THE INTERNATIONAL FINANCIAL REPORTING STANDARD FOR SMALL AND MEDIUM-SIZED ENTITIES: THE NEED AND FORM OF A THIRD-TIER FINANCIAL REPORTING STANDARD IN NAMIBIA

by

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I, the undersigned, declare that this dissertation, **The International Financial Reporting Standard for Small and Medium-sized Entities: The need and form of a third-tier financial reporting standard in Namibia**, is my own work, and that all the sources I have used or quoted have been indicated and acknowledged by means of complete references.

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ABSTRACT

The development of the *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs)* was based on the demand for a more simplified financial reporting standard, compared to International Financial Reporting Standards (IFRS). Despite simplifications, the requirements of the *IFRS for SMEs* are still regarded complex and costly to apply, especially for micro entities in developing countries such as Namibia. Consequently, there is a need to further simplify financial reporting requirements for micro entities in the form of a third-tier financial reporting standard. A third-tier standard can take the form of either a separately developed standard or a simplification of existing standard(s). There are more advantages to the development of a standard based on existing standard(s), taking into account the Namibian financial reporting environment. It is therefore recommended that Namibia develop a third-tier standard based on the *IFRS for SMEs.*

Keywords

IFRS for SMEs, third-tier financial reporting standard, differential reporting, GAAP, Namibia, Small and Medium-sized Entities, IASB, public accountability, general purpose financial statements, fair presentation

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LIST OF ABBREVIATIONS

AASB	Australian Accounting Standards Board
AcSB	Accounting Standards Board of Canada
ASB	Accounting Standards Board of the UK
DP	Discussion Paper
EC	European Commission
ECSAFA	Eastern Central and Southern African Federation of Accountants
ED	Exposure Draft
EU	European Union
FRC	Financial Reporting Council
FRSSE	Financial Reporting Standard for Smaller Entities
GAAP	Generally Accepted Accounting Practice
GDP	Gross Domestic Product
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSA	Hong Kong Society of Accountants
IASB	International Accounting Standards Board
ICAN	Institute of Chartered Accountants of Namibia
IFAC	International Federation of Accountants
IFRS for SMEs	International Financial Reporting Standard for Small and Medium-sized Entities
IFRS	International Financial Reporting Standards
ISAR	Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting
MSME	Micro, Small and Medium-sized Entities
SAICA	South African Institute of Chartered Accountants
SME-FRF	Small and Medium-sized Financial Reporting Framework
SME-FRS	Small and Medium-sized Financial Reporting Standards
SMEs	Small and Medium-sized Entities
UK	United Kingdom
UNCTAD	United Nation Committee on Trade and Development

CHAPTER 1
INTRODUCTION

1.1 BACKGROUND

Differential reporting, that is, different reporting requirements for small and medium-sized entities (Stainbank, 2011:104), was first introduced to the Namibian financial reporting environment in 2006. At that time, the Namibian Institute of Chartered Accountants (ICAN) had adopted the *International Financial Reporting Standards* (IFRS) as statements of Generally Accepted Accounting Practice in Namibia (GAAP), effective 1 January 2005 (ICAN, 2006:1). At the time of passing the resolution to adopt IFRS, ICAN recognised that compliance with IFRS would impose a significant burden on preparers of financial statements, particularly of small and medium entities (SMEs) (ICAN, 2006:1). In an effort to give immediate relief of this burden, ICAN adopted the *Eastern Central and Southern African Federation of Accountants Guide on Reporting for Small and Medium-sized Entities* (*ECSAFA Guide*) as a statement of Namibian Generally Accepted Accounting Practice in 2006 (ICAN, 2006:1). This guide was developed by the Eastern Central and Southern African Federation of Accountants (ECSAFA) to reduce the reporting complexities of SMEs with relation to recognition, measurements and disclosure requirements (ECSAFA, 2006). The *ECSAFA Guide* was adopted by ICAN as an interim measure in anticipation of the release of the *International Financial Reporting Standard for Small and Medium-sized Entities* (hereafter referred to as *IFRS for SMEs*) under development by the International Accounting Standards Board (IASB) at the time.

IFRS for SMEs was adopted as GAAP in Namibia in 2010 (ICAN, 2010:1). Since that time, ICAN has considered whether *IFRS for SMEs* sufficiently alleviates the compliance burden of SMEs, especially those outside the scope of the standard. This consideration is not unique to Namibia. South Africa has also considered the need for a third-tier simpler and easier financial reporting framework for smaller, non-public entities (Van Wyk and Rossouw, 2011:259). Further abroad, Australia and the European Commission have expressed concern regarding the complexity of *IFRS for SMEs* and have thus not adopted the standard (Perera and Chand, 2015:165). Since the adoption of *IFRS for SMEs*, ICAN has been considering the withdrawal of and possible replacement of the *ECSAFA Guide* with another reporting standard for which the form and content are to be determined.

This report first gives an outline of the *IFRS for SMEs*, followed by a review of the need for a third-tier standard. Thereafter, an overview of the form that this standard may take is given and applied to the Namibian context. The report closes with results and conclusions.

1.2 PROBLEM STATEMENT

The *IFRS for SMEs* may not be the most suitable standard for all SMEs, especially micro entities, in Namibia. Accordingly, there is a call to investigate the need for further differentiation of accounting requirements by means of a less complex third-tier reporting standard. The form such a standard could take also needs to be examined.

The *IFRS for SMEs* was adopted as GAAP in Namibia in 2010 (ICAN, 2010:1). Since that time ICAN has considered whether *IFRS for SMEs* sufficiently alleviates the compliance burden of SMEs, especially of those SMEs outside the scope of the standard. ICAN considers the withdrawal of and possible replacement of the *ECSAFA Guide* with another reporting standard for which the form and content are to be determined.

1.3 RESEARCH OBJECTIVES

The objective of this research was to investigate the need for a third-tier financial reporting standard in Namibia and the form that such a standard could take:

- In order to assess the need for a third-tier financial reporting standard, the *IFRS for SMEs* and its intended scope is outlined to give context to the type of reporting entities to which it is intended to apply. The importance of SMEs is outlined and international definitions of SMEs are reviewed. This is followed by the explanation of cost-benefit considerations relating to the *IFRS for SMEs* and as a justification for or against a third-tier accounting standard. The common users of SME financial statements are then determined to put their needs for financial reporting into context. In addition, the development of the *IFRS for SMEs*, its advantages and criticism against it are examined, followed by an overview of international support for a third-tier financial reporting standard.

- Thereafter, the form that a third-tier accounting standard could take is analysed with reference to advantages and disadvantages of the most commonly applied international forms. Differential reporting approaches followed internationally are investigated.
- The findings are applied to the Namibian regulatory context and a recommendation is made.

1.4 THESIS STATEMENT

There is a need for a third-tier financial reporting standard for SMEs, especially micro-entities, in Namibia, as the *IFRS for SMEs* is not the most feasible reporting standard.

The *IFRS for SMEs* is intended to meet the financial reporting needs of a wide range of users that are not in the position to request information to satisfy their specific information needs (IASB, 2015:para 1.2). In order to serve the information needs of a wide range of users, associated compliance costs are incurred. Clearly not all SMEs, especially micro entities, have a wide range of users and the compliance with *IFRS for SMEs* is burdensome. Further differentiation by means of a third-tier reporting standard may be desirable. However, this and the specific form such a standard may take would create unique advantages and disadvantages that need to be analysed before concluding on the feasibility of a third-tier reporting standard in Namibia.

1.5 DELINEATION AND LIMITATIONS

The research did not address the content of a third-tier reporting standard in detail nor the quantitative thresholds for the entities that such a standard might be intended for in Namibia.

The research involved the financial reporting of for-profit companies only, and not of charities or other forms of business.

1.6 DESCRIPTION OF KEY TERMS AND CONCEPTS

Differential reporting – a widely used term in international accounting literature, albeit not officially adopted by the IASB. Differential reporting allows entities in different circumstances to adopt different reporting practices and disclosures (Institute of Chartered Accountants of New Zealand, 1994:1a-21).

Generally Accepted Accounting Practice (GAAP) – accounting practices and standards that have been codified by a responsible standard setting body (South African Institute of Chartered Accountants (SAICA, 1999:para 07).

General purpose financial statements – financial statements intended to meet the information needs of a wide range of users that are not in the position to demand reports that satisfy their individual reporting needs (IASB, 2015:para P8).

International Accounting Standard Board (IASB) – international independent standard setting body responsible for the development of the *International Financial Reporting Standard for Small and Medium-sized Entities*.

International Financial Reporting Standard for Small and Medium-sized Entities (*IFRS for SMEs)* – the accounting standard published by the IASB for use by small and medium sized entities that do not have public accountability and that publish general purpose financial statements.

Micro entity – the smallest company within the SME spectrum tentatively defined as a company with ten employees or fewer as defined by a report by the International Federation of Accountants (IFAC) about the preparers and users of micro entity financial reports and their information needs (IFAC, 2008:6). Such a company does not have public accountability, and is not required to prepare general purpose financial statements.

Public accountability – an entity has public accountability if 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 market) or if it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (IASB, 2015:para 1.3).

Small and medium sized entities (SMEs) – registered companies that do not have public accountability.

Third-tier standard – an easier to apply and less complex standard of GAAP, compared to IFRS and *IFRS for SMEs*, typically for application by micro entities.

1.7 UNDERLYING ASSUMPTIONS

The Namibian economy is closely linked to that of South Africa (World Bank, 2014b). Namibia's close economic ties to South Africa are the result of a shared history (Odén,1991:6). For the period from 1920 up to Namibia's independence in 1990, Namibia was under South African rule and effectively treated as a fifth province of South Africa (Odén,1991:6). During the time of South African rule, the Namibian monetary system was incorporated into the South African monetary system. (Kalenga, 2001:3). To date the Namibia Dollar is pegged to the South African Rand (World Bank, 2014b). After gaining its independence in 1990, and up to the present day, Namibia has been closely linked to South Africa in terms of trade, and South African companies have a large number of investments in key industries in Namibia (South African Embassy Windhoek, 2015). South Africa serves as the top market for imports into Namibia, constituting 56.8% of total imports in 2014 (Namibia. Namibia Statistics Agency, 2014:10). In 2013, South Africa was the primary export destination for Namibian goods and in 2014 remained second to Botswana only (Namibia. Namibia Statistics Agency, 2014:8). A significant portion of Namibian exports go through South Africa (South African Embassy Windhoek, 2015). Namibia and South Africa are also partners in the South African Customs Union and South African Development Community (South African Embassy Windhoek, 2015).

Furthermore, Namibia's legislative environment was shaped under South African rule, as during this time South African statutes were transferred to Namibia (then South West Africa) (Namibia. Legal Assistance Centre, 2010:5). The Namibian *Companies Act 61 of 1973*, still in force with minor amendments (now *Companies Act 28 of 2004*), is one of the acts so transferred. This act regulates the use of companies as a form of business vehicle and also has shaped the regulatory reporting environment for companies.

In addition, the financial reporting environment in Namibia has been influenced by developments in South Africa. With the formation of ICAN in 1990, the institute adopted the entire suite of statements of GAAP issued by the South African Accounting Practice Board as representing Namibian GAAP (ICAN, 2005a:1). After the process of harmonisation of SA GAAP with IFRS was completed in 2004, the South African Accounting Practice Board agreed to issue IFRS as SA GAAP without amendments (ICAN, 2005a:1). In 2004 IFAC announced that the adoption of IFRS would be expected of all member bodies for periods beginning on or after 1 January 2005 (ICAN, 2005a:1). ICAN as a member body of IFAC would consequently be expected to comply (ICAN, 2005a:1). Simlarly, ICAN adopted South African Auditing Standards (SAAS) as Namibian Auditing Standards with its formation in 1990 (ICAN, 2005b:1).

With the close economic links between Namibia and South Africa, similar regulatory and financial reporting environments support the notion that South African findings are regarded equally relevant to Namibia.

1.8 RESEARCH METHODOLOGY

The research method is based on a literature review that comprises the collection, analysis and interpretation of relevant material in order to assess the need for and form of a third-tier reporting standard in Namibia. The main written sources are the following:

- *IFRS for SMEs;*
- Relevant provisions of the Namibian *Companies Act, No. 28 of 2004*;
- Discussion papers, consultation and exposure draft documents, comment letters and updates issued by the Canadian Institute of Chartered Accountants, Hong Kong Institute of Chartered Public Accountants, Institute of Chartered Accountants Australia, Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants of Namibia, and the South African Institute of Chartered Accountants on the *IFRS for SMEs* and each country's specific differential reporting framework;
- Academic journal articles;
- Relevant theses;
- Textbooks and other publications that relate directly to the research objective.

Ethical principles and policies were applied in analysing and interpreting source documents. As all the data used for this research is in the public domain, no additional ethical considerations needed to be taken into account. Refer to Appendix A for the ethics approval.

1.9 SIGNIFICANCE OF THE STUDY

The study reviews the literature pertaining to the theoretical background and findings of the suitability of the accounting standard *IFRS for SMEs,* especially for micro entities. It also investigates the approach followed by countries that have implemented comprehensive differential reporting frameworks and the extent to which this applies to the Namibian context.

The study is significant for ICAN, providing additional insights in their investigation of the need for and form of a third-tier reporting standard in Namibia.

1.10 OUTLINE OF CHAPTERS

The remainder of this mini-dissertation is organised in the following chapters:

Chapter 2: The need for a third-tier financial reporting standard

This chapter investigates the need for a third-tier reporting standard with reference to the background and scope of the *IFRS for SMEs,* the importance of SMEs, and the definition of an SME. Then, it explains the meaning of the cost-benefit criteria as often applied as a justification for differential reporting, followed by arguments against a third-tier financial reporting standard. Thereafter, it delineates the needs and main users of SME financial statements and criticism against the development process of the *IFRS for SMEs*. The chapter then outlines international support for a third-tier financial reporting standard and closes with a summary and conclusion substantiating the need for further differentiation in the form of a third-tier financial reporting standard.

Chapter 3: The form of a third-tier financial reporting standard

This chapter outlines the most common forms of differential reporting followed internationally, namely an independently developed standard for SMEs or simplification of existing standard(s), with the related advantages and disadvantages. This is followed by an overview of the development of differential reporting approaches followed by Canada, Australia, the UK, Hong Kong and South Africa.

Chapter 4: Application to the Namibian context

This chapter provides a summary of the need for a third-tier financial reporting standard based on the current Namibian regulatory reporting environment and legislation. It critically examines whether compliance with the *ECSAFA Guide* as a reporting standard in Namibia, results in 'fair presentation' of financial statements in accordance with the standard on which auditors can express an opinion. The chapter then evaluates the suitability of international differential reporting approaches followed in the Namibian context and provides a recommendation of the most feasible form.

Chapter 5: Results, conclusions and recommendations

This chapter provides a short overview, and results and conclusions in relation to each of the chapters of the study. Following this, it evaluates the contribution and limitations of the study. The study closes with the main, final recommendations.

CHAPTER 2

THE NEED FOR A THIRD-TIER FINANCIAL REPORTING STANDARD

The *IFRS for SMEs* was developed to fill the gap in international financial reporting standards specifically to meet the needs of SMEs. This chapter critically examines this objective and thereby considers the need for a third-tier financial reporting standard for smaller SMEs, or micro entities. In doing this, the chapter presents an analysis of the scope of the *IFRS for SMEs,* the importance of SMEs, definitions of SME and micro entities, cost-benefit considerations and the uses and users of SME financial statements.

2.1 THE IFRS FOR SMES

In 2009 the IASB issued the *IFRS for SMEs,* expressly designed to meet the financial reporting needs of small and medium entities that are not publicly listed, banks or similar institutions, but that prepare financial statements for a wide range of outside users (IASB, 2015). *IFRS for SMEs* is a self-contained standard, consisting of 35 sections arranged by topic. The standard is a high quality, global financial reporting standard based on the fundamental principles of full IFRS, but is less complex (IASB, 2009:16; Perera and Chand, 2015:169).

Full IFRS was developed mainly to aid the investment decision of equity investors of users of financial statements of companies listed on capital markets (IFRS Foundation, 2015b:9). In order to protect these investors, the requirements of full IFRS have evolved over the years and have become increasingly more rigorous, including a widespread range of issues, implementation guidelines and a substantial number of disclosures (IFRS Foundation, 2015a). Many jurisdictions, like Namibia, have started to align their local GAAP with IFRS and/or later replaced their national GAAP with IFRS, thus subjecting SMEs to the same reporting requirements as public companies (Pacter, 2009:4). The extensive financial reporting of full IFRS has become burdensome for SMEs, whose users do not find them relevant or do not necessarily benefit from the costs incurred to produce them (Greeff, 2008:1; Perera and Chand, 2015:166).

In order to address this concern, the IASB developed the *IFRS for SMEs.* The development was spread over a five-year period following a rigorous due process, including extensive public consultation with SMEs world-wide (IFRS Foundation, 2015a). The resulting *IFRS for SMEs* has been simplified, compared to full IFRS, in a number of ways. Topics not relevant to most SMEs, such as earnings per share or segment reporting, have been omitted (IFRS Foundation, 2015a). Many recognition and measurement principles have been simplified by including only the simpler option (from full IFRS), and many 'undue cost or effort exemptions' are included for specific requirements (IFRS Foundation, 2015a). Disclosures have been significantly reduced to approximately 90% of full IFRS and the standard is written in a simpler and clearer language (IFRS Foundation, 2015a). By including these simplifications, the *IFRS for SMEs* has been reduced in volume to about 300 pages, compared to full IFRS that already contained 2700 pages in 2008, with the volume steadily increasing as new standards are added (Pacter, 2009:9). In order to further reduce the compliance burden of continuous updates on SMEs, revisions of the standard are expected to be limited to once every three years (IFRS Foundation, 2015a). The first revision was concluded in May 2015, which resulted in limited modifications to the standard (IFRS Foundation, 2015a).

Section 1 of the *IFRS for SMEs* delineates the scope of the standard as applicable to SMEs characterised by non-public accountability and that publish general purpose financial statements for external users (IASB, 2015:para 1.2). Inherently, there will be SMEs that do not meet these criteria as they produce financial statements for their own use only or for external users that may be in the position to request additional information they may require (e.g. banks or creditors). The preface to *IFRS for SMEs* acknowledges that, based on the definition, the standard will not be applicable and thus suitable to many SMEs (IASB, 2015:para P11) and, by implication, most micro entities. This gives rise to the need for an evaluation of further differentiation by means of a third-tier reporting standard.

Since its release in 2009, *IFRS for SMEs* has gained widespread international acceptance. The IASB reports that 77 nations across the globe either require or permit the *IFRS for SMEs*, with a further 11 considering its adoption (IFRS Foundation, 2015a). This widespread acceptance underlines not only the importance of the standard, but also of SMEs, which is discussed next.

2.2 THE IMPORTANCE OF SMES

According to the IASB, it is estimated that 95% of all companies around the world are SMEs (IFRS Foundation, 2015a). SMEs are an important role player in the promotion of economic growth (Greeff, 2008:5) and employment creation in both developing and developed economies (Perera and Chand, 2015:165). The European Commission (EC) reports that in 2013 there were over 21-million SMEs in the European Union (EU), representing 90% of all businesses in the EU and employing two-thirds of the workforce (EC, 2015:3). In South Africa it is estimated that SMEs account for 91% of all formal businesses, contributing 52% to 57% to gross domestic product (GDP) and employing 61% of the private sector (Abor and Quartey, 2010:218).

IFAC recognises that SMEs play a particularly pertinent role in developing countries, since larger listed entities are less prominent and many larger entities are wholly or partially state-owned (IFAC, 2006:9). Namibia is a developing country with a population of about two-and-a-half million, a GDP of N$13-billion and a high unemployment rate estimated at 28% (World Bank, 2014b). Regrettably and despite its importance, accurate and quantitative data about SMEs of this developing country is deficient (Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015:10). The Namibia Statistics Agency does not collect any data specifically related to SMEs and their contribution to the economy's gross domestic product (Sakaria, 2015), which makes it difficult to quantify the importance of SMEs in monetary terms. The latest, outdated, data available is from 1997 and indicates that SMEs[1] comprise of 33 700 entities (of which roughly half are formally registered with the Ministry of Industrialisation, Trade and SME Development) and provide income to 160 000 people, representing a third of Namibia's workforce and contributing 12% to Namibia's GDP (Grossman, Mwatotele, Stork & Tobias, 2005:16; Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015:8).

However, micro, small and medium-sized entities (MSMEs) are regarded key contributors to employment creation, income generation and poverty reduction (Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015:8; Stork, 2010:13). This is recognised by the Namibian government and

[1] Based on the 1997 Namibian Ministry of Trade and Industry definition of an 'SME' as having fewer than 10 employees, N$1-million turnover and N$500 000 capital employed (Grossman, Mwatotele, Stork & Tobias, 2005:3).

incorporated into the country's industrial policy, which specifically addresses the development and promotion of SMEs (Republic of Namibia. Ministry of Trade and Industry, 2012:10; Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015:5).

In order to establish which entities are intended to apply this third-tier reporting standard, it is important to define SMEs and micro entities (Koppeschaar, 2009:121). This is the focus of the next section.

2.3 DEFINING SMES AND MICRO ENTITIES

It is generally accepted that there is no universal definition for SMEs (Greeff, 2008:5; Ram, 2012:2; Perera and Chand, 2015:165). The heterogeneous nature of SMEs makes it difficult to find a globally applicable definition (IFAC, 2006:7-8); different jurisdictions define SMEs based on their specific economic circumstances (Perera and Chand, 2015:167). Additionally, within a country there may be more than one institution, such as government agencies, statistical agencies and banks, that use their own definition of an SME. Some jurisdictions include micro businesses under the definition of SMEs (Perera and Chand, 2015:172) or further categorise SMEs into micro, small and medium businesses, also referred to as MSMEs (IFAC, 2006:para 3.5).

2.3.1 Quantitative and qualitative criteria – advantages and disadvantages

In practice, quantitative size criteria are used by many jurisdictions to define SMEs and to differentiate accounting requirements for different entities (IFAC, 2006:7-8). The most commonly applied quantitative (size) criteria are total revenue, total assets and number of employees (Institute of Chartered Accountants of New Zealand, 1994:1-25; Perera and Chand, 2015:167).

More recently, qualitative criteria such as legal type, separation of ownership and control, ownership share held by management, management structure and public accountability have become more popular (Koppeschaar, 2009:90; Perera and Chand, 2015:169). Selecting the appropriate criteria to define an SME is challenging and there are mixed views on what the best criteria are (IFAC, 2006:1).

Using qualitative and quantitative criteria have both advantages and disadvantages. One such advantage of definitions relating to qualitative criteria used to define SMEs is that they better reflect the nature and characteristics of entities that they are intended to apply to (Koppeschaar, 2009:92). Qualitative criteria emphasise the operating differences between large and small entities and are also more comparable than size criteria. Disadvantages of qualitative criteria include that the practical application can be subjective because judgement is required to interpret the criteria. The subjectivity in the use of judgement also makes it more difficult to apply in practice (Koppeschaar, 2009:92).

On the other hand, the benefit of quantitative criteria is that they are easier to apply and widely used, but the cut-off point is arbitrary and must be revised regularly and adjusted due to the impact of inflation (Accounting Standards Board [AcSB], 2007:9; Koppeschaar, 2009:92), which in turn increases monitoring and compliance costs (AASB, 2010:25). Entities can manipulate their results in order to qualify for exemption or reporting under a certain standard (AcSB, 2007:9; Koppeschaar, 2009:92). Total revenue figures are sometimes difficult to determine as some incorporated entities do not make these figures publicly available and may not even have reliable figures themselves (IFAC, 2006:7). Different jurisdictions apply different thresholds, which decreases comparability of businesses; furthermore, size thresholds do not take cognisance of the type of entity, its use or users (Koppeschaar, 2009:92,113; Perera and Chand, 2015:173). Significantly, the smallest SMEs in developed countries are often larger than the largest SMEs in developing countries (Devi and Samujh, 2015:126).

Eierle and Haller (2009:197-199) support the application of quantitative criteria. They discuss, based on previous literature, how firm size is a surrogate for economic and social importance of a firm, and the number and heterogeneity of users and user needs. They also argue that the agency conflicts resulting from the separation of ownership and control also depend on size (Eierle and Haller, 2009:225). The jurisdictions in favour of a size test maintain that size is a good indicator for assessing the cost-benefit considerations of financial reporting (refer also to 2.4.1 below) (AcSB, 2007:9). However, Eierle and Haller (2009) find that size is not a factor determining cost-benefit considerations when empirically testing the effect of size on regulatory and reporting issues of 406 German SMEs.[2]

[2] Based on the IASB definition of an SME.

Albu (2013:436) empirically tested the relevance and applicability of various criteria in setting the scope of the *IFRS for SMEs* and the implications of using size instead of other criteria by selecting a sample of 194 Romanian professional accountants working with SMEs. The results confirm prior literature that indicates that size is correlated with the number of users, international exposure and use/users of the financial statements. However, the same study also highlights a major shortcoming of size criteria. Entities are left outside the scope of a standard if size is chosen over qualitative criteria that consider users (i.e. public accountability). For this particular study, more than half of the SMEs were excluded from the scope of a standard by applying size criteria only (Albu, 2013:437). To overcome this limitation, Albu suggests a combination of quantitative and qualitative criteria (Albu, 2013:437), which is also the approach followed by many jurisdictions, as can be seen from the discussion below.

2.3.2 IASB

Finding the appropriate criteria and/or thresholds for defining an SME is challenging and many researchers have struggled with it (IFAC, 2006:7), as did the IASB during the development of the *IFRS for SMEs* (Ram and Newberry, 2013:13). The IASB working group on accounting standards for SMEs recommended size criteria based on dollar value and number of employees, which the IASB rejected (Ram and Newberry, 2013:10), since it did not consider it feasible to establish size criteria that would be suitable across a wide spectrum of countries intending to apply the *IFRS for SMEs* (IASB, 2007b:18).

Instead, the IASB prefers to select ‘public accountability’ as criterion for differentiation (see 1.6 for the definition). It proposes that each jurisdiction establish its own set of quantitative criteria and identify economically significant entities, which are required to apply full IFRS rather than *IFRS for SMEs* (IASB, 2007b:19). To demonstrate the different approaches being followed internationally, the definitions of SMEs of Canada, the United Kingdom (UK), Australia, Hong Kong and South Africa are outlined below, since these countries have a history of implementing comprehensive and extensive differential reporting approaches.

2.3.3 Canada

For purposes of financial reporting, Canada has adopted a similar approach to the IASB and distinguishes private entities from public entities on the basis of public accountability, not size. The rationale of the Accounting Standards Board (AcSB) of Canada is that size is not a factor distinguishing private and public entities, but public accountability is (AcSB, 2007:9). Effective 1 January 2011, private entities reporting in terms of Canadian GAAP may use the standard applicable to publicly accountable entities (IFRS in Part I of the CPA Canada Handbook) or the 'made in Canada' accounting standard for private enterprises in Part II of the CPA Canada Handbook (AcSB, 2010:5). To date, Canada has not adopted the *IFRS for SMEs.*

2.3.4 United Kingdom

The UK has amended its financial reporting regime effective 1 January 2016 (Financial Reporting Council [FRC], 2015:3). It differentiates between entities and the reporting standards that are applicable based on size, whether the entity is part of a group and whether the shares are listed in a regulated market. According to the size criteria for the small and micro entities regime, a company qualifies if it does not exceed two of the following criteria (FRC, 2015:6):

Table I: United Kingdom - size criteria

Company category	**Employees**	**Turnover**	or	**Balance sheet total**
Small	< 50	≤ £10,2-million		≤ £5,1-million
Micro	< 10	≤ £632 000		≤ £312 000

Source: FRC, 2015:6. Overview of the financial reporting framework.

The reporting standard that applies to small entities is Section 1A Small Entities of FRS 102, which is derived from the *IFRS for SMEs*, but with significant modifications and simplifications (FRC, 2015:9). Small entities may also adopt full IFRS (FRC, 2015:7). Excluded from the small entities regime are any public companies or financial institutions, including insurance companies or banking companies (FRC, 2015:6).

Micro entities may apply FRS 105, which is based on FRS 102, but the accounting requirements are even further simplified (FRC, 2015:8). Any company that is excluded from the small entities regime is also excluded from the micro-entities regime, plus financial institutions including credit and insurance institutions, charities, small parent companies that choose to prepare group accounts and companies that are not parent companies but whose accounts are included in group accounts (FRC, 2015:6). All listed companies must report in terms of full IFRS, according to EU regulations (IFRS Foundation, 2015b:159).

2.3.5 Australia

Australia differentiates entities based on quantitative (size) criteria, 'public accountability' and the 'reporting entity' concept. The *Corporations Act 2001* exempts small proprietary companies from external reporting obligations, unless they are controlled by a foreign company, are directed by at least 5% shareholding, or the Australian Securities and Investments Commission requires reports (AASB, 2010:BC4). Small companies qualify if they do not exceed any two of the following three thresholds: consolidated revenue of Aus$25-million or consolidated gross assets of Aus$12,5-million for the group or more than 50 employees (KPMG, 2015:46). These entities are not prohibited from applying the *IFRS for SMEs*, or full IFRS, even though *IFRS for SMEs* is not adopted as statements of GAAP (IFRS Foundation, 2015b:37).

A 'reporting entity' is defined as 'an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statement for information that will be useful to them for making and evaluating decisions about the allocation of resources' (AASB, 2015:BC 2). 'Public accountability' means 'accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs' (AASB: 2010:12). The rest of the definition is consistent with the IASB's definition in the *IFRS for SMEs* (AASB, 2010:B1). For-profit entities that are not 'reporting entities' and that are not publicly accountable apply AASB Tier 2 reporting requirements, being IFRS with reduced disclosure and without consolidation (IFRS Foundation, 2015b:37).

2.3.6 Hong Kong

Hong Kong applies criteria based on size and public accountability to differentiate SMEs for financial reporting purposes. Any non-publicly accountable private company that is not part of a group, irrespective of its size, may qualify for the reporting exemption if it obtains 100% written shareholder approval annually (Hong Kong Institute of Certified Public Accountants [HKICPA], 2014:8). Other small private companies (or group of companies) do not need to obtain shareholder's approval to qualify for the exemption if they do not exceed two of the following criteria, unless prohibited by their articles (HKICPA, 2014:6):

- Total annual revenue of HK$100-million;
- Total assets of HK$100-million at the end of the financial reporting period;
- 100 employees.

Large 'eligible' companies need to obtain approval from 75% of the shareholders to qualify. Large 'eligible' private companies (or group of companies) qualify for exemption if they do not exceed two of the following criteria (HKICPA, 2014:7):

- Total annual revenue of HK$200-million;
- Total assets of HK$200-million at the end of the financial reporting period;
- 100 employees.

Private companies that qualify under the reporting exemptions may optionally apply Hong Kong's own simplified *Small and Medium-sized Financial Reporting Framework and Financial Reporting Standards* (SME-FRF and FRS) or they may report in terms of full *Hong Kong Financial Reporting Standards* (HKFRS) (IASPlus, 2016). The financial reporting exemptions correspond with the New Company Ordinance (Cap. 622), which contains an optional reporting exemption for private companies that satisfy the conditions as set out in section 359 of the new Ordinance (IASPlus, 2016). Companies with securities listed on the public market are required to report in terms of HKFRS, which is identical to full IFRS (IFRS Foundation, 2015b:85).

2.3.7 South Africa

South Africa, as an early adopter of the *IFRS for SMEs,* applies the IASB definition of 'public interest' to define SMEs. Effective 2011, with the promulgation of the *Companies Act 71 of 2008*, South Africa has also introduced size thresholds to define SMEs (SAICA and Juta, 2012:1-1). The size thresholds exempt for-profit private entities from applying GAAP (which is either IFRS or *IFRS for SMEs*) based on a 'public interest score' (SAICA and Juta, 2012:Annexure-24). The public interest score is calculated at the end of each financial year as follows (SAICA and Juta, 2012:Annexure-19):

- A number of points equal to the average number of employees of the company during the financial year;
- One point for every R1-million (or portion thereof) in third party liability of the company at the financial year end;
- One point for every R1-million (or portion thereof) in turnover during the financial year; and
- One point for every individual who, at the end of the financial year, is known by the company to directly or indirectly have a beneficial interest in any of the company's issued securities.

Depending on the public interest score, entities must apply full IFRS or the *IFRS for SMEs* (IFRS Foundation, 2015b:142). Entities with a public interest score of less than 100 may apply their own financial reporting standards (SAICA and Juta, 2012:Annexure-24). All listed companies must report in terms of full IFRS (IFRS Foundation, 2015b:142).

Table II: South Africa – size criteria

	Financial statements compiled	
	Internally	**Independently**
Listed companies	IFRS	IFRS
Public interest score 350+	IFRS or *IFRS for SMEs**	IFRS or *IFRS for SMEs**
Public interest score 100-349	IFRS or *IFRS for SMEs**	IFRS or *IFRS for SMEs**
Public interest score <100	Financial reporting standards as determined by the company	IFRS or *IFRS for SMEs**

* subject to the scoping restrictions of the standard

Source: Adapted from South African Institute of Chartered Accountants and Juta & Co. Ltd (SAICA and Juta). 2012. *The SAICA Guide to the Companies Act:* Annexure 24.

2.3.8 Namibia

Namibia has no criteria to define an SME for financial reporting purposes, other than the public accountability criterion as defined in the scope paragraph of the *IFRS for SMEs* (refer to 1.6 above). Broadly speaking, this criterion includes all entities that are not listed or that are not banks, i.e. that have public accountability (IASB, 2015:para 1.3). Consequently, all non-publicly accountable companies need to comply with the *IFRS for SMEs* or the *ECSAFA Guide,* irrespective of their size or ownership structure.

Evidence suggests that SMEs in developing countries like Namibia are very small in size, with few employees and low revenue (Chand, Patel & White, 2015:143). For purposes of this report, in order to better differentiate between small and micro businesses, an SME is further sub-categorised into a micro entity. A micro entity is an SME at the lower end of the SME size spectrum and it should be interpreted as an entity of truly small size (Van Wyk and Rossouw, 2009:101). The IFRS Foundation's *Guide for Micro-sized Entities Applying the IFRS for SMEs* (2009:IN4) defines a micro entity as a 'very small entity with few transactions, few employees and often owner-managed and has low to moderate levels of revenue'.

The *National Policy for Micro, Small and Medium Sized Entities in Namibia* (Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015) aimed at the economic promotion of SMEs defines MSMEs according to two criteria, namely number of employees and annual turnover:

Table III: Namibia - size criteria

Company category	Employees	Turnover
Medium	< 100	≤ N$10million
Small	< 30	≤ N$3-million
Micro	< 10	≤ N$ 300 000

Source: Trade and SME development, 2015:7*. National Policy for Micro, Small and Medium Sized Entities in Namibia.* Republic of Namibia. Ministry of Industrialisation.

ICAN, as the national financial reporting standard setter in Namibia, has not set any quantitative criteria for the application of the different standards of Namibian GAAP. The quantitative guidelines as outlined by the *National Policy for Micro, Small and Medium Sized Entities in Namibia* are supported by the national policy of the

Namibian government for the promotion of SMEs, and it appears advisable for ICAN to adopt these guidelines to define SMEs and micro entities for financial reporting purposes too, together with the 'public accountability' criteria currently adopted.

Nonetheless, the *IFRS for SMEs* has been developed based on issues considered to be applicable to a business of 50 employees (IASB, 2007b:6). The number of employees was not intended to be a size test, but a guideline to identify topics for inclusion in or exclusion from the *IFRS for SMEs*. Van Wyk and Rossouw (2009:107) surveyed accounting practitioners on the suitability of the *IFRS for SMEs* to SMEs and found that the guideline is too large in the South African business context. It can be expected that similar results apply to Namibia. Additionally, what is regarded as micro in the UK context with a turnover of £632 000 (N$10,9-million)[3] exceeds the SME threshold in Namibia. Future empirical research may indicate quantitative criteria and/or thresholds for SMEs in the Namibian context and possibly further financial reporting exemptions or exclusions for larger SMEs (not only micro entities).

Much of the debate around differential reporting and the need of a third-tier reporting standard for small entities hinges on the financial burden experienced by SMEs (particularly micro entities) by applying accounting standards and the perceived lack of benefit derived from the application of the standard by the users of the financial information (Stainbank and Wells, 2007:32; Van Wyk and Rossouw, 2011:258). The cost-benefit criteria are discussed below.

2.4 THE COST-BENEFIT CRITERIA

The cost-benefit criteria deal with the financial burden of complying with financial reporting standards experienced by preparers of SME financial statements in relation to the perceived benefit to the users of these financial statements. The application of the high-quality, internationally recognised financial reporting standard, *IFRS for SMEs,* has distinct benefits, but also involves costs. The question of whether the benefits justify the costs requires consideration.

2.4.1 Cost-benefit considerations

Most accounting regulatory systems recognise that there are differences between large and smaller entities, those that are listed and unlisted, and those that have

[3] Based on a £:N$ one year average exchange rate of 17.2 as on 20 November 2015 (www.oanda.com).

public accountability (IFAC, 2006:9). The IASB recognises that the information needs and capabilities of SMEs may differ from those that are publicly traded entities or financial institutions (IFRS Foundation, 2015a). As a result, the IASB developed the *IFRS for SMEs* taking into account 'cost-benefit considerations' (IASB, 2009:19).

The costs or financial burden mostly takes the form of compliance with complex reporting requirements by the reporting entity (or preparers) (Greeff, 2008:19; Van Wyk and Rossouw, 2011:258). This may be additional costs incurred to collect, store and retrieve financial information (Chand, *et al*; 2015:143) or costs to employ additional qualified staff or for the training of staff. Relevant expertise and resources for application of the *IFRS for SMEs* are also a cost factor (Chand, *et al*; 2015:143). SMEs often rely on auditors to ensure compliance with financial reporting requirements, resulting in increased professional fees (Greeff, 2008:19; Ram, 2012:29). SMEs operating in developing countries, where professional bodies and networks that provide efficient support are limited, may incur additional costs due to the scarcity of resources (Chand, *et al*; 2015:143).

Other costs are the implicit cost of financial reporting such as to accept a qualified report for not complying with requirements that are too complex or irrelevant (Wright, Fernandez, Burns, Hawkins, Hornsby & Patel, 2012:299). The qualification on the report may not be understood or interpreted correctly by the user (Wright*, et al;* 2012:299). Other indirect costs are opportunity costs of limited accounting resources that are diverted to prepare financial information (IFAC, 2006:10).

The benefits relate mainly to the value of the information to the user (Institute of Chartered Accountants of New Zealand, 1994:1a-23). In the context of applying a global standard, such as the *IFRS for SMEs,* these benefits are regarded as having internationally comparable and understandable financial statements and easier access to finance (Evans, Gebhard, Hoogendoorn, Marton, Di Pietra, Mora, Thinggaard, Vehmanen & Wagenhofer, 2005:30; Litjens, Bissessur, Langendijk & Vergoossen, 2012:230). Financial statements prepared under the *IFRS for SMEs* also 'facilitate cross-border trade, mobility of accounting and audit staff and increasing confidence in the SME' (Pascu and Vasiliu, 2011:128-129). Furthermore, there is the argument for universality, meaning that companies should not be subject to different rules given different 'true and fair views' (Evans, *et al*; 2005:26). Compliance with the *IFRS for SMEs* facilitates easier transition to full IFRS for entities planning to enter listed capital markets (Epstein and Jermakowicz, 2007:38). The IASB (2009:16) argues that global standards reduce the cost of capital, increase audit quality and facilitate education and training. A single set of international reporting standards 'can also serve the public interest by enhancing the credibility of accounting information to external parties and also internally to firms' managers' (Kaya and Koch, 2014:98). Internationally recognised reporting standards are likewise beneficial for developing countries to signal their commitment to preparing credible, high quality information to international investors and lenders (Kaya and Koch, 2014:99).

Views as to whether SMEs have the need for international accounting rules are mixed. Many SMEs are domestically focussed (Chand, *et al;* 2015:144; Devi and Samujh, 2015:127). A study by Aboagye-Otchere and Agbeibor (2012:199) based on a sample of 149 SMEs[4] in Ghana found that cross-border structures, including imports, exports and competition with foreign entities, occurred rarely or never in 75% of the participating entities. Consistent with this, 85% of the participating entities indicated that they rarely or never received requests to prepare financial statements in accordance with international financial reporting rules, which was even higher for micro entities[5] (Aboagye-Otchere and Agbeibor, 2012:200). However, 25% of micro entities and 50% of SMEs of the participating entities saw at least an average need to prepare internationally comparable financial information, which the study regarded as a considerable portion (Aboagye-Otchere and Agbeibor, 2012:200).

Further evidence of SMEs' involvement in international activities not necessarily leading to a need for international SME accounting rules is provided by an IFAC study on the perspectives of preparers and users of micro entities (IFAC, 2008). The study entailed focus group interviews with owners, financiers and preparers of micro entities in the UK, Kenya, Italy, Poland and Uruguay. Participants of the UK focus groups indicated preferences for national standards, while the reverse applied in Kenya (IFAC, 2008:8). Poland and Italy favoured national SME standards that are aligned with tax laws (IFAC, 2008:8). The study further revealed that there was 'overwhelming agreement' amongst participants that (the then exposure draft) the *IFRS for SMEs* was 'far too complex and long to be useful for micro entities' (IFAC, 2008:10).

[4] Based on a turnover of less than US$2 370 000.
[5] Based on a turnover of US$23 700.

Eierle and Haller (2009:204) surveyed German SMEs[6] and of the 406 responding entities, between 50% and 60% showed moderate to high levels of relevance for imports and exports. About 25% to 30% bought and sold their products in a foreign currency, thus outside the eurozone (Eierle and Haller, 2009:204). More importantly, the larger entities showed comparatively more cross-border activity than the smaller entities, supporting the notion that foreign activity is related to size and increases with the growth of an entity. Foreign borrowings and equity investments were of minor importance for more than 80% of the respondents (Eierle and Haller, 2009:204). Despite this high international activity, about half of the surveyed entities did not see the need to prepare internationally comparable financial information. It is noted that the turnover threshold of €8-million is high compared to the SMEs thresholds in Namibia (refer to 2.3.8).

Many smaller entities in South Africa have limited global focus apart from exporting (Schutte and Buys, 2011a:189). Likewise, Namibia's SMEs (including micro entities) have limited cross-border activity. According to Namibia's *National policy for micro, small and medium sized entities in Namibia* (Republic of Namibia. Ministry of Trade and Industry, 2012:10), only about 4% of these entities export their goods or services. The policy does recognise this as a constraint and is promoting export to enhance growth of MSMEs. The opening of markets and lower tariffs expose them to competition from imports (Republic of Namibia. Ministry of Trade and Industry, 2012:10), giving an indication that at least some entities may benefit from internationally comparable information.

Many SMEs rely on retained earnings or owner's resources in the form of equity or loans, rather than seeking external sources of capital, especially internationally (Perera and Chand, 2015:172). SMEs may find it difficult to obtain external and international funds due to barriers such as liquidity problems, creditworthiness and delinquency issues (Perera and Chand, 2015:172). It is questionable whether the benefit of global standards of easier and cheaper access to finance for micro entities holds under these circumstances.

The benefits (or value) derived from providing the information to users should outweigh the cost of implementing standards for providers of financial statements (Institute of Chartered Accountants of New Zealand, 1994:1a-23). The IASB has

[6] Based on the IASB's definition of SME and having a turnover of at least €8m.

taken this cost-benefit consideration into account when developing the *IFRS for SMEs.* However, research based in South Africa indicates that compliance with the *IFRS for SMEs* places an undue financial burden on SMEs, without related benefits (Stainbank and Wells, 2005:51; Hattingh, 2009:1; Koppeschaar, 2009:314; Van Wyk and Rossouw, 2009:113; Stainbank, 2010:70). These findings are also supported internationally by studies performed in the Netherlands (Litjens, *et al*; 2012:243), South East Asian Nations (Samujh and Devi, 2015:53), Ghana (Aboagye-Otchere and Agbeibor, 2012: 205) and Fiji (Chand, *et al*; 2015:148). The *IFRS for SMEs* is found to be still too difficult to understand and the extent of guidance provided is inadequate, especially with judgement decision-making (Chand, *et al*; 2015:149). The volume, nature and complexity of disclosure is regarded excessive for most SMEs (Chand, *et al*; 2015:150). The EC has rejected the adoption of the *IFRS for SMEs* at EU level as the standards 'would not appropriately serve the objective of simplification and reduction of administrative burden' (EC, 2014).

Chand, *et al* (2015:152) also argue, with particular reference to empirical research done in Fiji, that the *IFRS for SMEs* may not be appropriate to all SMEs, especially micro entities. In a survey conducted on professional accountants in Fiji, 66,9% of the 155 respondents strongly agreed with the statement that the costs of complying with the *IFRS for SMEs* are far greater than the corresponding benefits (Chand, *et al*; 2015:148) and 70% of the respondents saw the need for a third-tier standard for really small (micro) entities (Chand, *et al;* 2015:151).

Admittedly, a cost-benefit analysis is not that straightforward, as the benefits to users are more difficult to determine and to measure (Institute of Chartered Accountants of New Zealand, 1994:1a-23) than the cost of applying the *IFRS for SMEs* (Litjens, *et al;* 2012:234). In the case of SMEs, the benefits are mostly available only for a smaller number of users compared to publicly traded companies (Greeff, 2008:19) and the benefits are considered to increase as the number of users increases (Institute of Chartered Accountants of New Zealand, 1994:1a-23). Empirical evidence from the Netherlands further suggests that costs are connected to firm size, but benefits are not (Litjens, *et al;* 2012:234). Evans, *et al* (2005) report similar results for a study done in the UK. Many of the costs are fixed or do not vary considerably with size, therefore they are relatively more costly for smaller entities (IFAC, 2006:10), i.e. the smaller the entity, the larger the costs are relative to the benefit, since these entities lack the advantage of economies of scale.

Overall, the benefits from applying a global standard for access to finance and comparability would be limited, especially for micro entities. Consequently, the costs of dealing with the complexities of the *IFRS for SMEs* may therefore not justify the benefits (Wright, *et al;* 2012:291). It is these costs of applying the *IFRS for SMEs*, with limited related benefit, which justifies the further differentiation in the form of a simplified third-tier reporting standard for micro entities.

2.4.2 Arguments against a third-tier reporting standard

Apart from the costs and benefits relating specifically to the application of the *IFRS for SMEs*, there are arguments against further differentiating financial reporting by means of a third-tier reporting standard, namely:

- Change can bring confusion (Wright, *et al;* 2012:291).
- Alternative accounting for similar events undermines the usefulness and integrity of financial reporting (Greeff, 2008:22).
- Different rules may mean different results and specifically profit figures, which undermines the credibility of financial reporting (IFAC, 2006:10).
- Different rules would result in diverse accounting practices (Schutte and Buys, 2011a:189). The need for comparability of financial information is reliant on the same rules being applied (IFAC, 2006:10; Greeff, 2008:22; Schutte and Buys, 2011a:189; Wright, *et al*; 2012:291).
- Different rules result in different 'true and fair views', undermining universality (Evans, *et al*; 2005:26).
- Costs incurred by standard-setters in the form of developing, implementing and revising financial reporting standards and the cost of enforcement (Institute of Chartered Accountants of New Zealand, 1994:1a-23; Litjens, *et al*; 2012:230).
- Availability of expertise and resources to develop local reporting standards that have a similar quality to the IASBs standards (Kaya and Koch, 2014:100).
- Further differentiation would adversely affect accounting education. Auditors would have to learn an additional set of accounting rules and educating accountants, auditors and financial analysists would be more difficult (Epstein and Jermakowicz, 2007:39).

The last three arguments can be mitigated by choosing an appropriate form of differential reporting, as will be discussed later (refer to chapter 3). The first five arguments must be evaluated in the light of the fact that the *ECSAFA Guide*, being a third reporting standard, is already GAAP in Namibia. Different reporting rules therefore already exist. Replacing the *ESCAFA Guide* will therefore not result in a more detrimental situation. The concern with the *ESCAFA Guide* is discussed below (refer to chapter 4.1.1.2).

The information needs of users of financial statements are an important consideration to determine whether a third-tier standard is desirable. The users of financial statements are the focus of the next section.

2.5 THE USERS AND USES OF SME FINANCIAL STATEMENTS

Financial statements are used by a range of different users for a diverse collection of decision-making. Users are seen to be different for small entities compared to those for large ones, with different needs. Criticism has been voiced that this has not been adequately considered during the development of the *IFRS of SMEs.* Users and their needs are presented as an argument in favour of a third-tier financial reporting standard. These factors will be considered next.

2.5.1 Different needs of small and large entities

According to IFAC (2006:10) there is 'general agreement that user and user needs of smaller entities are not the same as those of larger entities' (see also Sian and Roberts, 2009:290; Baldarelli, Demartini, Mosnja-Skare & Paoloni, 2012:26). Public companies raise finance by the sale of owners' capital, therefore investors are mainly concerned with financial statements that provide them with information assisting in the analysis of the growth potential and return of investment of an entity (Schutte and Buys, 2011b:19; Feltham, 2013:31). Users are more interested in the entity's information to assist them in making long-term cash-flow forecasts, projecting profit or loss and assessing value (IASB, 2009:19). Financial statements of public companies must satisfy the information needs of a large user group of different investors and creditors that have no direct access to information other than the information displayed in the audited, published financial statements (Wright*, et al*; 2012:298). IFRS has been developed with the capital markets as the most important user group (IASB, 2007a:3; IFRS Foundation, 2015b:14).

SMEs seek capital mainly from owners, banks and suppliers by loans and credit (Schutte and Buys, 2011b:19; Feltham, 2013:31). These users are more interested in the 'short-term cash flows, liquidity, balance sheet strength and interest coverage, and in the historical trends of profit or loss and interest coverage, than in information that is intended to assist them in making forecasts of an entity's long-term cash flow, profit or loss, and value' (IASB, 2009:18). Also, historical information assessing the stewardship function of financial statements is considered more important by SMEs (Devi and Samujh, 2015:132). SMEs have the unique characteristic of a tendency to aim for survival rather than maximising profit and growth (Devi and Samujh, 2015:127; Sian and Roberts, 2009:290). Their transactions are less complex and the need for a sophisticated analysis of highly aggregated information is lower (Jarvis and Collis, 2003:5). Correspondingly, information that is relevant for SMEs is different from that for large public companies.

2.5.2 Main users and uses

The *IFRS for SMEs* is intended to produce financial statements that satisfy the information needs of a wide range of users, shareholders, creditors, employees and the public at large (IASB, 2015:para P7). Internationally, scholars argue that the financial statements of SMEs are typically used by only three main types of user, namely shareholders, taxation authorities and creditors (mainly banks) (IFAC, 2006:15; Maingot and Zeghal, 2006:525; Greeff, 2008:10; Koppeschaar, 2009:6; Sian and Roberts, 2009:291; Van Wyk and Rossouw, 2009:109; Schutte and Buys, 2011b:20; Ram, 2012:30; Wright, *et al;* 2012:296). Equally, Hattingh (2001:35) claims that 90% of companies in South Africa prepare financial statements for shareholders, taxation authorities and banks only. Additionally, Wright, *et al* (2012:298) identify the venture capitalist as another possible user. However, little evidence exists that financial statements of SMEs are used by other external users; where such evidence does exist, it is contradictory (Sian and Roberts, 2009:292).

The study performed on 149 SMEs in Ghana supports the view that competitors, suppliers and customers are not major users of financial statements (Aboagye-Otchere and Agbeibor, 2012:191). This is also supported by the response in the study of the 406 German SMEs, which does not find customers and suppliers as major users (Eierle and Haller, 2009:204). In contrast, a study performed on 849 individual users of mainly Belgian listed and unlisted companies indicates that suppliers, customers, competitors and consultants are ‘underestimated user groups’ (Cole, Breesch & Branson, 2009:11). However, SMEs may be able to operate with a limited number of suppliers on a credit basis, thus their financial position can be monitored by the suppliers on a more personal basis by direct contact (Chand, *et al*; 2015:144). This characteristic of SMEs reduces the need for internationally comparable general purpose financial statements.

Conversely, Namibia’s economy is dependent on international trade, particularly for the importation of goods and services. A World Bank survey performed on 580 private entities in Namibia indicates that 45% use imported supplies or inputs (World Bank, 2014a:7). SMEs in many developing countries obtain financing from government agencies, SME or regional development agencies (IFAC, 2006:18) or external funds from institutions such as the World Bank and the International Monetary Fund (Kaya and Koch, 2014:94). The development of the *IFRS for SME* was advocated by the World Bank and they support its adoption (Devi and Samujh, 2015:126,129), which in turn may motivate SMEs to prepare high quality financial statements based on its standardised rules (such as *IFRS for SMEs)* to attract funds*.* Namibia obtained more than N$19-billion of foreign aid to fund development projects between 2004 and 2014 (Ngatjiheue, 2015). Consequently, many international trading partners may require financial reports that are internationally understandable (Chand, *et al;* 2015:144). However, these financial reports, complying with full IFRS or the *IFRS for SMEs,* can be prepared based on demand of these users, justifying the higher costs incurred to produce them.

High concentration of ownership is a key characteristic of SMEs (Kaya and Koch, 2014:94; Chand, *et al*; 2015:144). In the German study referred to before, over 90% had 10 or fewer owners (Eierle and Haller, 2009:202). Paragraph 11 of the preface to the *IFRS for SMEs* indicates that SMEs often prepare financial statements for owner-managers and that these financial statements are not necessarily general purpose financial statements (IASB, 2015:para P11). Owners that are involved in the management of the company are not regarded as external users and can request additional information to satisfy their reporting needs. Furthermore, small owner-managed entities may not find financial statements that useful and tax statements are often considered sufficient (Neag, 2011:181). In a UK survey SME owners placed a stronger emphasis on bank reconciliations and bank statements for decision making than on annual accounts (Sian and Roberts, 2009:297).

For small companies, the owners and managers are typically not separate (Schutte and Buys, 2011b:19; Wright*, et al;* 2012:296). However, in the German study more than 70% of the participating SMEs had owners who were not actively involved in managing the business, even though this significantly depended on the size of the SME (Eierle and Haller, 2009:202). This separation of owners and managers shows that agency conflicts do exist for SMEs, warranting the small business to prepare more detailed or cumbersome information, even if there are no outside investors (Wright*, et al;* 2012:296).

Owners that are not involved in the management of the business often use financial statements to assess the stewardship of managers (Koppeschaar, 2009:64), i.e. how well managers have made use of the funds of the business (Schiebel, 2007:5). The usefulness of information for decision-making is regarded as lower since the financial statements are often prepared long after year end (IFAC, 2006:20). Consequently, owners use financial statements as confirmatory rather than as forward planning or decision-making (AcSB, 2007:7; Sian and Roberts, 2009:296). In addition, the usefulness of financial statements is limited due to the level of the owner's ability to understand the financial statements (Van Wyk and Rossouw, 2009:104; Sian and Roberts, 2009:298), thus indicating the need for easy to understand accounting guidelines and standards. This is especially true for developing countries, since financial capabilities are regarded as a constraint to SME growth (Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015:10).

In most countries the most important source of finance of SMEs are banks (IFAC, 2006:19). Banks typically require financial statements as part of the terms and conditions to provide loans or finance or as part of periodic compliance reviews. They do not base their decision on the financial statements only and mostly require additional collateral for loans such as pledges, cessions or personal guarantees (Greeff, 2008:10; IASB, 2009:18). Financial statements prepared in terms of the *IFRS for SMEs* are not a requirement by Namibian banks.

Many SMEs prepare financial statements for taxation purposes only (Devi and Samujh, 2015:127). The *IFRS for SMEs* was not developed with tax authorities as primary users, since global accounting standards cannot deal with tax reporting requirements of different jurisdictions (IASB, 2009:20). Tax authorities in Namibia require financial statements to be filed with the annual income tax return together with a reconciliation of the profit to the taxable income and supporting schedules for line items within the tax return. There is no specific requirement by the Namibian tax authorities to prepare financial statements in accordance with the *IFRS for SMEs.*

SME owners, banks and tax authorities as users of financial statements would be in the position to request additional information to satisfy their information needs (Institute of Chartered Accountants of New Zealand, 1994:1a-22). Considering the users' needs, there is less benefit of high quality, costly to comply, internationally comparable, general purpose financial statements, such as those prepared in compliance with the *IFRS for SMEs.* An example of this can be seen in other developing countries such as Fiji, which has adopted the *IFRS for SMEs* for all users that are not 'large', according to the Fiji definition. However, many entities in Fiji have sought exemption from compliance with the *IFRS for SMEs*, due to the small number of external users of their financial statements, or users who only require special purpose financial reports (Chand, *et al;* 2015:143). This substantiates the need to simplify the reporting requirements of SMEs in the form of a third-tier reporting standard, especially for micro entities.

2.5.3 Criticism of the development of the *IFRS for SMEs*

The development of the *IFRS for SMEs* marks an important milestone in the globalisation of financial reporting for SMEs, providing a common set of internationally understandable rules that facilitate the preparation of high quality, consistent and comparable financial statements. 'The *IFRS for SMEs* is a significant development that may have real impact on the future accounting and auditing standards issued by organizations participating in the standard-setting process.' (Jermakowicz and Epstein, 2010:77). Simplifications and the reduced complexity of the *IFRS for SMEs*, compared to full IFRS, have reduced the cost of preparing financial statements for SMEs, especially in jurisdictions that had previously adopted full IFRS for both public and private entities and that do not have the capacity to develop their own set of financial reporting standards. The financial reporting environment in Namibia has undoubtedly also benefited in this way. The *IFRS for SMEs* also eases the transition to full IFRS for growing companies.

However, the development of the *IFRS for SMEs* has not escaped criticism. The IASB has set the needs of users as one of the primary objectives for the development of the *IFRS for SMEs* (Perera and Chand, 2015:172). International scholars claim that the IASB has failed to meet this objective as users and their needs were not adequately considered during its development and additional research is required (Devi and Samujh, 2015:126; Perera and Chand, 2015:172). Further, they maintain that using full IFRS as the starting point for developing the *IFRS for SMEs* did not necessarily result in a product that addresses users' needs (Ram and Newberry, 2013:8; Chand, *et al*; 2015:141; Devi and Samujh, 2015:126), as 'SMEs are not merely smaller versions of larger entities' (Aboagye-Otchere and Agbeibor, 2012:191). Evans, *et al* (2005:38) warn that the objectives and concepts of the IASB's Conceptual Framework, on which the *IFRS for SMEs* is based, are 'biased towards large entities with public accountability, and [are] therefore not suitable for SMEs' (see also Ram and Newberry, 2013:8).

The IASB's due process during the development of the *IFRS for SMEs* included obtaining the opinions and inputs of stakeholders to a discussion paper (Schiebel, 2007:14). The majority of respondents were auditors and accountants (Schiebel, 2007:15); hence, the opinions were biased towards these users and their concerns of audit and compliance costs, rather than taking into account the common information needs of external users of general purpose financial statements (Schiebel, 2007:15; Ram and Newberry, 2013:5). Also, the research on information needs focussed on one kind of user or on one country or region at a time, thus the common information needs at national or international level remain largely unaddressed (Schiebel, 2007:18). The majority of responses were from Europe, therefore the input of developing countries during the development of the *IFRS for SMEs* was not sufficiently represented, and consequently it is unlikely that their needs were adequately considered (Schutte and Buys, 2011a:192; Devi and Samujh, 2015:125).

One of the IASB's concerns during the development of the *IFRS for SMEs* was that it should produce financial statements that provide 'forward-looking' information of predictive value based on fair value accounting, rather than transaction-based historical cost accounting (Ram and Newberry, 2013:10; Devi and Samujh, 2015:129). The relevance of ‘forward-looking’ information and of future cash-flow projections, based on elaborate, complicated assumptions, may be limited for SMEs (Ram and Newberry, 2013:10; Devi and Samujh, 2015:132). ‘Relevance’ is one of the underlying qualitative characteristics of information in financial statements and describes information that is capable of influencing the economic decision-making of users (IASB, 2015:para 2.5). Information provided must be relevant to the decision-making needs of the SME users. As indicated in section 2.5.1 these needs, and therefore their relevance, are more based on short-term cash flows, liquidity, balance sheet strength and interest coverage.

The IASB claims that the *IFRS for SMEs* would be suitable for developing countries (Ram and Newberry, 2013:10). Chand, *et al* (2015:144) are of the opinion that the *IFRS for SMEs* was developed for larger SMEs in developed countries and not for the small SMEs in developing countries. Specifically, the technical challenges of fair value accounting are a major concern (Chand, *et al*; 2015:150). In many developing countries, such as Namibia, active and liquid markets do not exist for fair value estimation, making fair value requirements unreasonable (Ram and Newberry, 2013:10; Chand, *et al*; 2015:146; Devi and Samujh, 2015:126). Also, the lack of resources and capacity makes the application of fair value measurements difficult (Ram and Newberry, 2013:11). Furthermore, Namibia is affected by a lack of resources as it has only 408 resident chartered accountants equating to approximately one chartered accountant for every 5 718 Namibian citizens (ICAN, 2015:5). The resource constraint in Namibia is at least three times larger compared to other Sub-Saharan countries such as South Africa and Mauritius, where the ratios of resident chartered accountants to the population are 1:1 727 and 1:510, respectively (ICAN, 2015:5).

The IASB’s focus and experience is the development of standards for the world’s capital markets (Ram and Newberry, 2013:5). Arguably, the *IFRS for SME* project has been outside of this area. Perera and Chand (2015:172) point out, based on EU consultation on the *IFRS for SMEs* by German Cooperative and Raiffeisen Confederation (DGRV) (2010), that none of the IASB board members or SME working group members had any SME background. It is thus questionable whether the concerns and needs of SMEs’ financial statement users could have been adequately addressed and, by the same token, the benefits of the information published by the

IFRS for SMEs compliant financial statements to the users (Perera and Chand, 2015:172). Furthermore, literature relating specifically to micro entities was historically scarce and mostly incorporated under SMEs (IFAC, 2006:1; Coetzee, 2007:32); therefore, it is improbable that this group was appropriately considered. However, since the development of the *IFRS for SMEs* the situation has changed and international scholars, national regulators and accounting bodies have given more consideration to the existence and needs of micro entities and their need of a simplified third-tier reporting standard.

2.5.4 International support for simplification

The merits of a three-tier financial reporting approach have been recognised internationally. Even prior to the development of the *IFRS for SMEs* by the IASB, starting in 2001 (IASB, 2009:6), the United Nations Committee on Trade and Development (UNCTAD) recognised the need and benefits of a user-friendly and understandable financial accounting and reporting system that is appropriate to the needs of SMEs in different developmental stages and that produces reliable and meaningful financial information (Devi and Samujh, 2015:126). The UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has made a distinction between small, owner-managed micro entities (level 3) and non-publicly accountable 'significant commercial, industrial and business entities' or SMEs (level 2) (Sian and Roberts, 2009:290; Bertoni and De Rosa, 2013:9), and has released two sets of guidelines accordingly. Level 3 guidelines were developed specifically with management, lenders and other creditors, government and SME agencies in mind (UNCTAD, 2009:2). These guidelines are considerably less complex and follow a simple accrual-based accounting system covering about 20 pages only (Sian and Roberts, 2009:290; Bertoni and De Rosa, 2013:9). Level 2 entities' guidelines propose a simplified version of IFRS (Bertoni and De Rosa, 2013:9). The first level applies to listed entities (level 1) which should apply full IFRS (Bertoni and De Rosa, 2013:9). After the release of the *IFRS for SMEs* by the IASB, the UNCTAD disagreed that the standard was suitable for micro entities and revised its third-tier of reporting guidelines for micro entities (UNCTAD, 2009:iv).

Evans, *et al* (2005:38) support the development of a separate set of financial reporting standards for SMEs by the IASB, but are of the opinion that a three-tier system may be required. It may be the case that the needs of micro entities are best served by a system developed by national regulators (Evans, *at al*; 2005:39) taking into account their specific economic environment. Ghana has also seen the need for an accounting standard for small businesses that is more simplified than the *IFRS for SMEs* (Aboagye-Otchere and Agbeibor, 2012:205).

On the other side of the spectrum, many countries exempt smaller entities from issuing general purpose financial statements and statutory audit altogether (IFAC, 2006:9; Baldarelli, *et al*; 2012:29). On 31 July 2012, New Zealand introduced national legislation exempting many SMEs from preparing general purpose financial statements in a move to reduce compliance costs for smaller domestic entities. Instead, these entities prepare financial statements in compliance with taxation regulations (Devi and Samujh, 2015:129). Effective 2011, with the promulgation of the *Companies Act 71 of 2008*, South Africa has also exempted certain smaller companies from preparing general purpose financial statements and audit (SAICA and Juta, 2012:7-20). The absence of legislation in Namibia exempting micro entities from audit makes the need for a simpler, third-tier financial reporting standard more pressing.

2.6 SUMMARY AND CONCLUSIONS

This chapter has established the need for a third-tier reporting standard in Namibia by giving an overview of the *IFRS for SMEs,* highlighting the importance of the SME sector, defining an SME and a micro entity, reviewing cost-benefits consideration, establishing the main users of SME financial statements, while considering criticism raised during and after the development of the *IFRS for SMEs* and international support for a third-tier standard.

The *IFRS for SMEs* was issued by the IASB in 2009 as a financial reporting standard intended to apply to SMEs that are characterised by non-public accountability and that publish general purpose financial statement for external users (IASB, 2015:para 1.2). The development was in response the international importance of SMEs and the increasing complexity of IFRS being pushed down to SME level. The *IFRS for SMEs* is based on the fundamental principles of full IFRS, but simplified and considerably reduced in volume (IASB, 2009:16). However, definitions of SMEs adopted by jurisdictions worldwide vary significantly. Criticism has been mooted that the *IFRS for SMEs* is aimed at entities at the larger end of the spectrum.

Despite its simplifications, the *IFRS for SMEs* is regarded costly to apply and thus burdensome for SMEs, especially micro entities. There are few typical users of SME financial statements and they are in the position to demand additional financial information to satisfy their information needs. Consequently, the cost incurred to prepare high quality general purpose financial statements that comply with the *IFRS for SMEs* exceeds the benefits. These characteristics are even more dominant for micro entities who tend to have limited resources and international focus.

The development process of the *IFRS for SMEs* was criticised for not properly taking into account the users and needs of typical SMEs, especially micro entities in developing countries. The relevance of 'forward-looking' information based on fair value assumptions in financial statements is questioned.

Internationally, there is support for a three-tier financial reporting system, with the third tier applicable to very small SMEs or micro entities. The development of Namibia as a developing country is characterised by SMEs that are smaller in size, with fewer resources than a typical SME in more developed countries. There is thus a need for a simpler third-tier financial reporting standard to ease the financial reporting burden.

Despite international support and arguments in favour of a third-tier reporting standard, there are arguments against further differentiating financial reporting. These arguments include increased training, education, development and implementation costs as well as reduced comparability and universality of financial statements. These costs can be limited by selecting an appropriate form of a third-tier standard. The next chapter focusses on the form such a standard could take.

CHAPTER 3

THE FORM OF A THIRD-TIER FINANCIAL REPORTING STANDARD

Internationally, financial reporting requirements have increased significantly over the past three decades. Many of these reporting requirements, originally intended for large, multi-national entities, were passed down to SMEs level, thereby placing a significant burden on them. This burden is not necessarily justified on a cost-benefit basis, taken the users SME financial statements and their needs. This burden has been recognised by countries who have identified the need to subject SMEs to differential reporting requirements. Differential reporting can take on various forms.

Koppeschaar (2009:121) identifies three different forms or approaches to differential reporting most commonly followed internationally: 1) an independently developed standard for SMEs, 2) simplifications of existing accounting standard(s), and 3) *IFRS for SMEs* (Koppeschaar refers to this as a standard based on IFRS). Namibia adopted *IFRS for SMEs* in 2010, but its application is considered costly for micro entities. Consequently, the form of a third-tier standard is a matter of either a separately developed standard or further simplification of the *IFRS for SMEs.* These two forms are briefly analysed next, together with the advantages and disadvantages of each.

3.1 INDEPENDENTLY DEVELOPED STANDARD FOR SMES

An independently developed standard entails the development of a stand-alone standard for SMEs with simplified recognition and measurement requirements (IFAC, 2006:22) based on principles contained in a specified conceptual framework or on a cash basis or tax basis. The tax basis of accounting 'may be described as presenting the financial statements based on the tax treatment of items' (Van Wyk, 2015:para 1). The cash basis of accounting refers to the practice of recording revenue when cash is received and expenses when cash is paid (Schmidt, 2015).

Advantages of an independently developed standard are that the specific issues and circumstances of the country can be incorporated into the standard while developing it and accounting issues are approached from a different, new perspective (AcSB, 2007:para 81). Additionally, a separate standard can present a condensed and more manageable set of standards tailored specifically to the users of the financial statements. This presents the opportunity to more fully incorporate the cost-benefit considerations that underpin most differential reporting frameworks (HKSA, 2002:9). Advantages of such a standard, specifically applicable to the cash and tax basis, are that they are simple and easy to understand and to implement, without the use of sophisticated software (Schmidt, 2015), and thus cost efficient.

Disadvantages of this approach are that the process for development is capital intensive and often lengthy and costly. The maintenance and updating of the standard is also time consuming and costly (AcSB, 2007:para 81). Internationally trends are towards harmonisation of accounting standards, whilst locally developed standards may show large divergence from international accounting practice (AcSB, 2007:para 82), thereby making them less comparable (Wright, *et al;* 2012:297). Divergent standards can also cause confusion and bring the profession into discredit (Wright, *et al;* 2012:297). A further disadvantage is that an independently developed standard based on a tax basis does not always reflect the economic reality of items and thus does not reflect the needs of a wider group of external users, e.g. the creditors (Van Wyk, 2015:para 5). This basis may be appropriate if the only user is the tax authority. Similarly, the cash basis does not accurately reflect the financial position when there are timing differences between when revenue accrues (i.e. when one is entitled to the revenue) and when the cash is received (Schmidt, 2015), and may accordingly not be appropriate to external users.

3.2 SIMPLIFICATION OF EXISTING STANDARD(S)

Simplification of the existing accounting standard(s) takes the full standard(s) applicable to entities (e.g. IFRS or *IFRS for SMEs*) and incorporates differential reporting requirements only applicable to SMEs, or in the case of a third-tier standard, smaller or micro entities (Koppeschaar, 2009:123). Simplifications may take the form of partial exemption from or simplification of certain recognition and measurement requirements and/or disclosure requirements (Koppeschaar, 2009:123). In this approach, the differential reporting requirements can either form part of the IFRS or *IFRS for SMEs* as a separate section (integrated approach) or be in the form of a separate standard (stand-alone approach) (Koppeschaar, 2009:123).

Advantages of this approach include that the international recognition and credibility of the IFRS or *IFRS for SMEs* is maintained; confusion resulting from divergent standards is avoided (AcSB, 2007:para 62). Only limited differential reporting requirements are incorporated as applicable and the key characteristics of the standards remain the same (AcSB, 2007:para 62). Internationally accepted principles are maintained, which makes it easier for users of financial statements to understand the principles applied (FRC, 2014:para 3.19). There would consequently be broad consistency and comparability between IFRS, *IFRS for SMEs* and the third-tier standard. This approach requires fewer resources and is therefore more cost efficient to develop and maintain (HKSA, 2002:9; AcSB, 2007:para 62). Standard setters can consider and seek comment for differential reporting exemptions at the same time they are considering changes to the *IFRS for SMEs* (HKSA, 2002:9). This approach can also ensure that reporting standards applicable to qualifying entities do not 'lag behind' standards applicable generally (HKSA, 2002:9). Changes in accounting policies, as entities grow and may need to apply IFRS or *IFRS for SMEs,* are also kept to a minimum (FRC, 2014:para 3.19). Furthermore, there is limited training involved for preparers, users and auditors as it is based on an existing standard already widely used in practice (AcSB, 2007:para 71).

Disadvantages include that not all issues encountered by smaller entities may be addressed (AcSB, 2007:para 72). Simplification may mean that sections not applicable to most micro entities are deleted (e.g. service concession agreements), but they may still be an issue that is encountered by some smaller entities. The standard can be interpreted differently to IFRS or *IFRS for SMEs* by users applying the accounting principles, when this is not the intent. This can result in different accounting practices influencing comparability and consistency (AcSB, 2007:para 72). The simplified requirements may also still be too complex and costly for micro entities. Some international definitions of small and micro entities are discussed in chapter 2.3.

There are evidently more advantages and fewer disadvantages relating to a standard based on IFRS or the *IFRS for SMEs* than to an independently developed new standard. A third-tier standard based on the *IFRS for SMEs*, rather than full IFRS, has the advantage that the wheel is not re-invented, since the *IFRS for SMEs* already contains simplifications. A reporting standard based on existing international financial reporting standards (IFRS of *IFRS for SMEs*) is also supported by studies done in South Africa (Hattingh, 2002:23; Wells, 2005:199; Stainbank and Wells 2007:44; Koppeschaar, 2009:316; Van Wyk and Rossouw 2009:113; Stainbank 2011:122; Schutte and Buys 2011a:199), as outlined in the next chapter.

Internationally, jurisdictions have adopted many different variations in form towards differential reporting. The next discussion focusses on the financial reporting approach followed by a selection of countries together with a short history of its development.

3.3 INTERNATIONAL APPROACHES TO DIFFERENTIAL REPORTING

Whilst the rationale for adopting differential reporting is similar for most countries, the reasons for adopting different approaches vary. The differential reporting developments of Canada, Australia, the UK, Hong Kong and South Africa are further discussed as these countries are regarded as playing an important role internationally with regard to differential reporting. Canada and the UK (Greeff, 2008:25) were amongst the first countries in the world to adopt differential reporting, whilst South Africa was the first country in the world to adopt the *IFRS for SMEs* (then in exposure draft form). Developments in South Africa are also significant for the differential reporting debate in Namibia due its geographical closeness to Namibia and its strong economic links. Hong Kong is a developing country that implemented differential reporting more than a decade ago.

3.3.1 Canada

The question whether financial reporting standards for private entities should be different from those developed for publicly accountable entities in Canada was first considered in 1980 (AcSB, 2007:2). However, at the time 'two sets of GAAP were not warranted' (AcSB, 2007:2), as financial reporting requirements were not considered 'excessively complex or detailed' (AcSB, 2007:26).

The mood changed in the late 1990s as increased complexity and volume of financial reporting standards started to place an undue burden on smaller entities (AcSB, 2007:26-27, Appendix 29). Concerns were raised by individuals and organisations prompting the Canadian AcSB to engage in discussion, debate and an extensive due process (AcSB, 2007:27). In January 2002 Section 1300, *Differential reporting*, was issued (AcSB, 2007:27), which gave non-publicly accountable entities the option to follow different accounting treatment in specific areas in generally accepted accounting practice (AcSB, 2010:para 4) and provided some relief for privately owned entities, irrespective of their size. In order to qualify for differential reporting, unanimous written consent by all the shareholders was required (AcSB, 2007:7).

Section 1300, *Differential reporting*, was integrated into the main standards of generally accepted accounting practice, forming a separate section and giving qualifying entities an option as to what differential reporting exemptions they chose to apply (AcSB, 2010:para 4). Differential reporting exemptions included recognition, measurement and presentation issues (AcSB, 2010:para 4).

In 2011 the Canadian AcSB made a policy decision to adopt full IFRS for publicly accountable entities (AcSB, 2010:para 4). The appropriateness of the differential reporting model had to be reconsidered, as Section 1300, *Differential reporting,* provided options to standards that would be withdrawn (AcSB, 2010:para 4). Additionally, many users were of the opinion that Section 1300, *Differential reporting*, did not provide adequate relief for private entitites as it was still too complex and burdensome (AcSB, 2010:para 4). Users acknowledged that, from a cost and complexity perspective, the development of separate standards for private entitites would be beneficial and provide them with the information they needed (AcSB, 2010:para 6).

Consequently, the AcSB (2010:para 7) considered three different approaches to the development of standards for private entities:

1) An approach based on the standards for publicly accountable entities (i.e. IFRS) with differences on a number of topics;
2) Adoption of *IFRS for SMEs*, possibly with some modifications; or
3) An independently developed set of standards.

Responses to the invitation to comment were less supportive of the second option as the *IFRS for SMEs* was still under development at the time and therefore ‘unproven’. Also, a number of technical concerns were raised that were considered unacceptable in the Canadian financial reporting environment (AcSB, 2010:para 10).

Options 1 and 3 were equally supported by stakeholders. Option 1, an IFRS based approach, had the advantage of maintaining the close ties in reporting between private and publicly accountable entities. Additionally, this option avoided the difficulties in understanding and maintaining two separate set of standards (AcSB, 2010:11).

Considerable support was given to option 3, a separate set of standards based on the existing standards (i.e. Canadian GAAP prior to the adoption of IFRS). Under this approach, the *CICA Handbook – Accounting*, as at June 2009, would be used as a starting point, simplifying it for private companies. Section 1300, *Differential reporting* would then be withdrawn. Respondents noted that this approach seemed to result in the timeliest development of standards as nearly all respondents saw the need for reporting standards for private entities in the short term (AcSB, 2010:3). The AcSB noted that the existing standards had been in place for some time and had essentially met the needs of users. Non-publicly accountable, private entities represent 99% of Canadian companies that would be affected by a change (Durocher and Fortin, 2014:218). Developing a separate set of standards based on the existing standards would not require private entities to embark on significant changes to implement a transition to new standards or training and education costs (AcSB, 2010:14).

It appears that in selecting the differential reporting approach, greater weight was given to a pragmatic, short-term solution, rather than to the disadvantages of maintaining two separate sets of standards. Earlier studies by the Canadian Institute of Chartered Accountants did not favour a two GAAP approach, as this was considered to cause confusion and would be detrimental to the image of the profession and the credibility of accounting standards (Maingot and Zeghal, 2006:515). Global movements towards IFRS may render future harmonisation of accounting standards to IFRS for private entities inevitable in Canada. The AcSB does not consider the accounting standards for private enterprises to be a pre-changeover set of standards or 'inferior' to IFRS, but an appropriate set of standards for private enterprises (AcSB, 2010:para 13). This view is reinforced by the AcSB strategic plan for 2016 to 2021 to maintain 'made in Canada' standards for private enterprises and not to converge these standards with IFRS or *IFRS for SMEs* (AcSB, 2015:28). Underlying this decision was the AcSB's view that the factors that led to the original decision to develop 'made in Canada' standards still remained valid (AcSB, 2015:42).

The *Accounting Standards for Private Enterprises* became effective for reporting periods beginning in 2011, with earlier application permitted from 2009 (Durocher and Fortin, 2014:219). The standards are stand-alone (AcSB, 2010:para 26) and available for adoption by all private entities regardless of their size (AcSB, 2010:para 21). Unanimous consent of shareholders is not a requirement as it was with Section 1300, *Differential reporting* (AcSB, 2010:para 22).

The *Accounting Standards for Private Enterprises* are based on a conceptual framework which is consistent with the International Accounting Standards Board's *Framework for the Preparation and Presentation of Financial Statements* (AcSB, 2010:para 29). The standards are based on the previous Canadian GAAP, which were independently developed and bear no direct relation to IFRS.

The approach adopted in the development was to consider only issues that caused significant concern for private entities on a cost-benefit basis and modifications to measurement and recognition were limited. The standards are principle-based, encouraging the application of professional judgement. During their development disclosures were re-evaluated based on the needs of external users, and they were considerably reduced (AcSB, 2010:para 13). *The Business Corporations Act and Regulations* and related legislation in most territories and provinces require financial statements to be prepared in accordance with Canadian GAAP (AcSB, 2007:6), of which the *Accounting Standards for Private Enterprises* forms part.

The strategic plan consultations done by the AcSB during the period subsequent to the adoption of IFRS for publicly accountable entities and to maintain a separate set of standards developed for private entities in 2011 indicated 'strong support' for these core strategies followed by the AcSB (AcSB, 2015:41). Whilst participants noted that none of the standards were perfect and they provided suggestions for improvement, the standards had overall support and were viewed as an improvement over the ones previously in place (AcSB, 2015:41). PwC is of the opinion that *Accounting Standards for Private Enterprises* is probably not a long-term solution and that the standard may evolve to IFRS in the future (PwC, 2011:3).

3.3.2 Australia

Differential reporting has formed part of the Australian financial reporting environment since the early 1990s (AASB, 2010:16). The move towards differential reporting was initiated in order to address the 'standard overload problem'. Standard overload was said to arise when entities were required to produce financial reports of a higher standard than should be the case, considering current and potential users of the reports (Potter, Revlic & Wright, 2013:20). For a long time, relief from preparing financial statements in accordance with the full Australian Accounting Standards was only available to non-reporting entities not required to prepare general purpose financial statements.

A reporting entity (see definition under section 2.3.5) must prepare general purpose financial statements that comply with all applicable accounting standards and interpretations (KPMG, 2015:127). ‘General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs’ (AASB: 2010:12).

Australia adopted full IFRS for financial reporting periods beginning on or after 1 January 2005, which applied to all entities that were obliged to prepare financial statements in terms of the *Corporations Act 2001*, regardless of size (Potter, *et al*; 2013:21). The differential reporting debate was dominated by criticism that full IFRS is too detailed for the needs of users of SMEs and too costly to apply (Potter, *et al;* 2013:21). After a rigorous process of public consultation, further relief became available for for-profit entities that are reporting entities and that are required to prepare general purpose financial statements (Potter, *et al;* 2013:25). The relief came in the form of a two-tier system of financial reporting effective 1 July 2013 (AASB, 2010:7). The tiers only apply to entities that are required to prepare financial statements in accordance with Part 2M.3 of the *Corporations Act 2001* (AASB, 2010:7). These are mainly public companies and large proprietary companies (see definition under section 2.3.5) (AASB, 2010:BC17).

Tier 1 applies to for-profit entities in the private sector that have public accountability (see definition under section 2.3.5) (AASB, 2010:5). It comprises Australian Accounting Standards and is equivalent to IFRS, resulting in entities applying the standards to be simultaneously compliant with IFRS (AASB, 2010:4).

Tier 2 applies to profit entities that do not have public accountability (AASB, 2010:5). Tier 2, *Australian Accounting Standards – Reduced Disclosure Requirements* comprises the recognition, measurement and presentation requirements of IFRS (Tier 1) with reduced disclosures (AASB, 2010:5). Disclosure requirements of Tier 2 are similar to the *IFRS for SMEs.* Tier 2 recognition and measurement corresponds to full IFRS, whereas *IFRS for SMEs* contains limited modifications not adopted or amended for Tier 2 (AASB, 2010:34). This is in line with the AASB’s policy that the same transactions should be subject to the same accounting requirements (i.e. neutrality)

(AASB, 2010:22). The AASB used the *IFRS for SMEs* as a basis to determine disclosure exemption and, where the recognition and measurement accounting policy options or requirements of the *IFRS for SMEs* differed from Tier 2, applied 'user needs' and 'cost-benefit' principles (i.e. the same basic principles applied by the IASB to determine the disclosure requirements under the *IFRS for SMEs*) (AASB, 2010:37-38). The AASB was of the opinion that this was the most cost effective approach to determine and maintain disclosures that produce general purpose financial statements (AASB, 2010:38).

No additional size thresholds were introduced to require companies that have a statutory obligation to prepare general purpose financial statements to apply Tier 1, as opposed to Tier 2, with public accountability being the only differentiator. The AASB was of the opinion that size thresholds were arbitrary and the public accountability criteria were consistent with international requirements. Also, the requirements of Tier 2 still result in high quality, general purpose financial statements and keeping size thresholds up-to-date only increases maintenance and monitoring costs (AASB, 2010:25). Entities eligible for adopting Tier 2 are still permitted to adopt Tier 1, e.g. if they require or prefer to state full compliance with full IFRS (AASB, 2010:26).

Australia decided not to adopt *IFRS for SMEs* as a second-tier financial reporting standard. The reasons given by the AASB (2010:36-37) for this decision include:

- Some of the accounting policy options removed by the IASB from IFRS in the development of the *IFRS for SMEs* would be the favoured options for Australian entities.
- Different recognition and measurement principles would place a reporting burden on subsidiaries of listed companies that need to either comply with full IFRS or maintain two sets of accounting records to comply with IFRS compliant parent accounting policies.
- Having two streams of recognition and measurement would increase education and training costs.
- Moving to the *IFRS for SMEs* would be seen as 'retrograde' for a country already having adopted full IFRS recognition and measurement.

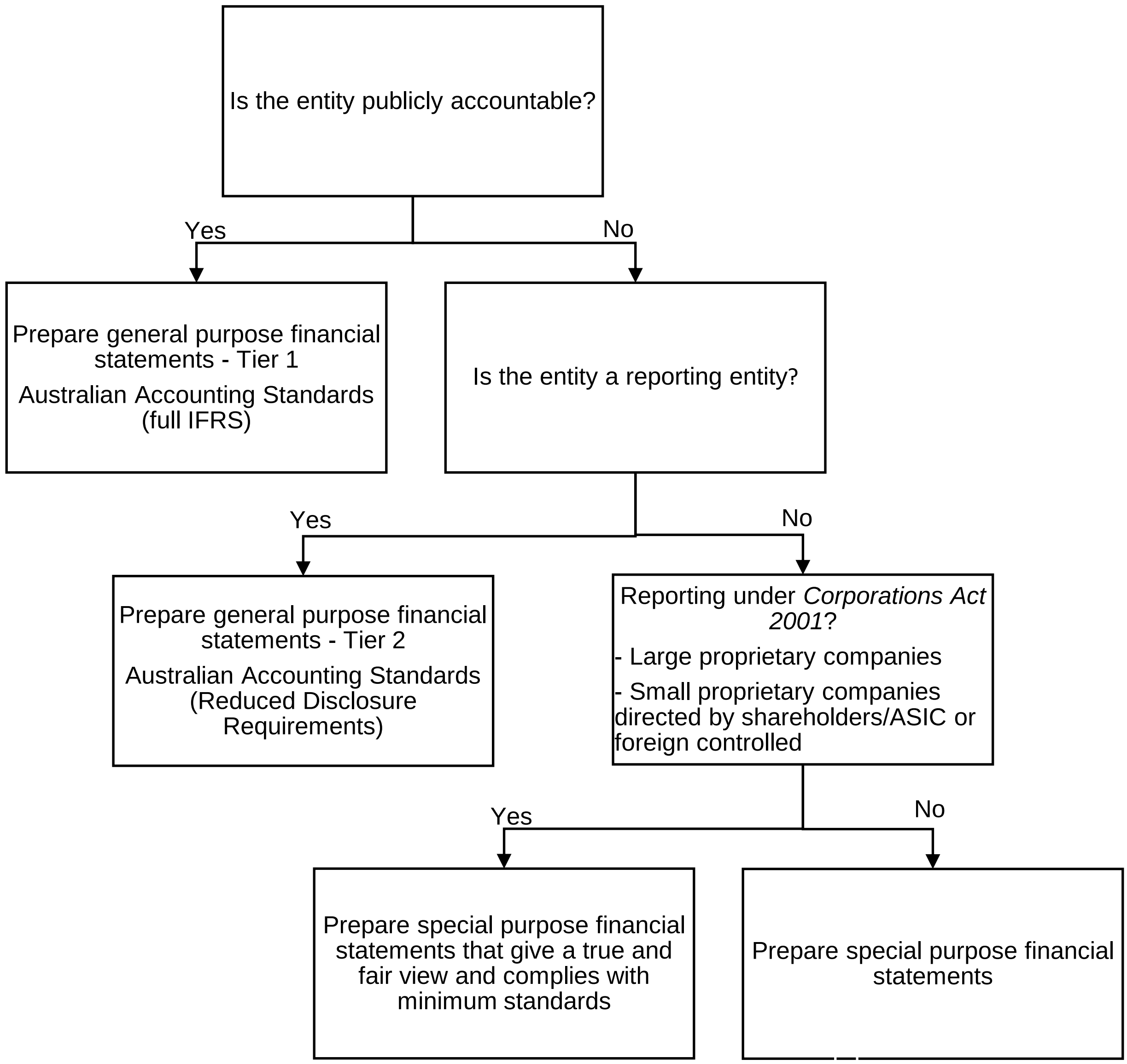
- Limited benefits for international comparability with entities applying the *IFRS for SMEs* due to a loss of comparability across all types of general purpose financial statements within Australia.
- Lack of benefit of continuous updates and simplifications of full IFRS becoming available.

Notably, the last argument is regarded as a compliance burden by the IASB, who limits the updates to the *IFRS for SMEs* (IFRS Foundation, 2015a). Despite its decision, the AASB intends to monitor future changes to the *IFRS for SMEs* and does not rule out its potential future adoption, should it become suitable for the financial reporting requirements in Australia (AASB, 2015:2).

Non-reporting entities are not required to prepare general purpose financial statements. They may prepare special purpose financial statements that need not comply with all accounting standards (KPMG, 2015:129). Only AASB 101 *Presentation of Financial Statements*, AASB 107 *Statement of Cash Flows*, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, AASB 1031 *Materiality* and AASB 1048 *Interpretation of Standards* apply to such entities, by virtue of the application paragraphs in those standards (AASB, 2010:BC17-BC18). Special purpose financial statements are, like general purpose financial statements, subject to the true and fair view requirement of the *Corporations Act 2001* for entities that fall within the requirements of the Act only (AASB, 2010:BC17; KPMG, 2015:135). Section 2M.3 of the *Corporations Act 2001* requires companies to prepare financial statements if they are large non-reporting proprietary companies (see 2.3.5 for related size thresholds), or if they are small and the members request them to or if they are a subsidiary of a foreign company (KPMG, 2015:134-135).

All other small proprietary companies are effectively exempt by law from external reporting obligations (AASB, 2010:17). Consequently, the AASB did not consider a third tier of reporting to provide a simpler reporting framework and reduce the reporting burden on cost-benefit grounds (AASB, 2010:22). Figure I below gives an overview of the reporting obligations in Australia.

Figure I: Australian financial reporting standards decision tree



Source: Adapted from KPMG. 2015. *Australian Financial Reporting Manual*: 40.

Australia is one country that has developed reporting standards based on simplifications to IFRS. It can be concluded that Tier 2 Australian Accounting Standards with reduced disclosure are aimed at the larger SMEs with external users that rely on the general purpose financial statements to make decisions. Compared to the *IFRS for SMEs*, Tier 2 requirements are more onerous. Larger proprietary companies, without external users, may prepare special purpose financial statements that give a true and fair view and comply with a minimum of standards. These requirements are less onerous than compliance with the *IFRS for SMEs.* Smaller SMEs prepare special purpose financial statements and are thus subject to less stringent financial reporting obligations than SMEs in most jurisdictions, while micro entities are exempt from external reporting obligations.

3.3.3 United Kingdom

The *Companies Act of 1985* (now replaced by the *Companies Act of 2006*) introduced differential reporting to the UK. This was in response to financial reporting requirements becoming longer and more complex and the relevance for smaller companies being questioned (Barker and Noonan, 1996:6). Further changes in more recent years have introduced abbreviated accounts and statutory exemptions for smaller entities (Wright*, et al;* 2012:296).

Since 2007, all listed companies have been required to report in terms of IFRS (as adopted by the EU) (previously reporting under UK GAAP) (IFRS Foundation, 2015b:159). For SMEs, the UK had a two-tier financial reporting system prior to 2015, with SMEs reporting either under the *Financial Reporting Standard for Smaller Entities* (FRSSE) or optionally under the full 'old' UK GAAP. The FRSSE was a document aimed at small companies at the larger end of the SME spectrum. It was derived from the accounting standards for larger entities, a previous version of UK GAAP, with disclosure exemptions (Sian and Roberts, 2009:290). The previous version of UK GAAP was independently developed by the UK standard setters and not IFRS based (Accounting Standards Board [ASB], 2012:59).

In line with the global move towards IFRS, the UK standard setters embarked on extensive consultation regarding the future of financial reporting in the UK. The results supported the UK's move towards an internationally based financial reporting system for SMEs, rather than maintaining two separate independent systems (ASB, 2012:59) that 'lack strong underlying cohesion and principle' (ASB, 2012:30). Two systems were regarded as costly to maintain (ASB, 2012:59) and a financial reporting system based on a consistent framework would reduce costs of education and training (FRC, 2015:8). However, the new framework should be proportionate to the needs of preparers and users and take related cost-benefit considerations into account (ASB, 2012:32). Revision was also necessary as FRSSE permitted certain transactions to remain unrecognised, which was considered to have an impact on the true and fair view of the financial statements (ASB, 2012:51).

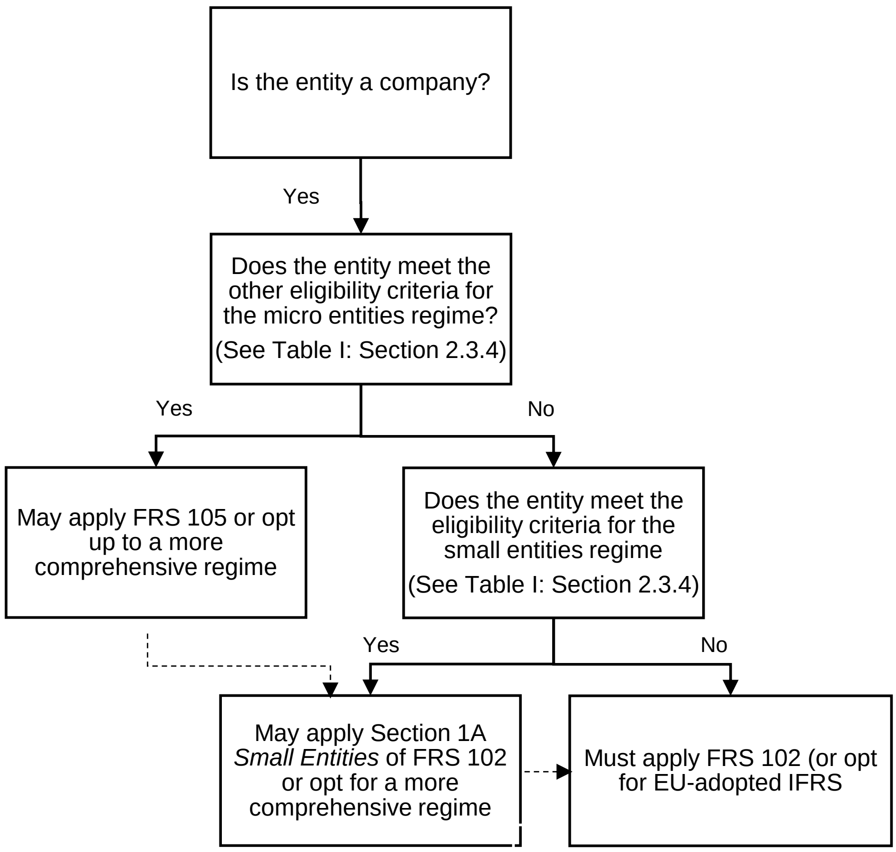
Under the ‘new’ UK financial reporting system, listed companies continue to report under IFRS for their group accounts (FRC, 2015:4). Effective 1 January 2015, ‘old’ UK GAAP was replaced with *FRS 102: Financial Reporting Standard applicable to the UK and Republic of Ireland* (FRC, 2015:8). FRS 102 is aimed at large and medium private companies and groups (KPMG, 2013:11) and is applied by entities that do not qualify for the small or micro-entity regime due to their size (refer to section 2.3.4), or that are not required to apply IFRS due to their listed status (KPMG, 2013:22).

The FRS 102 is based on the *IFRS for SMEs* but with significant modifications (KPMG, 2013:8). Unlike the *IFRS for SMEs*, FRS 102 may be applied by non-listed publicly accountable entities. The removal of the ‘public accountability’ differentiator was done in response to consultation and concerns raised by respondents that the cost of compliance of entities that would now be within the scope of full IFRS was not justified by the benefits to the users (ASB, 2012:7). This widened the use of the standard to a broader group of entities, which necessitated the increased reporting requirements, additional disclosure and inclusion of more accounting policy choices as contained in the *IFRS for SMEs*. (ASB, 2012:19). Even so, FRS 102 is a document with just over 300 pages, compared to the ‘old’ UK GAAP that covered over 2,400 pages (FRC, 2015:8). The FRSSE remained the applicable reporting standard for micro entities at the time prior to 2016 (FRC: 2014:10).

Concurrent to the development of FRS 102, the financial reporting regime for even smaller entities was also further developed. Effective January 2015, the FRS 102 was further extended to include ‘Section 1A *Small Entities’* applicable to smaller entities, based on size (refer to section 2.3.4). The recognition and measurement criteria remained the same, but simplifications of disclosure for smaller entities were implemented (FRC, 2015:9).

Effective 1 January 2016, *FRS 105: The Financial Reporting Standard applicable to the Micro-entities regime*, replaced the FRSSE (FRC, 2015:8). In order to base all accounting standards on a consistent framework, FRS 105 was developed from the recognition and measurement requirements of FRS 102, but with further simplifications to take due regard of the size and complexity of the smaller companies (FRC, 2015:8). Adoption of the standard is optional even if micro entities meet the size-based eligibility criteria with a turnover of up to £632 000 (see section 2.3.4 for size criteria) (FRC, 2015:8). The standard is the least complex FRS of all and requires only a balance sheet and a profit and loss account. Neither a statement of changes in equity nor a cash flow statement is required. All assets are measured at cost and revaluations or fair value upward adjustments are not permitted. Mandatory disclosures are limited to information regarding commitments, guarantees, contingencies and securities as well as detailed disclosure of advances to directors (FRC, 2015:8-9). All accounting policy options, such as capitalisation of borrowing costs, are removed and deferred tax is not recognised (FRC, 2015:9). Micro entities whose financial statements comply with the minimum legal requirements are presumed to give a true and fair view (FRC, 2015:9). Figure II below gives an overview of the reporting options available for SMEs in the UK.

Figure: II: Financial reporting options in the UK



Source: Adapted from Financial Reporting Council (FRC), 2015. *Overview of the financial reporting framework*: page 7.

The UK has adopted the *IFRS for SMEs* with additional requirements for SMEs that have public accountability, implying that it is aimed at the larger SMEs. Differential reporting developments in the UK have seen a move towards IFRS based financial reporting for smaller SMEs and micro entities, albeit more simplified than the *IFRS for*

SMEs. Adoption of the FRS 105 aimed at micro entities is optional and micro entities are thus not by definition subject to specific reporting requirements.

3.3.4 Hong Kong

The differential reporting debate started in Hong Kong in 2000. At the time, the Hong Kong Society of Accountants (now Hong Kong Institute for Certified Public Accountants) formed a working group to consider the need for differential reporting and how it could be applied in Hong Kong if considered appropriate (Hong Kong Society of Accountants [HKSA], 2002:4). The group issued its first consultation paper in 2002 (HKSA, 2002:4).

The drive was initiated by the policy decision to converge Hong Kong Accounting Standards with full IFRS. This was perceived to impose a burden of elaborate financial reporting requirements aimed at the users of financial statements of listed companies on private companies without the related benefit (HKSA, 2002:4; IFRS Foundation, 2015b:85). At the time, private companies were governed by almost the same reporting standards irrespective of their size or the public interest in them (HKSA, 2002:4).

The *Consultation Paper on a Proposed Framework for Differential Reporting* (CP-I) was based on public accountability, separation of governing body and size as surrogates for the cost-benefit criteria (HKSA, 2002:16). In terms of the proposed framework, qualifying entities would primarily enjoy disclosure exemptions from existing HKFRS, with recognition and measurement requirements substantially the same (HKSA, 2002:22-24). Application of the differential reporting framework would also comply with the legal requirements of financial statements to present a 'true and fair' view (HKSA, 2002:14).

Responses to the CP-I indicated support for differential reporting, but respondents indicated that preparation of financial statements on a differential basis would not result in financial statements presenting a 'true and fair view' and further simplification was required to give effective relief to SMEs on a cost-benefit basis (HKSA, 2004:4). This resulted in a second round of consultation, *Consultation Paper – Proposed Implementation of a Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (CP-II) in 2004 (HKSA, 2004:4). This consultation paper proposed a stand-alone statement of accounting standards for SMEs that specifies a measurement framework based on historic costs that better addresses cost-benefit constraints. This was motivated by the significantly fewer resources and less diverse range of users of SMEs, justifying reporting divergent from HKFRSs (HKSA, 2004:4) and correspondingly also from full IFRS. The proposal also stated that the financial statements prepared in accordance with the SME-FRS would not result in financial statements presenting a 'true and fair view', but that they would be 'properly presented' in accordance with the SME-FRS (HKSA, 2004:12). In August 2005, based on the comment received from CP-II, the Hong Kong Institute of Certified Public Accountants issued the SME-FRF and SME-FRS (HKICPA, 2005:4), allowing non-publicly accountable entities to adopt it based on size criteria (refer to section 2.3.6).

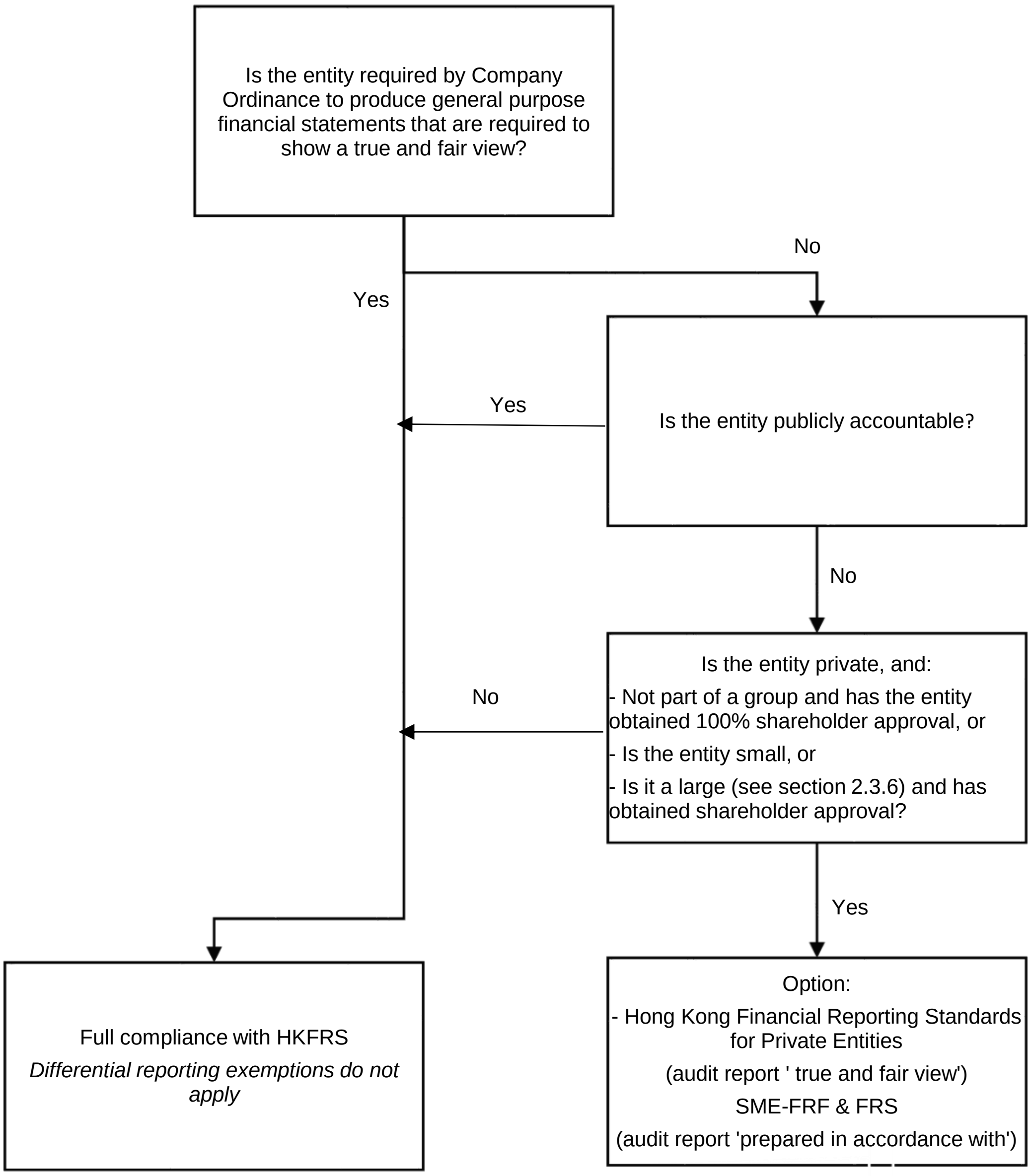
Furthermore, Hong Kong was subject to a corporate law reform with the new Hong Kong Companies Ordinance (Cap. 622) ('new CO') becoming effective in March 2013. Section 359 of the new CO gives more optional reporting exemptions, compared to its predecessor section 141D, to private companies that satisfy certain criteria (HKICPA, 2014:1,4). The most significant exemption is that the financial statements of the companies that take advantage of the exemption do not need to present a 'true and fair view'. Instead, they prepare financial statements that are 'properly prepared in accordance' with the applicable financial reporting framework and standard, currently the SME-FRF and SME-FRS (HKICPA, 2014:3). The corporate law reform would allow more entities to qualify to report in terms of the SME-FRF and SME-FRS.

With the release of the *IFRS for SMEs* by the IASB in 2009, the Financial Reporting Council deliberated about its adoption in Hong Kong. They decided that it was still too complex for small companies (HKICPA, 2010:5), but that it could ease the reporting burden of private entities as it provides an option for a simpler reporting framework (HKICPA, 2009:3).

In 2010, Hong Kong adopted the *IFRS for SMEs* with minor modifications as a financial reporting option for private entities (HKICPA, 2009:3; IFRS Foundation, 2015b:85). The standard was renamed to *Hong Kong Financial Reporting Standards for Private Entities* and the name change was motivated for clarity and differentiation, as the term 'SME' is widely used in Hong Kong and associated with the locally developed SME-FRS (HKICPA, 2015:6). Together with the name change, Hong Kong modified the recognition and measurement criteria of Section 29 *Income Tax* to conform with IAS 12 *Income Taxes,* a change the IASB has also taken as part of its comprehensive review of the *IFRS for SMEs* (IFRS Foundation, 2015a:28).

The scope of the *Hong Kong Financial Reporting Standards for Private Entities* is consistent with the *IFRS for SMEs* and applies to private companies without public accountability who publish general purpose financial statements. Application of the *Hong Kong Financial Reporting Standards for Private Entities* results in financial statements to present a 'true and fair' view (HKICPA, 2014:20). Consequently, entities may choose to apply the *Hong Kong Financial Reporting Standards for Private Entities* or SME-FRF & FRS, if they qualify to do so based on size and public accountability criteria (HKICPA, 2015:7). Figure III gives an outline of the reporting options in Hong Kong.

Figure III: Hong Kong financial reporting standards decision tree



Source: Author’s own observation.

Hong Kong has adopted the *IFRS for SMEs* with minor adaptions, known as the *Hong Kong Financial Reporting Standards for Private Entities.* The standard may be applied by entities as an option if they choose or require financial statements that present a ‘true and fair view’. SMEs and micro entities may also apply the independently developed SME-FRF & FRS, which contains less onerous reporting requirements than the *IFRS for SMEs.* However, compliance with the SME-FRF & FRS does not result in financial statements that present a ‘true and fair view’, which is not required by law. The SME-FRF & FRS was developed prior to the issuance of the *IFRS for*

SMEs by the IASB and has been maintained as the core framework and standard even subsequent to Hong Kong adopting the modified version of *IFRS for SMEs*.

3.3.5 South Africa

3.3.5.1 History and overview of financial reporting environment

In South Africa the differential reporting debate started around 2000. This was driven by the increased financial reporting burden experienced by SMEs to comply with general purpose financial statements in the form of South African Generally Accepted Accounting Practice (SA GAAP) without the related benefit (Stainbank, 2008:3, Van Wyk and Rossouw, 2011:258). SA GAAP was harmonised with IFRS to eliminate differences during the period 1993 to 2004 (Schutte and Buys, 2011b:11) and fully aligned with IFRS from 2005 (Stainbank, 2008:1). At this time, prior to the enactment of the *Corporate Laws Amendments Act 2007* in December of that year (Stainbank and Tafuh, 2011:70), all South African companies, irrespective of their size, form or users of the financial statements were required to apply SA GAAP (and later with IFRS) for the preparation of their financial statements (Stainbank, 2008:1).

The first proposal for differential reporting in South Africa was published in 2000 (Stainbank, 2010:64). *Discussion Paper (DP) 16 – Limited Purpose Financial Statements* proposed differential reporting requirements for companies that are closely held and controlled by owners and whose financial statements are only available to a limited user audience (Stainbank, 2010:64) and thus not required to be general purpose financial statements (Koppeschaar, 2009:164) The DP proposed mainly disclosure concessions for qualifying entities (Stainbank, 2010:64) and was received favourably by respondents who generally supported differential reporting (Koppeschaar, 2009:163). The discussion paper expressly mentioned that limited purpose financial statements should form an integral part of generally accepted accounting practice and should not be separate from it (Koppeschaar, 2009:164). SAICA supported this view for the following reasons (as reported by Stainbank and Wells, 2005:56):

- South Africa does not have the resources to develop separate recognition and measurement standards, a process that has taken the IASB many years to achieve for standards adopted widely across the globe.

- A uniform set of standards is required for analysing and benchmarking to assess the financial results and position of an entity. Benchmarking is required to assess the stewardship, evaluating loan applications and valuing securities in an entity.
- Auditors need authoritative recognition and measurement standards to formulate an opinion on the financial statements of an organisation.
- A changeover from limited purpose to general purpose financial statements would not require a change in accounting policy.

Subsequently, in 2003, SAICA issued ED 163 – *Limited Purpose Financial Reporting Standards* (Stainbank, 2010:64*).* If adopted, this ED would permit qualifying entities to prepare limited purpose financial statements with disclosure exemptions (Stainbank, 2010:64) and limited recognition and measurement concessions relating to deferred tax and financial instruments (Stainbank, 2008:7). The concessions were justified on the grounds of cost-benefits (Greeff, 2008:54). Similarly, and in line with international developments, SAICA consulted with the public on the *IFRS for SMEs* under development by the IASB at the time (Stainbank, 2008:7). Due to the international development of the *IFRS for SMEs* (Van Wyk and Rossouw, 2009:105), the exposure draft was never issued as accounting standard and never applied in practice (Koppeschaar, 2009:167).

At the same time, the issue of differential reporting was also addressed by a comprehensive law reform by the Department of Trade and Industry in South Africa (Stainbank, 2010:64). The draft *Financial Reporting Bill* acknowledged that it was neither reasonable nor practicable to require small companies to comply with standards that are based on international standards for general purpose financial reporting (Stainbank, 2010:64). In 2006, the first phase of the corporate law reform was concluded by the issuance of legislation distinguishing between widely held and limited interest companies (Stainbank, 2010:64). The corporate law reform also made provision for different accounting standards applicable to either of these two types of companies (Stainbank, 2010:65). Widely held companies are by definition mostly public companies, but private companies may choose to be so by special resolution (Stainbank, 2008:9). Differential reporting received legal backing for the first time in South Africa by means of the law reform (Koppeschaar, 2009:172).

In 2007, South Africa became the first country in the world to adopt the *IFRS for SMEs* in its exposure draft form. The standard was intended as a transitional standard for limited interest companies without public accountability (Stainbank, 2008:2) until such time that the Financial Reporting Council that was to be established under the corporate law reform, issued standards for this type of company as stipulated by the new act (Stainbank, 2008:8). This was also in line with SAICA's policy of moving away from the development of own standards and following international standards in order to enhance the credibility of financial reporting in South Africa (Greeff, 2008:56). Stainbank (2010:68) concluded that the main reason for the adoption of the *IFRS for SMEs* in South Africa was the need for auditors to express an opinion on statements drawn up in accordance with a framework that is acceptable to the auditing profession in South Africa and to provide SME users with a framework that protects their interest. Accordingly, full IFRS applies to companies that have a public interest element, while all other for-profit companies may apply the *IFRS for SMEs.*

SAICA has also embarked on a project for the development of a framework for non-public entities or a third-tier financial reporting framework/ micro GAAP at the request of members (SAICA, 2012:1). Members felt that despite the fact that the *IFRS for SMEs* (in its exposure draft form) was issued as a statement of GAAP in South Africa, a demand for a simpler framework of micro entities still existed, as the *IFRS for SMEs* was perceived too complex for micro entities (SAICA, 2012:2).

Three related exposure drafts (EDs) were issued by SAICA for public comment: firstly *ED 257, Framework for Non-public Entities* (2009), later replaced by *ED 275, Financial Reporting Framework for Non-public Entities* (2009), and finally *ED 285, Financial Reporting Framework for Non-public Entities* (2010) (SAICA, 2012:1). The standard, if adopted, was commonly referred to as 'micro GAAP' (Van Wyk and Rossouw, 2011:259) and was intended to present a reporting framework for entities not required by law to comply with any other accounting framework (Koppeschaar, 2009:164).

The ED 257 was criticised for bearing no reference to IFRS and because the scope was not clearly demarcated (Koppeschaar, 2009:170) to distinguish it from the *IFRS for SMEs* (Van Wyk and Rossouw, 2011:260). The development of the ED was also not in line with the arguments given by SAICA for the adoption of the *IFRS for SMEs* (in exposure draft form), which stated that SAICA would not independently develop standards, but follow international standards (Koppeschaar, 2009:170). Furthermore, SAICA did not view the standard to be significantly different from and simpler than the *IFRS for SMEs* and questioned whether it was a suitable third-tier standard, if it was aimed at the same group of companies and would potentially compete with the *IFRS for SMEs* (Van Wyk and Rossouw, 2011:259; SAICA, 2012:2). The ED was never issued as a standard in South Africa (SAICA, 2012:1), since SAICA was of the opinion, after public consultation, that a third reporting framework was unnecessary and would create confusion (SAICA, 2012:2). Also, according to SAICA (2012:2) the *Financial Reporting Framework for Non-public Entities* was not viewed as a fair presentation framework, despite it stating that it was. For companies that required an audit, a fair presentation framework was required.

The need for a third-tier financial reporting standard for micro entities in South Africa is limited (Greeff, 2008:68) due to the corporate law reform. The new *Companies Act* makes provision for profit companies with a public interest score of less than 100 (refer to section 2.3.7), that compile financial statements internally, to apply the financial reporting standards as determined by the company and are not required to comply with IFRS, *IFRS for SMEs* or SA GAAP (which was withdrawn in 2012) (SAICA and Juta, 2012:Annexures-24). These entities may apply tax-based accounting or select their own accounting policies (SAICA, 2012:2). Finally, the newly formed Financial Reporting Standards Council, established under the corporate law reform, also unanimously decided at their meeting on 2 February 2012 not to issue a third-level framework for entities with a public interest score of less than 100 as 'this would impose a burden on this level of companies', but to allow these entities to choose their own accounting policies (SAICA, 2012:3). This concluded the debate on the need of a third-tier reporting standard in South Africa. As an alternative to a framework for non-public entities and to facilitate the application of the *IFRS for SMEs* for these entities, SAICA developed and issued a *Guide on applying IFRS for SMEs for Micro Entities* in 2012 (SAICA, 2012:2).

South Africa has seen a distinct move towards harmonisation of its financial reporting standards with IFRS since 1993. In 2007 South Africa became the first country in the world to adopt the *IFRS for SMEs* (then in exposure draft form). Despite the adoption of the *IFRS for SMEs*, there were still some stakeholders that voiced their opinion that a simpler third-tier financial reporting standard for micro entities was required.

Throughout this process, SAICA remained with its policy decision to follow international standards. Corporate law reforms promulgated in 2012 effectively exempted micro entities from preparing financial statements in terms of an SA GAAP, which also concluded the debate on a third-tier reporting standard.

The need for and form of differential reporting in South Africa has been subject to extensive research over time. The significance of the South African financial reporting regime and its impact on the Namibian financial reporting environment warrants an overview of the studies performed. This is the focus of the next sub-section.

3.3.5.2 Studies on differential reporting forms in the South African context

Wells' study (2005) is a survey of the attitudes of registered accountants and auditors towards differential reporting in South Africa. This study designed a questionnaire that collected information on the desired form that differential reporting could take. The cash basis, tax basis, unlimited deviations from SA GAAP (i.e. companies may choose they own accounting policies), limited formalised deviations from SA GAAP and a separate statement of SA GAAP were given as possible forms that the respondents could select. Limited formalised deviations from SA GAAP were regarded as the most appropriate form of differential reporting in this study.

Hattingh (2002:23) surveyed 2 286 participants at his annual accounting updates on the preferred form of differential reporting in South Africa. Limited deviations from GAAP enjoyed the most support of 71% of the respondents, with GAAP with unlimited flexibility in second place with 19%. The tax basis and a separate statement for SMEs earned the least support.

Koppeschaar (2009:316) focusses on assessing information needs of users of small companies' financial statements in order to make recommendations to alleviate the financial reporting burden for SMEs by including both users and practitioners. Her research recommends a simplified form of the *IFRS for SMEs* as a third-tier financial reporting standard in South Africa.

Van Wyk and Rossouw (2009) survey practitioners to identify topics that could be omitted from the *IFRS for SMEs* and simplifications to the recognition and measurement principles. Although the research does not deal specifically with the form of a standard for micro-entities, by implication it suggests simplifications to the *IFRS for SMEs*, thus supporting the form.

Van Wyk and Rossouw (2011) survey practitioners to identify whether there is a need for and form of a third-tier reporting standard in South Africa (in addition to IFRS and *IFRS for SMEs*). Of the 819 accounting practitioners responding, 77% were of the opinion that a third-tier reporting standard would be required (Van Wyk and Rossouw, 2011:266). The survey differentiated between owner-managed and non-owner managed private companies and available options were full IFRS, *IFRS for SMEs*, micro GAAP, tax basis and cash basis. Over 60% of the respondents favoured the *IFRS for SMEs* for non-owner-managed private entities, whereas micro GAAP was favoured for owner-managed private entities. The least favoured options by respondents were the tax basis and cash basis (Van Wyk and Rossouw, 2011:267). However, 54,95% respondents favoured the *IFRS for SMEs* for private entities that need to be audited, with 20,27% indicating that micro GAAP would be acceptable (Van Wyk and Rossouw, 2011:267-268).

Stainbank (2011:112-113) conducted research surveying users and preparers (practitioners) of financial statements in KwaZulu-Natal, South Africa, on the proposed form that a differential reporting standard for SMEs should take. Her research comprised four different financial reporting forms, namely cash basis, tax basis, limited purpose financial statements and full compliance with IFRS. Limited purpose financial statements are prepared using a simplified form of IFRS (Stainbank 2011:113). The results indicate that 68% of those surveyed favoured limited purpose financial statements (Stainbank 2011:122). This is in line with an earlier study done by Stainbank and Wells (2005:63) on practitioners concerning the form that differential reporting in South Africa should take. The study found that a limited, formalised deviation from the then SA GAAP was the desired approach for differential reporting. Unlimited deviations from SA GAAP and the cash basis were rated as unsuitable by all respondents (Stainbank and Wells, 2005:63). This is also supported by a survey of registered accountants and auditors in South Africa by Stainbank and Wells in 2007.

The study investigated the need for differential reporting and whether options should be limited to presentation and disclosure or extended to include recognition and measurement. The results indicate strong support by the respondents for relief of presentation and disclosure as well as in respect of recognition and measurement requirements (Stainbank and Wells, 2007:49). The same survey also indicates support for multiple differential corporate reporting thresholds, each with their own financial reporting requirements (Stainbank and Wells, 2007:49).

Contrary to the findings above favouring differential reporting in the form of limited deviations from GAAP in South Africa, an international survey by the International Federation of Accountants (2008:57) of the preparers and users of micro entity reports concluded that minor adjustments to current standards were unlikely to make them better suited for micro entities and that a separate standard was required. Based on these findings, Greeff's research (2008:64), focussing on the need for and development of differential reporting globally, envisaged a separate 'concise and easy for business owners to follow' standard for micro entities, in addition to *IFRS for SMEs,* internationally.

Research in South Africa indicates that the *IFRS for SMEs* was well received in South Africa (Stainbank, 2008; Van Wyk and Rossouw, 2009), but that there is still a need for a third-tier financial reporting framework in South Africa (Hattingh, 2009:3; Van Wyk and Rossouw, 2011:259). It must be noted that most of these surveys were conducted prior to the financial reporting exemptions that became available for SMEs below a size threshold in terms of the corporate law reform and related regulations that became effective in 2011. The majority of these studies were done at the time that the draft *IFRS for SMEs* as a second-tier standard was under discussion in South Africa. The results show support for the form of a simplified reporting standard based on international standards in preference to other forms of differential reporting in South Africa. Similarities in Namibia's financial reporting environment to South Africa's (see underlying assumption section 1.7) render these results relating to a third-tier financial reporting standard based on international standards relevant for Namibia.

3.4 SUMMARY AND CONCLUSIONS

This chapter focussed on the advantages and disadvantages of the different forms of differential reporting mostly followed internationally. It gave an overview of the differential reporting history and approaches adopted by countries that play an important global role with regard to differential reporting, thereby focussing on studies on the desirability and form in the South African context.

The form of a third-tier reporting standard can be either an independently developed standard or simplification of existing standard(s). There are comparatively more advantages and fewer disadvantages of a standard based on simplification of the *IFRS for SMEs* than the development of a new independent standard.

By examining approaches followed by a sample of countries internationally, it was found that all jurisdictions, with the exception of Canada and Australia, have adopted the *IFRS for SMEs,* either with or without modifications, for companies without public accountability. The UK has developed different, simplified accounting standards for smaller and micro entities based on the *IFRS for SMEs.* Hong Kong has, in addition to the *IFRS for SMEs*, adopted independently developed reporting standards for SMEs. Australia has developed reporting standards based on IFRS with limited disclosure for larger SMEs and exempts smaller SMEs from preparing general purpose financial statements in accordance with Australian generally accepted accounting practice. Consequently, there is a definite trend towards harmonisation of financial reporting standards with IFRS for larger, publicly accountable entities and with an 'IFRS base' for SMEs. Even countries that had previously developed their own standards for SMEs are moving towards adoption (with or without modifications) of the *IFRS for SMEs*. Studies done in South Africa also favour an approach based on simplifications to existing GAAP standards. All jurisdictions discussed, with the exception of Canada, have statutory financial reporting exemptions based on size thresholds for small and/or micro entities.

The next section reviews these forms of a third-tier standard in the Namibian context.

CHAPTER 4

APPLICATION TO THE NAMIBIAN CONTEXT

The need for a third-tier financial reporting standard has been recognised globally. International organisations, like the UNCTAD, and a number of jurisdictions worldwide have either developed or implemented such simpler standards for smaller SMEs or micro entities. The need for simplification is also being considered in Namibia. The form of such a standard varies and depends on the specific circumstances of each country. Similarly, cognisance must be taken of the Namibian situation.

4.1 THE NEED FOR A THIRD-TIER FINANCIAL REPORTING STANDARD IN NAMIBIA

The SME sector plays an important economic role in Namibia. Since it is a developing country, the role of SMEs is regarded as even more pertinent than in its more developed counterparts. In the words of the former Namibian Minister of Trade and Industry, Honourable Minister Calle Schlettwein (December 2012 – March 2015) (Musariri, 2015:1):

> The importance and contribution of the SME sector to the economic growth and prosperity is well established.

In the Namibian context, the Namibian economy is characterised by low growth rate, high inflation and high unemployment (April, 2005:65). Namibia has a small population compared to its large geographical area (Musariri, 2015:7) and is classified as an upper-middle-income country in accordance with World Bank and United Nations agencies (Republic of Nambia. Ministry of Trade and Industry, 2012:3). However, there are large income inequalities, with the latest Gini coefficient data showing that 70% of the wealth is concentrated among 10% of the population (Republic of Nambia. Ministry of Trade and Industry, 2012:3). The SME sector is regarded as a key player in the eradication of poverty, job creation and economic development (Republic of Namibia. Ministry of Industrialisation, Trade and SME Development, 2015:4).

There is no specific data available with regard to the composition of the Namibian economy concerning the contribution that SMEs and micro entities make to the GDP. The *Namibian Business and Investment Climate Survey* done in 2013 used the number of employees as a criterion to classify entities (Schade, 2013:3), but the classification of a micro entity differs from the criteria in an international context applied by the International Federation of Accountants with an upper limit of ten employees (IFAC, 2006:6) and the *National Policy for Micro, Small and Medium Sized Entities in Namibia* (Republic of Namibia. Ministry of Industrialisation, Trade and SME development, 2015:7). The survey categorised companies into micro (up to five employees), small (between six and 25), medium (from 26 to 99) and large (more than 100 employees) businesses. The results of the survey show that of the 463 companies interviewed, 23% of entities employed up to five employees, while 40% could be classified as small, 22% as medium and 15% as large businesses. This survey was indicative of the significance of SMEs in the Namibian economy (Schade, 2013:3), consistent with trends internationally, and more significantly of South Africa, and supported inferences from related research and publications.

One of the factors regarded as contributing to the success of the SME sector in Namibia is the reduction of the cost of doing business (Stork, 2010:12). Statutory financial reporting and compliance costs, which include the preparation of financial statements in accordance with the *IFRS for SMEs* and the audit of these financial statements, are part of this cost. In order to reduce this cost, there is a need to simplify the financial reporting requirements for SMEs.

Financial statements prepared in accordance with the *IFRS for SMEs* are regarded as producing high quality, transparent, internationally comparable general-purpose financial reports (IASB, 2015:P2,P7). The value of this cannot be denied. However, as outlined in chapter 2, internationally the *IFRS for SMEs* is still regarded as complex and costly to apply, with limited benefit (Perera and Chand, 2015:176). Application of the *IFRS for SMEs,* as a standard of GAAP in Namibia, appears to be burdensome for SMEs. This is especially burdensome for micro entities in Namibia, which tend to have limited resources, and operate locally with limited international focus and limited users (see chapter 2). Namibia as a developing country is characterised by relatively small SMEs compared to the international context, adding proportionally to the costs of applying the *IFRS for SMEs.*

SMEs in Namibia are particularly constrained by a lack of management and accounting skills as well as technical and financial capabilities (Republic of Namibia Ministry of Industrialisation, Trade and SME Development, 2015:10). The capital market is also not developed, making the application of fair value accounting onerous and costly to apply, whilst not being relevant for users of the financial statements. These factors add to the burden experienced by SMEs in applying the *IFRS for SMEs* in Namibia*.*

Namibia's adoption of the *IFRS for SMEs* as GAAP in 2010 has brought some relief from the compliance with full IFRS for non-publicly accountable, private entities. In line with international literature as outlined in chapter 2, there remains a need for a simpler, third-tier financial reporting standard for smaller SMEs and micro entities in order to ease the financial reporting burden. A simpler, third-tier financial reporting standard will encourage active participation in the Namibian economy by creating a more efficient, flexible and simpler environment for the maintenance of companies. This need for simplification is further reinforced by the absence of exemptions for SMEs and micro companies to prepare statutory financial statements in accordance with generally accepted accounting practice, as is the case in jurisdictions such as Australia, the UK and South Africa. The Namibian legislative and financial reporting environment is outlined next.

4.1.1 The Namibian reporting environment and legislation

The legislative requirements of the *Namibian Companies Act, 2004* determine the financial reporting environment. In terms of the act, profit-making companies in Namibia may take the form of either a private or a public company. (Republic of Namibia. Parliament of Namibia, 2004:s.20).

A private company is restricted in its right to transfer shares, prohibited from offering its shares to the public, and restricted to 50 members (Republic of Namibia. Parliament of Namibia, 2004:s.2). The financial statements of a company 'must, in conformity with generally accepted accounting practice, fairly present the state of affairs of the company and its business as at the end of the financial year concerned and the profit or loss of the company for that financial year' (Republic of Namibia. Parliament of Namibia, 2004:s.294(3)). Statements of Namibian Generally Accepted Accounting Practice comprise IFRS, *IFRS for SMEs* and the *ECSAFA Guide* (ICAN, 2006:1; ICAN, 2010:1).

Additionally, all Namibian companies are by law required to be audited annually. Auditors need to express an opinion on the fair presentation of the financial statements (Republic of Namibia. Parliament of Namibia, 2004:s.309(1)). Fair presentation is one of the underlying principles financial statements need to comply with; however, it is difficult to define and apply this principle in practice.

4.1.1.1 Fair presentation

'Present fairly' is a legal concept (Walton, 1993:49), but it is not defined in the *Namibian Companies Act, 2004*. Legislators are seen to use it as a catch-all to meet the requirements of any factor that the act has inadvertently or deliberately left out (Kirk, 2001:4). There is also no legal precedence in Namibia to define its meaning.

Courts are likely to establish the meaning of 'present fairly' according to practice, and practice is determined by generally accepted accounting practice (Walton, 1993:52; Kirk, 2001:4). 'Present fairly' relates to a particular accounting jurisdiction and it changes over time (Walton, 1993:52-53; Kirk, 2001:4). Accounting evolves over time and acceptable accounting practice is established by past decisions on how to do it and what it is that accounting aims to achieve (Walton, 1993:53). A particular culture group will have its own understanding of what rules and principles are acceptable in their environment to prepare financial statements (Walton, 1993:53). It is interpreted according to historical, social, cultural, political and economic roots and environments (Kirk, 2001:2). The meaning is not very clear (Walton, 1993:50) and is constructed through professional judgement and usage similar to the abstract concepts 'material' and 'reasonable' (Kirk, 2001:4).

Different interpretations of the concept can be seen in practice in the UK and Hong Kong. In the UK, financial statements prepared in accordance with FRC 105, the simplest financial reporting framework applicable to micro entities, are regarded as presenting a true and fair view. Conversely, compliance with the simplest framework in Hong Kong, *SME-FRF and SME-FRS*, does not result in fair presentation. South Africa also had a debate as to whether the ED *Financial Reporting Framework for Non-public Entities,* if adopted as a standard, would result in a 'fair presentation' standard. Furthermore, fair presentation in accordance with the *IFRS for SMEs* does not result in fair presentation for an entity with public accountability (IASB, 2015:para 3.2).

Guidance for establishing the meaning of 'fair presentation' can be sought from IFRS. The *International Accounting Standard 1: Presentation of Financial Statements*

*(*IAS 1) states that financial statements should present fairly the financial position, financial performance and cash flows of an entity (IFRS Foundation, 2011:para 15). Conditions to present fairly are further outlined in IAS 1 to mean compliance with the definition and recognition criteria of assets, liabilities, income and expenses set out in the *Framework for Preparation of Financial Statements* with additional disclosure where necessary (IFRS Foundation, 2011:para 15). To achieve fair presentation, accounting policies should be selected in accordance with IFRS, or in the absence thereof, with the *Framework for Preparation of Financial Statements*, especially with the underlying principles of relevance and reliability (IFRS Foundation, 2011:para 17). The *IFRS for SMEs* states that 'fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria of assets, liabilities, income and expenses as set out in Section 2 *Concepts and Pervasive Principles*' (emphasis in original) (IASB, 2015:para 3.2). The application of the *IFRS for SMEs* with additional disclosure, when necessary, is presumed to result in financial statements that achieve fair presentation (IASB, 2015:para 3.2).

The IASB's conceptual framework describes fair presentation as 'information that has the qualitative characteristics of relevance and representational faithfulness enhanced by comparability, verifiability, timeliness and understandability' (IASB, 2010). Namibia's financial reporting environment is moulded by the IASB's conceptual framework together with IFRS (and the *IFRS for SMEs*) and the meaning of 'fair presentation' can be seen to be derived from it. Thus, if a third-tier framework has the same qualitative characteristics and is an 'appropriate accounting standard', fair presentation will be achieved (Van Wyk and Rossouw, 2011:263).

A third-tier standard based on the *IFRS for SMEs* will accordingly achieve fair presentation as it is based on the same conceptual framework. This conclusion is supported by the study of Van Wyk and Rossouw (2011:263) in South Africa of the views of accounting practitioners of whether a micro GAAP, in general, would achieve fair presentation. Of the 819 responses obtained, 90% are of the view that micro GAAP would achieve fair presentation.

4.1.1.2 The ECSAFA Guide

The *ECSAFA Guide* is a statement of GAAP in Namibia alongside the *IFRS for SMEs* for entities that do not have public accountability*.* As a former member of ICAN's technical committee, the author is conscious of concerns that have been raised in Namibia that application of the *ECSAFA Guide* does not result in the fair presentation of financial statements; more specifically, that auditors cannot express an opinion of the fair presentation of financial statements in accordance with *the ECSAFA Guide*.

The *ECSAFA Guide* requires SMEs to apply the underlying assumptions and qualitative characteristics for fair presentation as set out in the IASB *Framework for the Preparation and Presentation of Financial Statements* (ECSAFA, 2006:para 11) (publication title changed to *The Conceptual Framework for Financial Reporting* in 2010). The requirement for information to apply the IASB Conceptual Framework's qualitative characteristics to achieve fair presentation can thus be said to be complied with and is not the problem.

Relating to recognition and measurement, the *ECSAFA Guide* refers to the IASB *Framework for the Preparation and Presentation of Financial Statements* to prescribe the recognition principles (ECSAFA, 2006:para 14), but exempts SMEs from this requirement if the costs exceed the benefits (ECSAFA, 2006:para 15). No further guidance is given as to how the cost-benefit criteria are to be applied. With regard to the accounting policies, limited guidance is given, and management is mostly required to develop accounting policies by applying their judgement. It is advised, but not mandated, to revert back to IFRS for guidance on accounting policies (ECSAFA, 2006:para 22).

Auditors need authoritative measurement and recognition standards to formulate their opinion (Greeff, 2008:52). The International Standard on Auditing 700: *Forming an Opinion and Reporting on Financial Statements* defines a 'fair presentation framework' as 'a financial reporting framework that requires compliance with the requirements of the framework' (International Auditing and Assurance Standards Board, 2009:para 7(b)(ii)). The unlimited flexibility in the development and application of accounting policies can be seen not to meet the requirement of an 'appropriate accounting standard' upon which an auditor can express a 'fair presentation' opinion.

ECSAFA was wound up in 2011 (Hayes, 2011). The *ECSAFA Guide,* which is still a statement of Namibian GAAP, is thus a product of an accounting federation that no longer exists and accordingly is not updated centrally with the latest accounting developments. Furthermore, the *ECSAFA Guide* is founded on and refers to IFRS, which may no longer be the most relevant standards for SMEs since the release of the more simplified *IFRS for SMEs* in 2011.

It is therefore considered necessary to replace the *ECSAFA Guide* with a suitable third-tier standard applicable to micro entities. This standard must, however, give recognition, measurement and disclosure criteria to sufficiently enable the auditor to express an opinion of whether the financial statements are fairly presented in accordance with the standard. The form such a standard could take in Namibia is focussed on next.

4.2 THE FORM OF A THIRD-TIER STANDARD

Both an independently developed third-tier standard and a standard based on the *IFRS for SMEs* can achieve fair presentation, if they are based on an appropriate conceptual framework. It is presumed to be more costly for countries to independently develop such a new standard. Additionally, the cash basis or the tax basis of accounting are not regarded to be fair presentation frameworks. Financial statements prepared in accordance with the cash basis or tax basis are usually intended to satisfy the specific information needs of the users of these financial statements, for example to provide cash flow information to creditors or to accompany the entity's tax return. Auditors do not express an opinion on the fair presentation of the financial statements prepared in accordance with the cash basis or tax basis, but rather compliance with the cash basis or tax basis (International Auditing and Assurance Standards Board, 2009: par.13-14).

Internationally, this study has outlined the move towards adopting the *IFRS for SMEs*. South Africa adopted the *IFRS for SMEs* early on (in exposure draft form). Hong Kong has adopted the *IFRS for SMEs* with minor modifications as *Hong Kong Financial Reporting Standards for Private Entities* for SMEs that need to present 'true and fair' financial statements. The UK has moved away from independently developed standards and has adopted a third-tier standard, FRC 105, based on the *IFRS for SMEs.* These decisions are motivated by advantages relating to a common conceptual framework enhancing overall comparability and understandability with related savings in training and education costs not realised with separately developed standards unrelated to the *IFRS for SMEs* (or ultimately IFRS).

Koppeschaar (2009:316) aptly summarises the advantage of a third-tier standard based on the *IFRS for SMEs*: it is based on an internationally accepted standard and comparability is enhanced as reporting would be within the current reporting system. The IASB has the responsibility of updating and maintaining *IFRS for SME*s, thus the development and updating of a simplified version would be easier and more cost effective. The cost of implementing and enforcing standards that fit into the current reporting framework is also considerably reduced for a simplified standard based on the *IFRS for SMEs*.

The author has served as a member of ICAN's technical committee and is conscious of the resource constraints, since the technical committee comprises members practising full time. Whilst recognising the need of micro entities for simplifying the reporting requirements, the form of differential reporting must also be feasible, considering the constraints faced by the institute. Based on cost and resource constraints, the development and maintenance of an independent stand-alone standard for micro entities is not considered feasible. As indicated in chapter 2.5.3, Namibia is also facing resource challenges regarding qualified chartered accountants. Consequently, retraining costs for an independently developed standard would be higher than for a standard based on the *IFRS for SMEs.*

In the long run, a corporate reform is what may be required in order to allow micro entities in Namibia, like jurisdictions elsewhere, to prepare special purpose financial statements specifically tailored to the needs of the users of these financial statements. A corporate reform would entail the revision of the Namibian *Companies Act 28 of 2004* to incorporate statutory reporting exemptions for micro entities. The Financial Reporting Council of South Africa (Financial Reporting Standards Council, 2013:2) aptly commented on the characteristics of micro entities and for a third-tier financial reporting standard in South Africa as follows: 'These companies are therefore presumably mostly owner managed businesses. It could be argued that the need for these companies to comply with a set of prescribed financial reporting standards, in order to protect public or other interest, is low'.

4.3 SUMMARY AND CONCLUSIONS

Like elsewhere in the world and particularly because Namibia is a developing country with limited resources, a third-tier financial reporting standard is required. Simpler financial reporting will stimulate economic growth, reduce costs and increase welfare.

The preferred alternative to a separately developed standard for micro entities is a simplified version of *IFRS for SMEs* as it is based on a fair presentation framework. This preferred alternative can be incorporated into the current Namibian reporting system without undue costs. Such a standard can incorporate simplified recognition, measurement and disclosure requirements and accordingly reduce costs for the micro entities. A standard based on the *IFRS for SMEs* replacing the *ECSAFA Guide* can overcome the shortcomings of the latter by incorporating authoritative recognition, measurement and disclosure requirements, consequently presenting a standard on which auditors can issue a ‘fair presentation’ audit opinion.

CHAPTER 5

RESULTS, CONCLUSIONS AND RECOMMENDATIONS

This study investigated the need for a third-tier financial reporting standard in Namibia as well as the form such a standard could take with reference to international literature. The results, conclusions and recommendations are outlined in this chapter.

5.1 THE NEED FOR A THIRD-TIER FINANCIAL REPORTING STANDARD

Since its release in 2009, the *IFRS for SMEs* has gained widespread global acceptance and support as an international financial reporting standard aimed at non-publicly accountable entities that are required to or have chosen to prepare general purpose financial statements. The IASB maintains that more than 95% of companies worldwide are SMEs, justifying a separate standard specifically suited to this sector. The *IFRS for SMEs* was developed by the IASB in response to the increased complexity and volume of IFRS developed for publicly accountable entities being pushed down to SMEs level. Namibia adopted the standard as Namibian GAAP in 2010.

Despite simplifications compared to IFRS, compliance with the *IFRS for SMEs* is regarded complex and costly, both internationally and in Namibia. These costs often outweigh the benefits to users, who see little value in high quality, internationally comparable and transparent general purpose financial statements. The costs are also regarded proportionally higher for SMEs, especially micro entities.

The costs of compliance with the *IFRS for SMEs* are not necessarily justified by taking into consideration the needs of the users of the financial statements, who are regarded to be different for SMEs compared to larger, publicly listed companies. The users of SME financial statements are typically limited to owners, taxation authorities and providers of credit. All of these users are in the position to request additional information to make their decisions and need not rely on costly general purpose financial statements. International criticism has also been articulated that the needs of users were not adequately considered during the development of the *IFRS for SMEs*, especially of micro entities.

Definitions of SMEs vary significantly across the globe; for example, a micro entity in the UK context is considered large in Namibia. During the development of the *IFRS* *for SMEs,* the IASB had to consider the needs of a wide size spectrum of entities. The requirements suitable for larger SMEs are onerous for micro entities to apply. In Namibia as a developing country, the importance of SMEs and micro entities as a facilitator for economic development is recognised. SMEs and micro entities tend to be smaller here than in developed countries. Economic resources to apply the complex and onerous requirements of the *IFRS for SMEs* are also lacking in Namibia.

All these factors add proportionally to the burden experienced by compliance with the *IFRS for SMEs*. These costs can be avoided or kept to a minimum by reducing the compliance burden of the micro entities through a third-tier financial reporting framework. This approach has also been recognised and adopted internationally.

On the other hand, there are disadvantages of further differentiation in terms of a third-tier standard, such as development, implementation, training and education costs. These disadvantages can be overcome or limited by selecting the appropriate form of such a standard.

5.2 THE FORM OF A THIRD-TIER FINANCIAL REPORTING STANDARD

The form of differential reporting can be broadly classified as either independently developed standard(s) or simplification of existing standard(s). Simplification of existing standard(s) may take the form of measurements and recognition and/or disclosure exemptions of either locally developed generally accepted accounting practice or the international standards such as IFRS and/or the *IFRS for SMEs.*

As regards the form of a third-tier financial reporting standard, there are distinct advantages and comparatively fewer disadvantages to developing a standard for micro entities based on the *IFRS for SMEs*. Internationally, countries have moved towards harmonisation of their standards for SMEs with the *IFRS for SMEs*. This study has outlined this trend in South Africa, the UK, Hong Kong and Australia. Countries recognise the advantages of a common conceptual framework for publicly accountable entities and SMEs and standards based on international creditability, broad comparability and understanding of IFRS. Transition of micro entities to the *IFRS for SMEs* or full IFRS as entities grow is eased if standards are based on the same broad principles. Namibia has been reporting in terms of IFRS since 2006 and the reporting environment is already familiar with its requirements and interpretations.

5.3 APPLICATION TO THE NAMIBIAN CONTEXT

SMEs play an important role in Namibia for economic development, reduction of unemployment and creation of wealth. As a developing country, Namibia is particularly constrained by a lack of financial and economic resources.

All companies in Namibia, irrespective of their size, are by law required to prepare financial statements in accordance with generally accepted accounting practice. These financial statements are subject to a mandatory annual audit and auditors need to express an opinion on the fair presentation of these financial statements.

The application of the *IFRS for SMEs*, a high quality, global financial reporting standard, is regarded costly without the related benefits, especially for micro entities. In order to reduce these costs and free economic resources, a third-tier reporting standard for micro entities is required in Namibia.

Members of the accounting profession have raised concerns about the unlimited flexibility allowed by the *ECSAFA Guide* in the application of recognition and measurement accounting policies. This flexibility is seen as an impediment to fair presentation of financial statements and inhibits the auditors from issuing an opinion on the fair presentation of the financial statements in accordance with the *ECSAFA Guide.* This calls for the replacement of the *ECSAFA Guide* with a third-tier reporting standard that both complies with the IASB's conceptual framework and has authoritative recognition and measurement standards to formulate an opinion.

Development, maintenance costs, and education and training costs are reduced for a standard for micro entities based on the *IFRS for SMEs* as opposed to a new, independently developed standard. Such a standard will fit into the current reporting system, is based on an internationally accepted standard, and will support the understanding and broad comparability of financial statements. Studies done in South Africa support the favoured approach for a third-tier reporting framework as a simplified version of the *IFRS for SMEs*. The similarity of the Namibian economy to the South African economy and the arguments presented in favour of such an approach also point to this as the most feasible option for Namibia. Due regard to the scarcity of resources in Namibia, both in terms of economic wealth and availability of qualified chartered accountants, suggests a third-tier standard based on the *IFRS for SMEs* most practicable and viable. A simplified third-tier reporting standard for

Namibia will free scarce resources, stimulate economic activity, and lead to a reduction of poverty and increase in welfare.

5.4 CONTRIBUTION AND LIMITATION

The study contributes to filling the gap of proper research into the need and form of a third-tier financial reporting standard in Namibia. It argues that such a reporting standard is needed in Namibia to reduce the cost of financial reporting for micro entities and thereby to free resources for economic development and growth.

A limitation of this study is the lack of availability of data and studies relating specifically to Namibia. Inferences are drawn from international studies and particularly the South African context, which may not always be fully relevant for Namibia.

5.5 RECOMMENDATIONS

This study recommends that a third-tier financial reporting standard is needed in Namibia, as the *IFRS for SMEs* is not regarded as the most suitable financial reporting standard, especially for micro entities. Further, the study recommends that such a standard should be a simplified standard based on the *IFRS for SMEs.* Once the standard has been developed and adopted, the *ECSAFA Guide* should be withdrawn as a Namibian statement of GAAP.

Areas for potential further research are presented, by way of empirical studies, for the modifications required to the *IFRS for SMEs* to form the content of the third-tier standard in Namibia. Additionally, studies for the demarcation of criteria to which this standard would apply, are required in the Namibian context. Further research opportunities exist on the impact of a corporate law reform in Namibia to exempt smaller SMEs and micro entities from the statutory obligation of preparing financial statements in terms of generally accepted accounting practice.

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APPENDIX A: ETHICS APPROVAL

UNISA university of south africa

COLLEGE OF ACCOUNTING SCIENCES

RESEARCH ETHICS REVIEW COMMITTEE

Date: 26 November 2015

Ref: 2015_CAS_039
Name of applicant:
Ms P Klink
Student/Staff #:57660603

Dear Ms P Klink

Decision: Ethics Approval

Name: Ms P Klink,

P.O. Box 627
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Proposal: The International Financial Reporting Standard for Small and Medium-sized Entities: The need and form of a third-tier financial reporting standard in Namibia.

Qualification: MCompt

Thank you for the application for research ethics clearance by the College of Accounting Sciences Research Ethics Review Committee for the above mentioned research. Final approval is granted for the completion of the research.

For full approval: *The secondary data application was reviewed in compliance with the Unisa Policy on Research Ethics by the College of Accounting Sciences Research Ethics Review Committee on 25 November 2015.*

The proposed research may now commence with the proviso that:

1) *The researcher/s will ensure that the research project adheres to the values and principles expressed in the UNISA Policy on Research Ethics.*
2) *Any adverse circumstance arising in the undertaking of the research project that is relevant to the ethicality of the study, as well as changes in the methodology, should be communicated in writing to the College of Accounting Sciences Research Ethics Review Committee . An amended application could be requested if there are*

Open Rubric

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substantial changes from the existing proposal, especially if those changes affect any of the study-related risks for the research participants.

3) *The researcher will ensure that the research project adheres to any applicable national legislation, professional codes of conduct, institutional guidelines and scientific standards relevant to the specific field of study.*

Note:

The reference number [top right corner of this communiqué] should be clearly indicated on all forms of communication [e.g. Webmail, E-mail messages, letters] with the intended research participants, as well as with the College of Accounting Sciences RERC.

Kind regards,

Prof D Scheepers
(Acting chairperson of CAS RERC)
scheed@unisa.ac.za
(012) 429 4342

Prof Elmarie Sadler
(Executive Dean of CAS)