failed to properly elicit the views of users of SME financial reports. This failure has two sources. First, the RDR discussion was not targeted only at SMEs but included larger entities. Second, the RDR was not the only item on the AASB's agenda. At the same time as the RDR was being discussed, the AASB chose to raise issues concerning the repurposing of the reporting entity concept, which diverted focus from the information needs of SME report users.

The evidence from our survey confirms the need to reduce the reporting burden on SMEs. The conflicting findings from the interviews serve to underline the lack of focus on smaller entities by standard setters. While this paper goes some way to airing the concerns of SME users for decision-useful SME reports that minimise the burden on entities, further, targeted research is needed in this area.

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Notes

1 How entities decide whether they are required to use IFRS or not is illustrated in Figure 1.
2 IFRS for SMEs is *International Financial Reporting Standard for Small and Medium-sized Enterprises.*
3 Discussion of the reporting entity concept is beyond the scope of this paper. For more information, see Walker (2007) and Carey et al. (2014).
4 These omissions are based on those excluded in the process of creating IFRS for SMEs from IFRS (AASB 2009).
5 Both IFRS for SMEs and RDR exclude the same IFRS disclosures. The exceptions to this rule are disclosures that are no longer found in IFRS for SMEs because of changes in measurement and recognition from IFRS. Where the RDR does not change IFRS measurement and recognition, these disclosures remain in the RDR (see AASB 2009 Appendix 3: 44–6).
6 The change implemented in AASB 2012-2 and AASB 1053 allowed for disclosure relief for some SMEs that were already using full IFRS.
7 Professor David Boymal was the Chairman of the AASB at the time of the release of ITC 12.
8 In the 2013 amendment to the *Framework*, the list of users has been shortened to 'existing and potential investors, lenders and other creditors' (AASB 2013 OB2). In order to be contextually correct, this paper refers to the 2010 *Framework,* which was in place at the time of data collection.
9 There were 41 unique letters written to comment on ED 192. We interviewed 34% of these letter writers. The letters are publicly available at http://www.aasb.com/au
10 At the time of the interviews and survey, potential users were not explicitly included in the AASB *Framework*. This amendment only appeared in the 23 December 2013 release (AASB 2013).
11 IAS 1 *Presentation of Financial Statements.*
12 IAS 7 *Cash Flow Statements.*
13 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*
14 Does not have a corresponding standard in IFRS.
15 Does not have a corresponding standard in IFRS.
16 AASB 124 *Related Party Disclosures*
17 The survey also tested the effectiveness of and motives for participation and non-participation in the development of the RDR standard. The full survey instrument is available from the authors on request.
18 Since the purpose of Cole et al. (2012) was to examine differences between users of publicly and non-publicly traded companies in Belgium, there were items on their list that did not relate to Australian non-publicly accountable entities.
19 Eight pilot test respondents were drawn from the target population. The pilot group were members of the Sydney Corporate Group of the ICAA.
20 Now known as Chartered Accountants Australia and New Zealand.
21 Now known as the Institute of Public Accountants.
22 A limitation of this paper is the small sample size when compared with the full memberships of these professional bodies. However, this is normal for samples administered in this way.
23 The full list of available items is provided in Appendix A
24 Some topics are omitted such as Earnings per Share, Interim Financial Reporting, Segment Reporting, Special Accounting of Assets held for Sale. Some policy options in IFRS are limited to only one option in IFRS for SMEs such as Goodwill, or a new option is written such as not allowing revaluation of Property Plant and Equipment and other Intangibles.
25 Fewer disclosures than full IFRS. Based on the disclosures excluded from IFRS in the drafting of IFRS for SMEs, but still includes any IFRS disclosures that were removed from IFRS for SMEs because of changes made in this standard in measurement or recognition (not made in the RDR).

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Appendix A: List of financial statement items available for ranking in the survey instrument

Cash flow statement
Sales or revenue
Operational profit
EBIT or EBITDA
Net profit before tax
Profit margins
Cost structure
Wages
Superannuation
Lease costs
Other expenses
Composition of expenses
Composition of equity
Balance sheet structure
Level of debt
Working capital
Cash and cash equivalents
Goodwill
Trade receivables
Management discussion and analysis (MD&A)
Accounting policies
Off-balance sheet items
Impairments
Provisions
Notes to acquisitions
Events after the balance sheet date
Summary of accounting principles
The standards that were applied
Information about the shares
Dividend policy
Auditors report
Ratios

