

Full Length Research Paper

A comparative evaluation of South African SME financial statements against the IFRS requirements

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Research revealed that strong enforcement of accounting standards would improve the quality of financial reporting. As a result, information communicated by management to existing and potential shareholders should also improve. Proper financial reporting is however not necessarily an SME objective. Traditionally SME owners also fulfil a management function in the business. Moreover, little evidence exist that disclosure practices of SMEs are monitored. Notwithstanding these circumstances the IFRS for SMEs was developed for the SME sector worldwide. The relevance and adequacy of this accounting framework to the SME sector is therefore doubtful. This study compares current disclosure practices by South African SMEs against the IFRS for SMEs' illustrative financial statements. Based on a sample of financial statements from the SME sector in South Africa our results suggest to what extent the illustrative financial statements is suitable for South African SMEs.

Key words: Accounting, generally accepted accounting practice, small and medium entities, international financial reporting standards.

INTRODUCTION

When considering conventional accounting research the focus is often on the objective quantitative data that is publicly available such as from stock exchanges. Practising accountants are however also entrusted with a stewardship role and is also very much involved in the preparation of such data. Yet minimal accounting research seems to be conducted in this specific preparatory area of accounting. Although Ball and Foster (1982: 164 to 169) suggested that the financial statements exemplify the database in empirical accounting research, the focus of researchers in recent times has not been on the database or the information disclosed in the financial statements, but rather on the development of international financial reporting standards (IFRS) and more recently, on the adoption of these

standards by large industrialised countries, such as the United States (US), Canada, and members of the European Union. According to Zeghal and Mhedhbi (2006: 374) empirical research on the adoption of IFRS is of a general nature only and limited to a description of particular circumstances. Early on Ball and Foster (1982: 164) identified major differences between empirical research in the field of accounting (as a social science) compared to research in the basic scientific disciplines. They advocated that accounting researchers are confronted by the imperfect match between the theoretical background of the accounting discipline and the institutional data presented by accountants. In addition they identified major differences between accounting research and work undertaken by practitioners, suggesting that "good" accounting research might not satisfy either the disciplinary purist or the practising accountant.

In addition to differences between accounting and non-accounting disciplines, evidence of diversity within the discipline of accounting also exists. A number of researchers, such as Gannon and Ashwal (2004: 43) as well as Zanzig and Flesher (2006: 1) revealed

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inconsistencies in national and international accounting practices. As a result many governments, accounting regulators and other governing bodies called for accounting harmonisation. Van der Tas (1988: 157) defined the term harmonisation as the coordination, or the tuning of two or more objects. Accounting harmonisation therefore implies coordination between two or more sets of financial statements. According to Van der Tas (1988: 158) accounting harmonisation can either be formal as a result of the standard setting process or spontaneous without being influenced by accounting standards. The degree of formality is further influenced by the degree of legal backing for accounting standards. Although accounting is considered to be self regulated by the professional values, ethical rules and governing bodies prescribing business practices. Willmott et al. (1992: 33) suggested that the state should be more involved in mediating the process of accounting regulation. As a result legislative backing for accounting standards was introduced in the US, United Kingdom (UK), Canada, Australia and elsewhere (Sawani, 2009: 1; Bradbury and Van Zijl, 2005: 78). Although legal backing for accounting standards and related reporting frameworks for companies was identified as one of the critical components of the corporate reform process, the situation in South Africa remains uncertain. Apart from disclosure requirements for listed companies little evidence exists that disclosure practices and related adherence to accounting standards of unlisted SMEs are monitored. We therefore suggest that the format of financial statements of the SME sector in South Africa was to a certain extent, the subject of spontaneous harmonisation due to limited enforcement and monitoring of adherence to accounting standards.

Our research was further complicated by the lack of formalities of SMEs (White, 1995: 11) as well as the fact that most information is often considered confidential. SMEs do not disclose all the information utilised in similar research projects pertaining to listed companies. Moreover, in contrast to the financial statements of listed companies, SME financial statements were not readily available. Despite these limitations we attempted to analyse disclosure practices from a sample of SME financial statements and to compare the content thereof to the illustrative financial statements of the recently announced IFRS for SMEs.

Theoretical framework

Development of the database

The accounting "database" has been the subject of major developments over the years. Companies in the US and UK were not required to compile financial statements in the nineteenth century (Watts, 1977: 58). During this period many companies voluntarily compiled financial statements comprising a balance of profit or loss as well

as a balance sheet. Some companies disclosed only partial financial information and many companies did not have proper records to substantiate the financial information disclosed. In order to address this deficiency pertaining to the quality of the accounting database a number of statutory bodies were introduced in order to regulate financial reporting, for example the securities exchange commission (SEC) in the US, the Financial Reporting Review Panel in the UK and many other national monitoring bodies elsewhere (Sikka, 2001: 200). The introduction of financial reporting regularity bodies did not necessarily result in a reliable accounting database as accounting regulation has also undergone major developments in recent times. Even though IFRS was adopted by more than 100 countries, the convergence did not occur simultaneously. In 2002 the European commission (EC) issued a regulation which required listed companies from member states to prepare financial statements in accordance with IFRS as of 1 January, 2005. As a result the convergence to IFRS by European countries commenced in 2005 whilst others are planning to adopt IFRS in the near future, for example Canada, India, Japan and South Korea. In like manner the SEC outlined a roadmap that will result in mandatory transition from US generally accepted accounting principles (US GAAP) to IFRS by 2014 (Deloitte, 2009b: 1).

Major obstacles are expected in these convergence efforts, for example, without even considering other countries; there were initially approximately 200 key differences between US GAAP and IFRS alone. US GAAP contain specific rules whereas IFRS are considered to be based on principles (Gorelik, 1994: 95).

In addition to these differences, a number of new IFRSs were introduced since the formation of the international accounting standards board (IASB) in 2001. Over and above the 41 accounting standards developed from 1973 to 2001 by its predecessor, the International Accounting Standards Committee, the IASB developed a further nine accounting standards from 2001 to 2009 (IASB, 2009: 1). It appears therefore that the database of the accounting environment may not only be incompatible between different countries due to different prevailing local accounting regulations but also inconsistent from year to year due to different convergence rates to IFRS as well as new developments in IFRS.

Accountability and accounting regulation

Hope (2003: 236) suggested that strong enforcement of accounting standards would improve the quality of financial reporting. The enforcement of accounting standards is, according to the EC, dependant on transparent corporate governance systems, auditing regulation, as well as independent institutional review (CESR, 2003: 3). According to the SEC (2000: 1) a high quality financial reporting environment is dependant on a

combination of efficient reporting standards and active regulatory oversight. Despite the theoretical soundness of the regularity enforcement of accounting standards, little evidence exists in connection with the effectiveness of the methods to monitor compliance of accounting standards.

Firstly, although certain countries might have systems in place to monitor compliance with prevailing accounting standards, they might not necessarily be able to monitor compliance with IFRS. The fact that, prior to the adoption of IFRS, accounting standards in many countries were rules-based might be more burdensome in practice. Furthermore, due to the fact that IFRS was only recently adopted in many countries little evidence exists in connection with the monitoring and regulation pertaining to the application of IFRS.

Benston et al. (2006: 165) warned against inconsistent accounting practices when principles-based judgments are required to measure assets and liabilities. They also proposed a true-and-fair override requirement in order to address the inconsistent application of accounting principles. In addition, if accounting practices are burdened by the application of accounting principles the regulation of accounting principles should be even more difficult to achieve. Zeff (1995: 54) highlighted difficulties experienced by accounting governing bodies to regulate principles-based terms, for example "fair presentation".

Moreover, Kershaw (2005: 616) suggested that principles should not be taken too seriously in the process of accounting regulation and concluded that the presence of principles will not necessarily get in the way of misleading financial information. It is therefore possible that principles-based IFRS might result in inconsistent accounting practices which will in turn also complicate the process of monitoring and regulating accounting practices. In the second instance the monitoring function will be burdened by the diverse legal environments of countries across the globe. Daske et al. (2008: 2) suggested that the enforcement of IFRS will not be successful amongst countries with weak legal and enforcement regimes. Countries with stringent legal systems will therefore be more readily complying with IFRS which will in turn assist the process of monitoring compliance.

Thirdly, diverse levels of enforceability should be considered. Similar processes and practices will not necessarily be followed in the process of monitoring compliance with IFRS in different countries. The SEC will perform the monitoring function in the US, the EC will be entrusted with the function in Europe whilst the function can be conducted by securities regulators, stock exchanges or other mechanisms such as review panels in other parts of the world (Dao, 2005: 108). In addition to dissimilar processes and practices, monitoring bodies from different countries might be entrusted with different levels of enforceability. Ball et al. (2000: 4) argued that the extent to which accounting practices adhere to

accounting standards varies internationally and that the incentive to follow accounting standards depends on penalties under different enforcement institutions. As a result penalties and fines for non-compliance with accounting standards may vary between countries. We therefore suggest that the process of monitoring compliance with IFRS will be inconsistent between countries due to different processes and practices as well as different levels of authority to monitor compliance with IFRS.

SME reporting

Though, Hope (2003: 236) suggested that strong enforcement of accounting standards would also increase analysts forecast accuracy it is not clear whether he envisaged all types of businesses, especially the SME sector when he made this statement. Levin and Travis (1987: 30) advocated that the financial statements of SMEs tell only half the story about private companies. The nature of SMEs (with limited investors) is substantially different than that of listed companies (with a variety of investors). The involvement of owner-managers do not warrant the same comprehensive effort by the directors to communicate financial information to multiple and diverse shareholders. Most SME owner-managers are already involved in the day-to-day operations of the businesses. Not only do they have regular access to the financial information, but they also consider certain financial information to be confidential.

Khosrow-Pour (2006: 954) suggested that issues of security and privacy are considered to be the main barriers in respect of SME research. In addition the financial statements of SMEs are not necessarily utilised for budgetary and related forecast purposes as the principal role of SME financial reporting is retrospective and confirmatory in nature (Baskerville and Cordery, 2006: 11). According to McMahon (1998: 3) the financial information of SMEs is mainly utilised to evaluate the success of past decisions and in determining the present position. Furthermore, McCahey (1986: 123) found that owner-managers are the primary users of SME statutory reports and that they do not necessarily have the ability to properly interpret them. Since the primary users of SME financial statements do not know how to interpret the information we suggest that the contents of the financial statements are also not the subject of a detailed analysis process.

In the absence of detailed analysis of SME financial statements compliance with and the related enforcement of IFRS might not be a priority for accounting regulators. Moreover, Sian and Roberts (2009: 302) found that, in addition to owner managers, tax authorities are the key recipients of SME financial statements. The likelihood that the contents and format of SME financial statements are influenced by the disclosure requirements of tax

authorities, and not accounting regulators, can therefore not be ruled out. In conclusion evidence exists that the information needs of SMEs are very much different than the traditional IFRS audience.

The South African context

IFRS harmonisation in South Africa occurred from 1993 to 2004. During this period differences between South African generally accepted accounting practice (SA GAAP) and IFRS were eliminated.

The legal enforceability of SA GAAP/IFRS however remained uncertain. As a result legal backing for SA GAAP/IFRS was proposed as part of the corporate reform process (Vorster et al., 2007: 5; DTI, 2004: 1). Non-legislative measures were in place for companies listed on the JSE Ltd in the form of the GAAP Monitoring Panel who monitors disclosure practices and related compliance with IFRS. In contrast, disclosure practices of non-listed SMEs were not monitored to ensure compliance with SA GAAP/IFRS. Like their international counterparts the users of SME financial statements in South Africa will also not necessarily encourage compliance with SA GAAP/IFRS. In addition to the fact that the internal users of SME financial statements are also the owners of the business with regular access to the financial information, the financial statements of SMEs in South Africa may not always be up to date and readily available. Proper disclosure practices and compliance with accounting standards would also not necessarily address the requirements of external users. According to Collis and Jarvis (2000: 12) banking institutions and tax authorities are the main external users of SME financial statements and whilst the information needs of banking institutions and providers of finance are limited to liquidity ratios, the South African revenue service (SARS) is mainly concerned about taxable profits.

The lack of interest by SARS in a complete set of financial statements is further supported by the fact that companies are no longer required to submit financial statements, but to submit only certain tax related information for tax filing purposes (South African Revenue Service, 2010). Little evidence therefore exists that the disclosure practices of South African SMEs is in accordance with SA GAAP, IFRS or any relevant accounting framework. For this reason we suggest, based on the observations by Van der Tas (1988: 158), that the harmonisation process of SME disclosure practices in South Africa were spontaneous and not necessarily influenced by the standard setting process.

Development of hypothesis

Against the background of non-compliance with accounting standards by South African SMEs a reporting

framework for the SME sector was introduced in August 2007. The exposure draft on IFRS for SMEs was adopted as the South African Statement of GAAP for SMEs without any amendments to the exposure draft on IFRS for SMEs. The IASB, after considering additional feedback, adopted the exposure draft two years later. As from 2009 a global reporting framework for the SME sector will therefore be adopted by many countries. According to the IASB the IFRS for SMEs was developed to address the reporting needs of SMEs worldwide. In developing the IFRS for SMEs the IASB conducted a number of field tests to assess the relevance of the accounting standard in different countries which encompassed the restatement of a sample of SME financial statements in accordance with the IFRS for SMEs requirements (Pacter, 2009: 30). Based on the aforementioned and in order to assess the relevance of the IFRS for SMEs in the South African context the following hypothesis was formulated:

Ho₁: In order to adopt an accounting framework for the SME sector it should be possible to restate SME financial statements in accordance with the disclosure requirements.

The hypothesis was tested by comparing the illustrative financial statements of the IFRS of SMEs against information disclosed in the financial statements of SMEs in South Africa. This comparison might be an indication of the extent to which the IFRS of SMEs is applicable and acceptable to South African SMEs.

DATA AND METHODOLOGY

The research encompassed both a literature and empirical study. The literature review considered the susceptibility of accounting standards to the SME sector. Our literature review revealed that the IFRS for SMEs was introduced despite the fact that compliance with accounting standards is not necessarily a priority of the SME sector, nor following a full review of reality. Our empirical study was conducted to analyse the contents of a sample of financial statements compiled by South African SMEs and to compare the results to the IFRS for SMEs' illustrative financial statements and other relevant disclosure requirements. The research approach followed was a content analysis, which is a well-established research method used throughout the social sciences (ACCA, 2009: 18). Content analysis can be defined as a research technique for making replicable and valid inferences from text and related data (Krippendorff, 2004: 18). In addition, although content analysis does not exclude quantitative research, the emphasis is more towards qualitative research. The focus is also on transferability, instead of generalisations, which usually limits the size of the sample (White and Marsh, 2006: 36). Although Ball and Foster (1982: 167) found that many researchers, with accounting backgrounds, focussed on the development and adoption of IFRS by large industrialised countries, a number of researchers also considered the financial information included in the financial statements of entities, or the contents thereof.

Bowman (1984: 61) advocated that content analyses of financial statements represent a fine source of data of individual firms as well as for different industries. As far as the analysis of the contents of financial statements is concerned, Spathis (2002: 179) attempted to

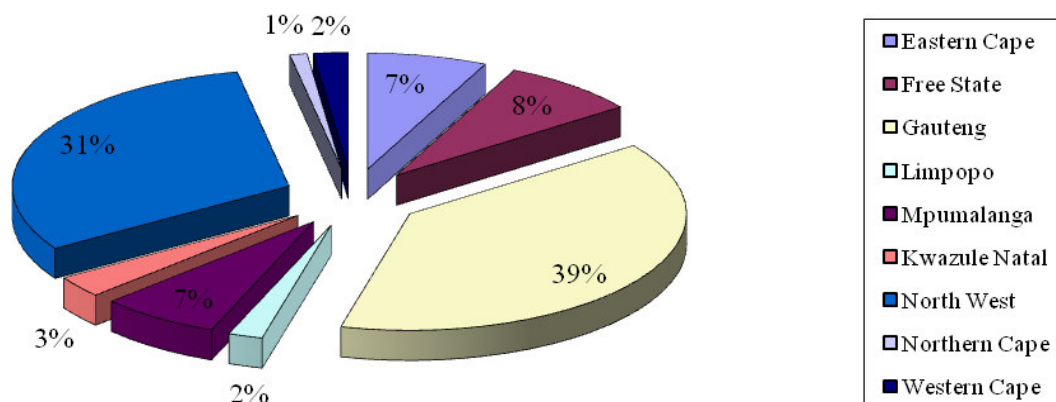


Figure 1. Classification of sample SME financial statements according to province.

develop a method to predict inaccurate financial statements from a sample of 76 Greek companies, Hernandez and Perez (2004: 126) evaluated the relevant usefulness of the various sections of the financial statements from a sample of 54 credit institutions in Spain whilst ACCA (2001: 17) constructed a disclosure index as a measure of the quality of disclosure practices for a sample of 57 UK firms. Christensen and Mohr (2003: 148) examined the financial statements of US museums and compared the results to a random sample of 50 for-profit annual reports. The contents of the IFRS for SMEs were also influenced by a number of field tests. The field tests in general encompassed compilation of financial statements in accordance with the IFRS for SMEs disclosure requirements. The IASB conducted a field test of 116 small entities from 20 different countries (Pacter, 2009: 30). ACCA (2008: 1) performed field tests of 25 companies in the UK. Their sample contained limited liability companies and one limited liability partnership ranging in sizes and sectors that are not publicly accountable. In Australia the IFRS for SMEs standard was field tested by two mid-tier medium-sized accounting firms, where each firm assessed the potential impact of the standard on the disclosure practices of three Australian entities. These entities included large proprietary companies, trusts and not-for-profit entities eligible to adopt the standard (CPA Australia and The Institute of Chartered Accountants in Australia, 2010: 12).

IFRS for SMEs in the South African context is intended for companies and other entities that are neither listed companies nor financial institutions (Heffes, 2009: 14). In contrast to the financial statements of listed companies the financial statements of SMEs were however not readily available. Where external users of SME financial statements are concerned research by Collis and Jarvis (2000: 12) suggested that tax authorities and banking institutions are the main external users of SME financial statements. Since entities in South Africa are no longer required to include financial statements when filing tax returns a sample of financial statements could not be obtained from the South African tax authority. Banking institutions could also not be considered due to contractual restrictions to share client information with third parties. Furthermore, from the perspective of SME owners the collection of financial statements might have been encumbered by issues of security and privacy considerations (Khosrow-Pour, 2006: 954). Despite these constraints a sample of financial statements from the SME sector was collected from business owners in South Africa. In an attempt to include independent data a group of fourth year accounting students assisted with the collection process. Since the IFRS for SMEs, in the South African context, is intended for entities other than listed entities and financial institutions (Heffes, 2009: 14) and owing to the fact that there is no central database available for the published financial statements of these entities, we were not

aiming to include SMEs from specific industries, sizes or any other relevant classification.

According to Figure 1 the sample size consisted of 100 financial statements from the SME sector. The reporting dates were the 2008 calendar years and the majority of the reporting dates ended on the last day of February. The majority of the financial statements was from Gauteng (39%) and North West (31%). A possible explanation for this is the fact that Gauteng is described as the business Mecca of South Africa. In addition to the fact that a large portion of South African businesses reside here, Gauteng is also a neighbouring province of North West where the majority of the students was based at the time of the sample.

Furthermore, as far as the business activities of the sample are concerned we noted that the majority of the sample financial statements was from the services and retail sectors in South Africa and only a limited number of entities from the mining, transport and agriculture sectors. Another two sets of financial statements from our sample did not provide any disclosure in connection with the nature or related business activities of the entity. The distribution of the sample according to business sectors is set out in Figure 2. The financial information of all the sampled financial statements was consolidated into a single statement of balance sheet and income statement after which we compared the data to the relevant sections of the IFRS for SMEs' illustrative financial statements. The financial statements included in the sample were compiled for the 2008 financial period. Due to the fact that this period was before the effective implementation of IAS1 – presentation of financial statements/statement of GAAP for SMEs the terms "balance sheet" and "income statement" will be used in this study instead of "statement of financial position" and "statement of comprehensive income". Moreover, all the financial statements included in the sample contained the terms "balance sheet" and "income statement".

In addition to the consolidated balance sheet and income statement our analysis also contained observations in connection with the statement of changes in equity, cash flow statements and notes to the sample financial statements. The consolidation incorporated firstly the balance sheets in Table 1. The distribution of the data in Table 1 implies a fairly high degree of variability in connection with the financial data included in the sample. This variance was also supported by coefficients of variances in excess of 100% for individual line items included in the consolidated balance sheet. The dispersion of the financial data relating to non-current assets and current assets included in Table 1 is summarised in Figure 3 (Y axis presented in South African Rand values). The dispersion of financial data relating to equity, non-current liabilities and current liabilities included in Table 1 is

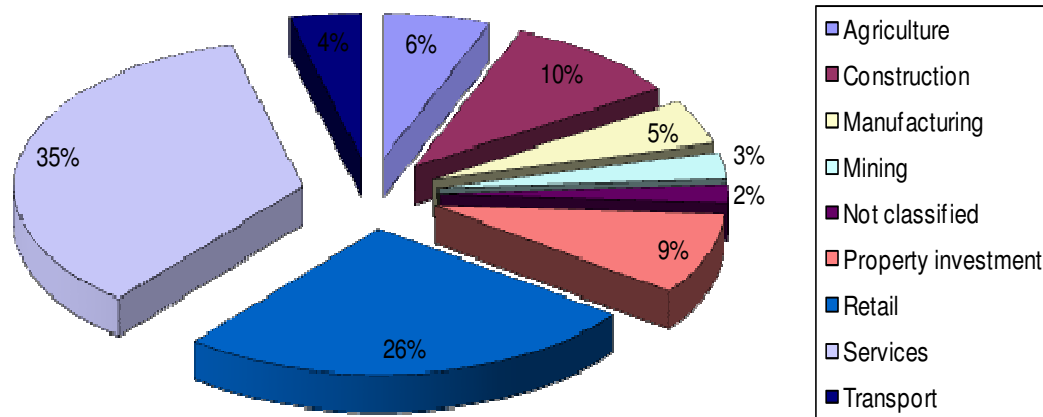


Figure 2. Distribution of sample across business sectors.

presented in Figure 4. Ninety eight percent of SMEs included statements of changes in equity, the only movement in equity for all the financial statements included in the sample however represented net profit or loss after taxation for the financial year and since this amount is included in the income statements it was decided not to consolidate the statements of changes in equity. We also decided to omit cash flow statements due to the fact that only 61% of the sample contained cash flow statements. The lack of cash flow information for certain entities might therefore distort any meaningful consolidation in this regard. In addition we analysed the notes to the sample financial statements in Table 3. The accounting policy notes are firstly presented in panel A.

Our analysis in panel A revealed that the sample financial statements contained accounting policy notes for 13 different line items in the financial statements. The number of items included in our sample is presented in the first column whereas the percentage of accounting policy notes in relation to the sections included in our sample is presented in the third column. The sections in the third column in excess of 100% (provisions, impairment of assets and foreign currency translation) implies that accounting policy notes might have been disclosed even though the relevant section was not included in the financial statements. Secondly our analysis in panel B provides a summary of additional information disclosed in the notes to the sample financial statements. These notes provide, in addition to accounting policy notes, supplementary information in connection with the balances and totals disclosed in the balance sheets and income statements. Our analysis revealed that the majority of the notes relate to the balance sheet and that a smaller number of information disclosed in the notes to the sample financial statements is applicable to the income statement. With regards to the consolidated balance sheet a number of different terms was used to describe the amounts disclosed in the sample financial statements, for example trade creditors, trade payables and accounts payable.

In addition to inconsistent descriptions several different formats were used for the income statements. Some income statements were classified by nature whilst others were classified by function. A number of entities included condensed income statements as opposed to detailed income statements. As a result it was not possible to include details of operating costs in the consolidation. Expenses were therefore classified into three different categories namely cost of sales, operating costs and finance costs. Furthermore, the three main categories in the consolidated income statement are income, expenditure and taxation. Finally our discussion covered the content and different formats of the financial statements included in our sample against the IFRS for SMEs' illustrative financial statements.

RESULTS

Consolidated balance sheet

Consolidated assets exceeded consolidated liabilities by R91 million (Table 1). Amounts disclosed as assets in the sample financial statements were between R50 for investments and R103.5 million for investment property. With reference to Figure 3 a total number of four SME financial statements contained non-current assets in excess of R20 million comprising investment property (R21.4 and R103.5 million) as well as property, plant and equipment (R43.4 million). Three of the financial statements selected contained current assets in excess of R20 million, including inventories (R26.9 million) as well as trade and other receivables (R36.9 and R46.2 million). In like manner only a few individual amounts from Figure 4 were in excess of R20 million, including long-term liabilities (R29.5, R93.3 and R63.4 million), retained earnings (R33.1, R20.8 and R48.8 million), accumulated loss (R91.8 million) as well as trade and other creditors (R28.1 million). Property, plant and equipment (87% of the sample), cash and cash equivalents (79% of the sample) as well as trade and other receivables (72% of the sample) were the main types of assets included in the financial statements. Investment property was included by only four entities ranging from R1.2 to R103.5 million with an average amount of R32.1 million per entity.

A limited number of financial statements contained goodwill (12%). Despite an accumulated loss of R91,8 million for an individual SME the consolidated retained income amounted to R64 million. Furthermore, 34% of the sample financial statements contained retained losses amounting to R135 million in total. Equity items were limited to share capital (99% of the sample), retained earnings (100%) and non-distributable reserves (11% of the sample). Liabilities were mainly long-term loans (94% of the sample) along with trade and other creditors (88% of the sample). With regards to current

Table 1. Consolidated balance sheet.

	Sum of totals (South African Rand)	Percentage of items included in sample (%)	Minimum amount disclosed	Maximum amount disclosed	Mean	Median	First quartile	Third quartile
Non-current assets	460,218,556							
Property, plant and equipment	180,648,079	87	4,426	43,358,437	2,076,415	586,172	101,617	1,840,981
Investment property	128,736,130	4	1,261,918	103,500,000	32,184,033	11,987,106	2,237,108	41,934,031
Goodwill	12,308,135	12	75,000	5,077,090	1,025,678	355,611	143,439	797,710
Investments	25,085,197	15	50	11,851,103	1,672,346	51,000	22,901	255,747
Loans receivable	108,364,582	46	1,242	26,689,215	2,355,752	396,856	114,426	1,941,377
Deferred taxation	5,076,433	14	4,240	1,849,907	362,602	53,309	15,103	474,089
Current assets	302,381,932							
Inventories	89,080,397	44	3,983	26,898,690	2,024,554	373,576	105,425	1,251,005
Trade and other receivables	167,943,035	72	375	46,248,417	2,332,542	233,693	40,581	1,504,839
Loans receivable	3,800,722	11	3,789	1,383,890	345,520	240,000	116,530	390,631
Current tax receivable	684,941	14	4,510	149,867	48,924	28,429	9,217	75,295
Cash and cash equivalents	40,872,836	79	145	9,095,130	517,378	35,867	6,785	280,072
	762,600,488							
Equity	91,286,610							
Share capital	8,130,598	99	2	7,500,000	82,127	100	100	250
Retained income	64,078,244	100	-91,796,790	48,821,142	640,782	138,921	-44,355	837,562
Non-distributable reserve	19,077,768	11	39,378	10,766,501	1,734,343	613,050	263,598	1,837,634
Non-current liabilities	410,777,210							
Long-term liabilities	381,709,145	94	506	93,289,204	4,060,736	952,388	447,557	2,274,136
Deferred taxation	29,068,065	10	17,009	14,923,198	2,906,807	355,751	72,750	3,170,149
Current liabilities	260,536,668							
Bank overdraft	54,110,374	36	3,363	14,233,203	1,503,066	121,760	30,638	905,223
Trade and other creditors	171,087,730	88	57	35,670,591	1,944,179	129,980	17,947	1,315,790
Provisions	14,415	1	14,415	14,415	14,415	14,415	14,415	14,415
Current tax payable	15,412,986	39	112	3,926,468	395,205	84,966	20,597	399,553
Deposits	1,033,927	2	33,927	1,000,000	516,964	516,964	275,445	758,482
Income received in advance	494,153	1	494,153	494,153	494,153	494,153	494,153	494,153
Short-term loans	18,383,083	21	17,154	8,776,993	875,385	328,678	80,206	678,822
	762,600,488							

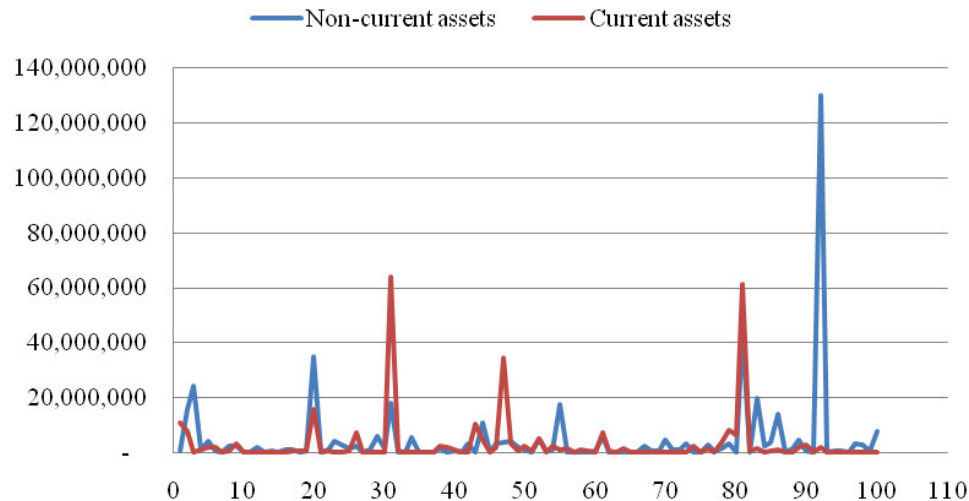


Figure 3. Analysis of assets included in sample.

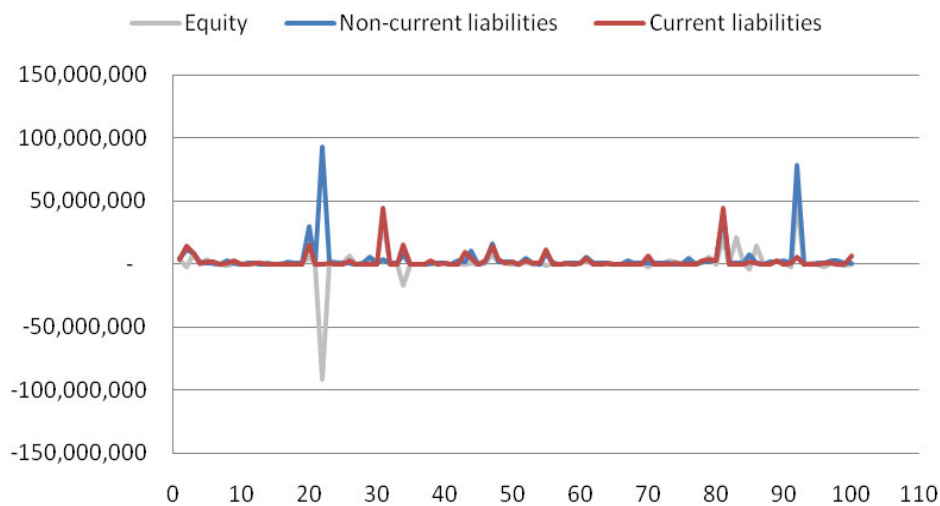


Figure 4. Analysis of equity and liabilities included in sample.

liabilities provisions (1% of the sample), deposits (2% of the sample) and income received in advance (1% of the sample) were not frequently disclosed items. With reference to Figure 4 and in addition to the aforementioned retained loss of R91,7 million a total number of five SMEs reported retained earnings under equity in excess of R20 million, A total number of four SMEs disclosed non-current liabilities in excess of R20 million while only two financial statements included in our sample contained current liabilities in excess of R20 million. As far as taxes are concerned many SMEs disclosed taxes receivable/payable separately from trade and other receivables/payables. Current tax receivable was encountered by 14% of the sample whilst 39% of SMEs disclosed current tax payable in their balance sheets. The combined total of 53% of our sample that disclosed current tax assets or liabilities as separate

items in the balance sheets could be significant if the assessed losses of many SMEs are also taken into account.

On the contrary, deferred taxation was not commonly disclosed as only 14% of the entities included deferred tax assets whilst deferred tax liabilities were included by 10% of the sample.

Consolidated income statement

The consolidated profit after tax amounted to R55 million and contained profits from 65 entities (65% of sample). The remaining 35% of the sample generated losses for the period under review ranging from R175 to R16,1 million. Profits included in the sample were between R1,708 and R25 million. Most SMEs included sales (83%

Table 2. Consolidated income statement.

	Sum of totals (South African rand)	Percentage of items included in sample (%)	Minimum amount disclosed	Maximum amount disclosed	Mean	Median	First quartile	Third quartile
Income	1,371,700,511							
Sales	1,296,629,746	83	16,400	230,729,801	15,622,045	2,420,683	810,415	12,396,190
Rental income	11,174,785	9	8,350	6,579,953	1,241,643	114,035	20,000	263,158
Investment income	7,927,844	52	1	4,417,117	152,459	6,200	161	69,241
Discount received	3,503	1	3,503	3,503	3,503	3,503	3,503	3,503
Other income	55,964,633	44	8	36,063,853	1,271,923	67,543	19,209	284,008
Expenditure	1,287,548,883							
Cost of sales	852,808,895	60	3,234	163,363,757	14,213,482	2,221,706	464,410	12,438,800
Operating cost	408,527,355	97	1,308	47,135,937	4,211,622	786,364	176,814	3,312,421
Finance charges	26,212,633	72	44	7,345,089	364,064	58,758	10,447	176,649
Profit before taxation	84,151,629							
Taxation	28,860,565	75	- 1,849,907	9,123,198	384,808	9,828	-	170,910
Profit for the period	55,291,064							

of the sample) as income and operating costs (97% of the sample) as expenses. A large number of SMEs incurred finance charges (72% of the sample) and income tax (75% of the sample) in the income statements (Table 2).

Notes to the consolidated financial statements

Even though the extent to which notes were included in the financial statements was summarised in Table 3, the detail from the notes to the sample financial statements was not consolidated as part of this study. Firstly, we noted that a relatively small number of SMEs disclosed accounting policy notes. In contrast to 31 different types of accounting policy notes for listed companies (Deloitte, 2009a; PricewaterhouseCoopers, 2009) the sample

contained only 13 different types of accounting policy notes. Without taking into account the amounts disclosed in the financial statements, a relatively small percentage of SMEs included accounting policy notes in their financial statements. Property, plant and equipment (71% of total sample) as well as revenue recognition (53% of total sample) were the only two types of accounting policy notes included by more than fifty percent of the sample. Accounting policy notes in connection with property, plant and equipment were limited to depreciation methods and periods and those applicable to revenue provided more information about revenue recognition criteria. If accounting policy notes are linked to items disclosed in the financial statements the following notes which provided additional information in connection with policies applied were in excess of 50%: Property, plant

and equipment (82% of the sample), investment property (75% of the sample), revenue recognition (64% of the sample), and provisions (800% or 8 accounting policy notes and 1 item disclosed as provisions in sample financial statements).

Secondly, notes other than accounting policy notes pertaining to non-current assets in the balance sheet were, except for goodwill (42%), included by the majority of the SMEs included in our sample. A significant number (>75%) of the SMEs included in our sample disclosed supplementary information for property, plant and equipment, investment property, investments, loans receivable, deferred taxation, long-term liabilities and short-term loans in the notes to the financial statements. Inventories (55%) and accounts receivable (56%) were the only two types of current assets in excess of fifty percent. A higher number of notes were also included for

Table 3A. Notes to the consolidated financial statements – Panel A.

	Number of items included in the consolidated financial statements	Number of items included in the notes to the consolidated financial statements	Items included in the notes as a percentage of items included in financial statements (%)
Accounting policy notes			
Property, plant and equipment	87	71	82
Investment property	4	3	75
Goodwill	12	2	17
Financial instruments	100	23	23
Inventories	44	26	59
Provisions	1	8	> 100
Impairment of assets	0	7	> 100
Revenue recognition	83	53	64
Borrowing cost	94	11	12
Employee benefits	97	1	1
Foreign currency translation	1	2	> 100
Leases	74	7	9
Taxation	75	36	48

non-current liabilities compared to current liabilities. Under current liabilities provisions (100% of the sample) and short-term loans (100% of the sample) were in excess of fifty percent. Additional information was also disclosed for share capital (70% of the sample) whilst no notes were included for non-distributable reserves (0%) under equity in the balance sheets.

Thirdly, we observed that a low percentage of SMEs disclosed notes to the income statement. The only significant income statement items for which additional information was disclosed in the notes thereto were revenue (29%) and taxation (60%).

Illustrative financial statements

When comparing our consolidated balance sheet with the IFRS for SMEs' illustrative financial

statements we noted that all the entities in our sample should include current assets/liabilities before non-current assets/liabilities. Although in a different sequence, the consolidated balance sheet could be converted into the format of the illustrative financial statements with relative ease. Investments, investment property and loans receivable were non-current assets included in our sample that are not included in the illustrative financial statements. Due to limited disclosure in this regard it was not possible to distinguish between investments in subsidiaries, investment in associates, financial assets, or any other relevant classification that may be needed in the financial statements. The majority of the long-term liabilities were classified as either loans from shareholders (60% of the sample contained loans from shareholders), loans from other related parties (40% of the sample) or instalment sale

agreements (31% of the sample). A small percentage (4% of the sample) of SMEs included finance lease obligations. Furthermore, R223,8 million or 59% of the total value of long-term liabilities in Table 1 represented unsecured loans from shareholders and related parties compared to 40% secured loans amounting to R153,5 million. Eight different loans, or 1% of the long-term liabilities in value terms, did not contain any disclosure as to whether loans are secured or not. It appears as if the conversion of the income statements from our sample to the format used in the illustrative financial statements would be more burdensome than the balance sheet. Our sample consisted of both detailed and condensed income statements. The comparison of the financial statements in our sample was also complicated by the inclusion of income statements classified by nature and by function. Limited guidance is given

Table 3B. Notes to the consolidated financial statements – Panel B.

	Number of items included in the consolidated financial statements	Number of items included in the notes to the consolidated financial statements	Items included in the notes as a percentage of items included in financial statements (%)
Notes - Consolidated balance sheet			
Non-current assets			
Property, plant and equipment	87	87	100
Investment property	4	3	75
Goodwill	12	5	42
Investments	15	12	80
Loans receivable	46	41	89
Deferred taxation	14	10	71
Current assets			
Inventories	44	24	55
Trade and other receivables	72	40	56
Loans receivable	11	2	18
Current tax receivable	14	0	0
Cash and cash equivalents	79	23	29
Equity and liabilities			
Share capital	99	69	70
Retained income	100	6	6
Non-distributable reserve	11	0	0
Non-current liabilities			
Long-term liabilities	94	84	89
Deferred taxation	10	10	100
Current liabilities			
Bank overdraft	36	11	31
Trade and other creditors	88	38	43
Provisions	1	1	100
Current tax payable	39	5	13
Deposits	2	0	0
Income received in advance	1	0	0
Short-term loans	21	21	100
Notes - Consolidated income statement			
Revenue	83	24	29
Cost of sales	60	5	8

Table 3b. Contd.

Depreciation	97	8	8
Accounting fees	97	3	3
Employee costs	97	4	4
Finance charges	72	18	25
Taxation	75	45	60

in connection with other income as well as the distinction between the different types of revenue. Moreover, none of the income statements in our sample classified operating costs as distribution costs, administrative expenses or other expenses. Instead, in addition to SMEs disclosing detailed income statements, a number of different classifications were used to group expenses together. Clear guidance in connection with the classification of operating costs is also not provided in the illustrative financial statements. In conclusion we noted that the majority of the SMEs included in our sample disclosed movements in retained earnings in the statement of changes in equity, as opposed to the income statement, and that these movements were limited to profits or losses pertaining to a financial year.

DISCUSSION AND CONCLUSION

Based on our literature review we found that the regulation of IFRS compliance is inconsistent between countries owing to inconsistent processes, practices as well as levels of authority and enforceability. Moreover, it appears that the monitoring of compliance with IFRS will be more acceptable to countries with politically and legally stable environments. In addition to differences in accounting regulation our literature review revealed key differences between SMEs and

listed companies. Owing to these differences a number of IFRS requirements are not necessarily applicable to the SME sector. Our sample confirmed the diverse nature of SMEs in South Africa. Retained earnings were between R92 million in deficit and R49 million in surplus with share capital ranging from R2 to R7,5 million. We observed that 34% of the entities reported accumulated losses. None of the entities however accounted for impairment losses or related expenses in connection with discontinued operations and activities. Furthermore, none of the SMEs disclosed any limitations to continue as a going concern.

The absence of these items might be indicative of the close relation between the SME management role and SME ownership. Under most circumstances SME managers and SME owners are inseparable. Due to the fact that SME owners have regular access to financial and related information we suggest that SME owners also have updated information about operational and financial challenges and in contrast to listed companies SME owners/shareholders do not have to wait until impairment losses, going concern problems and related items are communicated by management in the form of the financial statements. Our observation in connection with the close relation between SME owners and SME management is further supported by a significant number of shareholders' loans (60%) included under

non-current liabilities. Moreover, the majority of these loans were unsecured and interest-free with no fixed terms of repayment. The fact that SME owners are willing to finance the activities of SMEs by means of unsecured and interest-free loans provides even more evidence of the close interaction between the entity and its owners.

Our study revealed a further noteworthy difference between listed companies and SMEs. Unlike listed companies that often generate substantial funding through the listing process it appears that SMEs do not issue share capital for purposes of raising funds. The share capital of the majority of the SMEs (89%) amounted to R1,000 or less. Compared to an average amount of R4 million disclosed for long-term liabilities, the results suggest that activities are mainly financed by means of raising debt as opposed to share capital Figure 5. Further support for this observation was found in the statement of changes in equity. The only changes in equity represented accounting profits or losses for the year. The absence of dividends paid suggests that investors do not invest share capital in SMEs on which they expect a return in the form of dividends. In addition to internally generated loans from shareholders and related parties our study revealed that the majority of external loans comprised instalment sale agreements (31%) secured by underlying assets. The fact that the main type of external finance was obtained through instalment sale agreements might be

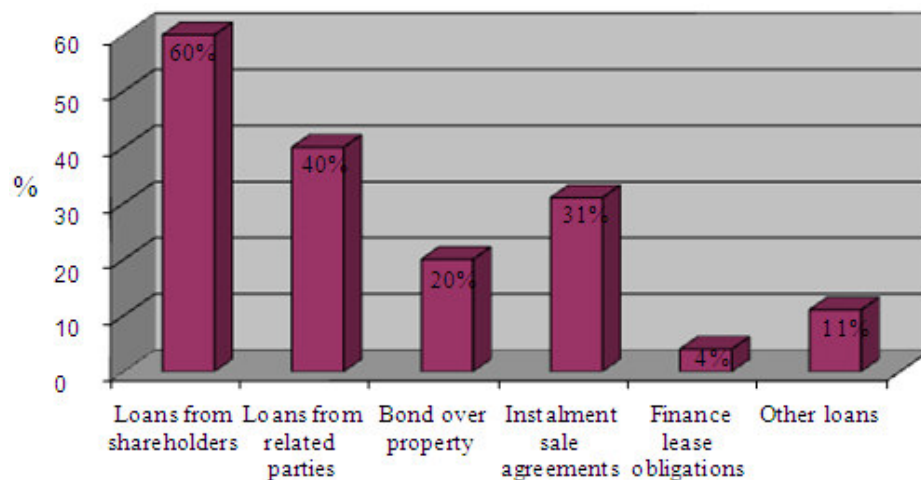


Figure 5. Analysis of long-term liabilities included in sample.

indicative of the fact that providers of finance to the SME sector are mainly concerned with the condition of the underlying assets as opposed to proper disclosure of other items included in the financial statements.

The relevant importance of non-current and other related assets was further emphasised by the fact that the majority of the sample financial statements contained property, plant and equipment (87% of the sample). Evidence that SME financial statements were compiled to address the information needs of tax authorities could be found in the fact that income taxes receivable and income taxes payable were disclosed separately from trade and other receivables/payables. A large number of SMEs also disclosed income taxes (75% of the sample) in the income statement. A small percentage of SMEs however disclosed deferred tax. Our study therefore provided evidence in connection with disclosure practices to address the needs of the two main types of external users of SME financial statements, as identified by Collis and Jarvis (2000: 12). Our research suggests that fair value accounting is not popular amongst South African SMEs. A small percentage of SMEs reported revaluations. Non-distributable reserves were disclosed by 11% of the sample whilst none of the entities disclosed additional information in connection with non-distributable reserves in the notes to the financial statements. Moreover, we observed that the majority of financial assets, for example investments are carried at cost. Despite the fact that a number of entities included rental income in the income statements, only a small percentage of SMEs classified property as investment property (4% of the sample). The practise of separating investment property from other types of property could therefore not be verified for the SME financial statements included in our sample. Even though 15% of our sample contained investments, none of the entities compiled consolidated financial statements. Due to limited

disclosure in this regard we were also not able to ascertain whether these SMEs are required to prepare consolidated financial statements. In the absence of consolidated financial statements the inclusion of goodwill by 12% of our sample appears to be abnormal. Our analysis in Table 3 also revealed that limited disclosure was provided in connection with goodwill.

A limited amount of information was also disclosed in the notes to the financial statements. Less than 50% of the different types of accounting policy notes pertaining to listed companies was included in the sample. It also appeared that the notes provided a mere summary of balances and totals disclosed in the balance sheet or income statement, with very limited qualitative disclosure. Only 61% of the sample financial statements contained cash flow statements whereas disclosure in the statements of changes in equity was limited to profits or losses. In view of the fact that the illustrative financial statements include movements in accumulated profits or losses on the face of the income statement, the relevance of the statement of changes in equity in the South African context might not be certain. Finally our study revealed that the IFRS for SMEs' illustrative financial statements could be adopted without much difficulty. We found that all the main categories from the sample balance sheets and income statements were covered by the illustrative financial statements. Based on the results the hypothesis cannot be rejected. It is therefore suggested that the IFRS for SMEs could become the preferred accounting framework for SMEs in South Africa.

LIMITATIONS AND FUTURE RESEARCH RECOMMENDATIONS

Owing to the fact that our sample contained a sample of

100 SME financial statements the results might not be representative of all SMEs and other South African entities planning to adopt the IFRS for SMEs. The sample size could however favourably be compared to similar studies and more specifically the field tests conducted by the IASB.

Another limitation could be the fact that we did not involve practitioners and preparers of these financial statements. Our analysis was limited to the information disclosed in the financial statements. Due to these limitations we recommend that future research should involve the classification of entities required to adopt and apply IFRS for SMEs into different groups and sectors as well as the analysis of financial statements prepared in accordance with the IFRS for SMEs. We also recommend that the views of preparers and users of these financial statements are considered when analysing SME financial statements prepared in accordance with the IFRS for SMEs.

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