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## **Practitioner Views on Financial Reporting for Smaller Entities**

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This paper has four purposes. First, to establish the policy background leading to a special financial reporting standard for small firms (FRSSE), aimed at reducing compliance costs. An indirect policy implication of this was that small firms would be stimulated, for example, in terms of start-up rate, performance (including survival rate, and profitability, and growth), and contribution to employment and innovation within the economy. Second, to consider the implications for FRSSE itself on compliance costs, and to ask what forms they may take. Third, to analyse new evidence on adopters and non-adopters of the FRSSE. Fourth, to cast this new evidence into a cost effectiveness framework, to judge whether adopters who engage in upgrading of skills to implement the FRSSE had attained a net benefit as compared to non-adopters. The conclusion, based on this preliminary evidence, is that upgrading of skills to implement the FRSSE has indeed led to a significant net benefit.

**JEL Classification:** G32, M13, M41

**Key Words:** Small firms, financial reporting, compliance costs, cost-effectiveness

## **Practitioner Views on Financial Reporting for Smaller Entities**

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### **1. Introduction**

Small firms have been an important focus of policy since the end of World War II. The concerns of policy makers have been manifold. Innovation, employment, entrepreneurship, flexibility and diversity have been amongst the most prominent (Acs and Audretsch, 1993; Chaston et al 1999; Industry Department for Scotland, 1989; Reid, 1999). A common theme in policy debate is that small firms face unnecessarily high compliance costs, and that the benefits of a vibrant small firms sector will be reduced or lost if these costs are not limited. Excess 'red tape' has been stylised as a significant problem, especially by the small firms lobby (e.g. the Federation of Small Business and the Forum of Private Business). A turning point (e.g. Jarvis et al, 1996) in this extended debate, as it relates to the theme of this paper, is that financial reporting has been identified as a possible source of excessive compliance costs.

The purposes of this paper are as follows: first, to trace the emergence of this concern for simplifying financial reporting, right through from its genesis to the emergence (and revision) of a new financial reporting standard for small firms (FRSSE). Second, to create an instrument for measuring the efficacy and usefulness of FRSSE. And third, to construct and test appropriate hypotheses for evaluating the relative costs and benefits of FRSSE.

The paper is in two parts. The first (Section 2) develops the relevant institutional background, and the second (Sections 3 and 4) engages in statistical analysis.

## **2. Background**

For some years now there has been concern expressed in the literature that small to medium sized enterprises (SMEs) differ, qualitatively, as well as quantitatively, from their larger counterparts (Welsh and White, 1981). Financial reporting has been slow to catch on to this, with only a handful of academic articles addressing the ‘Big GAAP<sup>1</sup>, little GAAP’ debate (Moss, 1989; Lippitt and Oliver, 1983; Campbell, 1984). Country specific studies (McMahon, 1999, 2001; McMahon et al, 1994; Friedlob et al, 1992; Patrone and du Bois, 1981) have raised the issue of using financial reports to assist in financial management, but it is only recently that researchers have begun to realise that much is still unknown, and needs to be discussed, explained and debated on the issue of financial reporting in UK SMEs. This first part of the paper examines, in order: reducing the burden on small firms; the birth of FRSSE; the emergence of the Committee on Accounting for Small Entities (CASE); commentators on the new standard; and the efficacy and usefulness of FRSSE.

### *Reducing the Burden on Small Firms*

The idea that small companies need only provide abbreviated financial information first received serious consideration by a working party of the consultative Committee of Accounting Bodies (CCAB), set up in July 1993 at the request of the Accounting Standards Board (ASB). The aim was to reduce the administrative burden on such enterprises by providing exemption from a number of accounting standards, and

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<sup>1</sup> GAAP - Generally Accepted Accounting Principles.

thereby reducing the reporting requirements. The working party produced, in 1994, a consultative document entitled 'Exemptions from Standards on the Grounds of Size or Public Interest', which received a mixed review, with the majority of respondents agreeing that the arrangements in place at the time (viz. that accounting standards and Urgent Issue Task Force (UITF) abstracts applied to nearly all businesses) were unhelpful and troublesome (Sheridan, 1997).

The consultative document proposed that small companies should not be required to comply in full with all accounting standards. Further, it was predicated on an assumption that the majority of small firms would be exempt from accounting standards. The criteria by which a small firm should be deemed exempt from accounting standards and UITF abstracts were to be size related, following Companies Act definitions. Finally, small companies should continue to comply with a number of UK Standards.

It is known (Sheridan, 1997) that most (73%) who commented on the draft agreed with the size criteria, although a sizeable proportion (16%) preferred the audit exemption threshold, and a further 11%, the medium-sized company threshold. The debate over which companies should qualify for exemptions continues today, and the size-related definitions remain unsatisfactory to many.

The main issues arising were as follows (CCAB, 1996):

1. Costs of preparing information in compliance with existing accounting standards outweighed potential benefits to be gained through improved financial reporting.

2. Providing exemptions for some small companies would not solve all of the problems of attaining positive net benefit.
3. Existing accounting standards themselves needed revising and updating.
4. Reassurance and guidance were required as to whether compliant small companies' financial statements would still provide a 'true and fair view'.

In 1995 the DTI postponed changing the financial definitions of a small company, while it awaited the results of the CCAB working party. In response to feedback on the initial document, a second paper was issued, entitled 'Designed to Fit: a Financial Reporting Standard for Smaller Entities'. And thus, in December 1995, the FRSSE was born.

#### *The Birth of FRSSE*

The draft FRSSE was discussed widely in the press and professional journals. Most respondents to the consultation exercise were in favour of a dedicated standard for smaller entities (Accountancy, 1996). With this in mind, the ASB issued an exposure draft of the FRSSE (Financial Management, 1997a; Accountancy Ireland, 1997), inviting comments.

Two main differences were evident between the CCAB proposals and the new ASB exposure draft. First, early commentators on 'Designed to Fit' had expressed reservations about requiring small firms to disclose related party transactions (e.g. common control from the same source); and second, 'Designed to Fit' had suggested the requirement for a cash flow statement, which the new Exposure Draft did not. The ASB argued for inclusion of the former, as it believed that "related party

transactions are often more prominent in, and material to, smaller entities than in larger entities” (Financial Management, 1997a, p.5). On the latter, the ASB were not convinced by comments submitted to the CCAB’s Working Party, and had excluded cash flow statements; but they still believed that a case could be made for their inclusion, and so invited comments to this effect.

At this stage, the ASB also raised the idea of a permanent advisory committee to review continually the FRSSE. As Sir David Tweedie said (Accountancy Ireland 1997, p.37), “The Board hopes that the proposed FRSSE will be of real assistance to those concerned with preparing the accounts of our very many small companies... [but] ... there are still a number of questions to be answered”.

One practitioner (Jackson, 1997) observed that the ASB had missed out on an opportunity to ease the burden on small firms once and for all. Because of their size, small firms tended to be less complex. Therefore they would have few tricky issues to address, and the many standards issued would have little impact on them. Next, it appeared that many of the standards that would not apply to firms eligible to adopt the FRSSE would only, in any case, apply to large companies. Further, the majority of small firms who were required (e.g. for audit purposes) to produce financial statements, employed financial or accounting professionals, and this would be unlikely to change. New companies wishing to adopt the FRSSE would also be required to comply with full accounting standards for the first two years; and an increase in professional fees might be expected, when it came to re-casting the company’s accounts to comply with the FRSSE. Finally, the criteria for FRSSE compliance might be better based on “the composition of the entities’ membership

and management, rather than size” (Jackson, 1997, p.75). There is a need for research to address the points raised above, in order to explore whether the concerns voiced in forums described above have any substance in practice.

### *The Emergence of CASE*

By September 1997 the ASB had announced the establishment of the specialist smaller entities committee (Financial Management, 1997b), CASE (the Committee on Accounting for Smaller Entities). Its aim was to advise the ASB on matters relating to small businesses, and to recommend any necessary changes to the FRSSE. Its members were to provide a suitable mix of technical specialists with small business practitioners and it met first in September 1997, under the chairmanship of Professor Geoffrey Whittington (Sheridan, 1997).

In November 1997 the FRSSE was published (Financial Management, 1997c). For small companies adopting the FRSSE, only those related party transactions deemed to be material in relation to the *reporting entity* needed be disclosed. Thus small companies were exempt from the stricter reporting requirements of *FRS8 Related Party Disclosures*, where a related party might be an *individual*, for whom the transaction was material. Second, the FRSSE did not require a cash flow statement. Instead, it included a ‘voluntary disclosures’ section, recommending, but not requiring, the provision of a simplified cash flow statement (Financial Management, 1997c).

CASE was charged with annually updating and revising the new standard, following public consultation. Early responses to the published FRSSE were encouraging, if a



little guarded. With around 90% of all registered companies falling within the scope of the FRSSE, the impact of the new standard could be potentially far reaching; though “its effectiveness in practice will need to be monitored and responded to appropriately, in due course” (King, 1997, p.70). Accountants dealing with small owner-managed companies called it “OK, but not perfect” (Accountancy, 1997, p.17). A main concern was that the FRSSE did not fully exempt smaller entities from the burdensome disclosures required by *FRS8: Related Parties Disclosures*; a criticism which was countered by the ASB’s statement that “the Board decided to keep the basic requirements of FRS8 in the FRSSE because almost all small companies’ business is with related parties” (Accountancy, 1997, p.17).

#### *Commentary on the New Standard*

Murphy and Page (1998) provide an interesting commentary on the new standard. Rather than reducing the burdens on accountants, they feel that “practitioners with even one medium-sized or large client will now need to keep up with two sets of standards, not one” (Murphy and Page, 1998, p.64). The ASB, they suggest, has failed to recognise that small companies are not simply scaled-down versions of larger companies (Welsh and White, 1981), and they put the case for a set of Small Entity Generally Accepted Accounting Principles (SEGAAP). These, they propose, should “be flexible enough to cover all small entities; be communicated in a way their stakeholders understand; reflect the long-term nature of small entity owners’ investment; cover companies and unincorporated entities; and take into consideration small entities’ weak bargaining position in forming contracts” (Murphy and Page 1998, p.64). More specifically, they recommend discarding the balance sheet

requirement for many small businesses; including a new set of clauses on accounting for VAT; and addressing measurement and reporting requirements more carefully.

While Murphy and Page (1998) argue that the FRSSE was not radical enough, others see it as a breakthrough, a necessary prerequisite to further improvements. Lennon (1998, p.44) for example, argues that “the principle of a little GAAP has been achieved [and] more profound changes may be permitted in future”. If anything, Murphy and Page’s proposals for SEGAAP serve mainly to muddy the waters; however, they do highlight the need for more detailed research into what small companies themselves require.

In 1998 the ASB issued an exposure draft of amendment to the FRSSE ([Financial Management, 1998; Accountancy, 1998), to incorporate changes in financial standards that had come about since publication of the FRSSEE. The first revision to the FRSSE was published in December 1998 and was effective from March 1999 (Accountancy, 1999). While broadly similar to the original, it did contain modifications relating to: intangible assets and goodwill; year 2000 costs; and the costs involved in introducing the euro (King, 1999, p.72).

By September 1999, a further exposure draft had been issued, containing additional proposed changes to the FRSSE. The newly revised FRSSE contained revisions primarily to incorporate *FRS12 Provisions, Contingent Liabilities and Contingent Assets*, and *FRS 15 Tangible Fixed Assets*, and reflected responses from commentators on the exposure draft issued earlier (Financial Management, 2000).

*Efficacy and Usefulness of FRSSE*

A report on one of the few early studies of FRSSE implementation was published by McAleese (2001). The study was aimed at determining the views of accounting practitioners in both the North and South of Ireland as to the efficacy and usefulness of the FRSSE in preparing and auditing the financial statements of smaller entities. Primarily, the aims of the study were:

“to ascertain the views of Irish accountancy practitioners on the burdens of small company financial reporting;  
to determine the level or use of the FRSSE and the benefits and drawbacks associated with its application; [and]  
to assess current opinions on the future direction of small company reporting”

(McAleese, 2001, p.18).

In fact, it was found that accounting firms were still struggling to keep up-to-date with the plethora of new accounting standards. Furthermore, practitioners were not convinced of the effectiveness of the information being provided for users of small company accounts. The use of the FRSSE was, perhaps surprisingly, not prevalent. 44% of respondents in this study used the FRSSE to prepare accounts for their smaller clients, mainly to take advantage of the reduced disclosure requirements.

Perhaps more interesting are the reasons given for non-adoption of the FRSSE. In general, the perception appeared to be that the FRSSE is simply another standard to be learned, and applied, as appropriate. In many cases, accounting firms had a

computer system set in place to generate financial accounts for their clients. Why, then, they argued, should they spend time and effort in converting to the FRSSE, when the standard “provided no significant benefit to the firm”? (McAleese, 2001, p.19).

Some useful suggestions were made by non-users, which they thought might encourage greater acceptance of the FRSSE. These included, first, the provision of practical courses, aimed at educating potential users of the standard as to how and why they might wish to adopt it. And second, practitioners thought that the standard could be further simplified and reduced, with a special emphasis being placed on the financial reporting requirements for owner-managers. However, we note that Sleight-Johnson would disagree, as “small company accounts produced in accordance with [accounting] standards can be incomprehensible to many users, often the owner-managers themselves seeking to understand and confirm how their business has performed during the financial year. Accounts prepared in accordance with the FRSSE can provide information that is more meaningful and understandable to such users” (Sleight-Johnson, 2001, p.92).

In January 2002 the fourth version of the FRSSE was produced, (Financial Management, 2002), and a related exposure draft was issued in July 2002, requesting comments on an amendment to FRS 17 (retirement benefits) and its consequential impact on the FRSSE (Accountancy, 2002).

In 2002 the Institute of Chartered Accountants of Scotland (ICAS) produced a report on the extent to which the FRSSE had been adopted (ICAS, 2002). They found,

similarly to the Irish study, that 49% had chosen to adopt the standard, which was an increase of 6% on an earlier (2000) study. However, these results were based on a survey of Scottish, English and Welsh companies; whereas the previous study had only inquired into (and questioned) Scottish companies. No geographical breakdown is given and, in general, the summary results presented tell us little more than that the FRSSE, where applied, provided few savings, in terms of time or effort spent on meeting the required disclosures protocol. It is on such methodology that we aim to improve in this paper.

More recently the accounting press has raised the issue of an international FRSSE (Accountancy, 2001). From 2005 all EU linked companies have started to produce accounts in accordance with International Accounting Standards. This has encouraged accounting firms and professional bodies to suggest that SMEs require an International Accounting Standard. This, they have argued, should not be too dissimilar to the UK's FRSSE, but should at least take the perspective of International Accounting Standards as its starting-point. At the same time, pressure from the small firms lobby, especially in less advanced economies, has been mounting for the development of "a simplified stand-alone international standard" (Sleigh-Johnson, 2001, p.92). In this context the UK FRSSE is seen as a credible model on which to construct an international standard.

To conclude this first part of the paper, we have explored the initial impetus for the FRSSE in the desire to reduce compliance costs on small firms. We have then traced its subsequent development through a variety of institutional innovations, including the UITF, CCAB and CASE. We concluded by balancing the views of a number of

commentators on the emerging new standards, including those who espoused using a cost-benefit or cost-effectiveness methodology for evaluating the efficacy and usefulness of FRSSE.

Concerning the latter, we endorse this recommended approach of the commentators, but note they have not adopted a clearly defined technique for calibrating terms like ‘cost-effectiveness’, for example. The next part of the paper is empirical and analytical. The empirical part (Section 3) shows how a new instrument was created, through two-stage piloting, for measuring attitudes to the FRSSE and related issues. It explains instrument design (a postal questionnaire), sampling, and the issues explored. The analytical part (Section 4) proposes a technique for calibrating the cost-effectiveness ratio from attitudinal data. It then states, and statistically tests, two hypotheses on the cost-effectiveness of the FRSSE.

### **3. Data and Methodology**

The discussion in Section 2 above gives rise to a number of questions, which we aim to address, in order to determine whether FRSSE is good, or a bad, in a cost-effectiveness sense. With funding from the Economic and Social Research Council (ESRC), we are investigating whether the FRSSE is a ‘help or a hindrance’. Our approach is statistical. We first undertook preliminary unstructured fieldwork which involved meetings with a number of key ‘gatekeepers’, or experts in the area. These included members of the International Accounting Standards Board (IASB) in London, and a Professor of financial Accounting at Cambridge University. In addition, we spoke to the Director of a small business incubator unit at the Cambridge

Science Park, who was willing to act as a facilitator in contacting the small business community.

The main issues we wished to explore in the fieldwork (laying the foundation for subsequent instrumentation) may be grouped under the following headings.

#### *Use of the FRSSE*

What are the key characteristics which distinguish those firms who have adopted the FRSSE, compared to those who have not e.g. by size, sector, geographical location, qualifications of accounting personnel (McAleese, 2001; ICAS, 2002)? With what aspects of the FRSSE do they find it easiest to comply? When did/will they adopt the FRSSE, and why? If they do not use it, why not? Is the accounting function located in-house, or is it contracted out? What would encourage adoption of the FRSSE (e.g. provision of practical courses, education, or further simplification)? Has its use increased professional/ accounting fees?

#### *Costs of the FRSSE*

Has adoption of the FRSSE increased the burden on the small firm [CCAB, 1996; Jackson (1997)]? For example, does it now take more time to prepare financial reports? Have training costs increased? Does it complicate reporting? Do practitioners now feel the need to keep up with two sets of standards?

#### *Effectiveness of the FRSSE*

Has adoption of the FRSSE eased the burden on the small firm (Lennon, 1998)? If so, in what way (e.g. by saving time and effort, including cost savings)? Does it help in

financial management (King, 1997; Sleigh-Johnson, 2001)? Does the company use the information generated by the FRSSE to perform financial ratio analysis on historical accounts (Patrone and du Bois, 1981)? What form does this take? Does increased performance encourage adoption of the FRSSE? Or does the FRSSE assist in financial management and, therefore, in performance?

#### *Structure of the FRSSE*

What do users and non-users think about the current format/structure of the FRSSE (Murphy and Page, 1998)? In particular, are they happy with the size-related definitions by which firms qualify for exemptions (Jackson, 1997)? Are these sufficient, or are there better criteria for inclusion? To what extent do small companies make related-party transactions, and should these be exempt from reporting? Should a cashflow statement be required? Should the interests of small companies be better represented on CASE and, if so, by whom?

#### *Internationalisation*

To what extent do small firms have overseas transactions? Would an international standard be useful (Sleigh-Johnson, 2001)? What should it contain? Who would consider adopting an international FRSSE? These issues having been explored, an instrument of enquiry was derived, based on fieldwork evidence, and our exploration of the extant literature. Our instrument of choice was the postal questionnaire.



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**Table 1: Postal Questionnaire Agenda**

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1. Workforce, practice, unit, sector

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2. Qualifications, skills

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3. Perceived costs of implementing new procedures and processes (including FRSSE)

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4. Perceived benefits of introducing new procedures and processes (including FRSSE)

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5. Urgency of changes in procedures

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6. Advantages of internationalising procedures

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Our postal questionnaire design was short and concise (See Table 1). First, it asked some general information (e.g. about sector, size, nature of business). It then asked about accounting skills and training, and sought to gauge opinions about costs, benefits and changes to financial accounting for smaller entities. The postal questionnaire was sent to an initial pilot sample of 200 practitioners. It was slightly modified in form, in the light of the pilot (see below), following which it was distributed widely to nearly 9000 members of the ICAEW,. They were working in business, in practice, in public and private sector institutions and/or in charities. The perceptions of respondents (cf. items 3 and 4 of Table 1) were part of the large body of information provided by the questionnaire returns. A detailed database of this evidence is currently being constructed. Initial results from representative replies, excluding outliers (one deviant observation), from 50 of our 800 or so respondents,

are presented and analysed below. The genesis of this approach, from trial pilot, to full pilot and then to full mailing of the questionnaire, will now be explored.

### *Pilot 1*

Our initial pilot study was developed by taking the research questions identified above as the starting point. It was a relatively long and detailed questionnaire, which covered all of our key topics in some detail. Our sampling frame of 100 was taken from the Financial Analysis Made Easy (FAME) database. We selected on the basis of those firms which satisfied the Companies Act criterion of small (turnover  $\leq$ £28m, balance sheet  $\leq$ £1.4m, employees  $\leq$ 50). The identified named contact was either the Director of Finance, or another senior member of the company's board.

Feedback from this early pilot was disappointing, with a low response rate. This was put down to several factors. First, the timing of the pilot may not have been ideal, as it was distributed in the run up to Christmas. Second, the length of the questionnaire may have put off potential respondents. Third, there could well be some ignorance about the FRSSE amongst our sample. And finally, even though we selected the sample according to FRSSE criteria, there were some companies amongst the sample who still did not feel that it was relevant to them. The good news from the pilot was that it appeared to work (for those who completed it). Further, its format suggested the basis of a semi-structured questionnaire to be used in later, more detailed face-to-face interviews.

The whole point of piloting is to determine the drawbacks of the methodology and to take steps to correct them. From our experience, it was apparent that a radical rethink

was in order. Not only did the questionnaire require a complete redraft, but it was also clear that we needed to expand the sample size, and needed to re-evaluate the suitability of the population and sampling frame for allowing us to pursue our research goals.

### *Pilot 2*

Our study proceeded with a second pilot, which was mandatory, given the nature of our redesign of the project. First, we sought a new sampling frame. For this, we approached the Institute of Chartered Accountants in England and Wales (ICAEW), who hold a database of all of their members. This can be searched on a number of criteria, according to needs. We decided to request a sample of members in business, in practice, working in the public sector and in charities. These were to come primarily from the UK (about 8000), but also with a substantial component from overseas (about 700). This, we were sure, would provide a large enough sample for insightful statistical analysis.

In terms of the questionnaire design, we decided to make it short and concise, addressing a number of key themes, embedded within a general questionnaire about financial reporting. The aim was to avoid respondent bias arising from hinting that we were only interested specifically in the FRSEE. We therefore included other attitudinal questions addressing different aspects of financial reporting. This, we hoped, would help to increase our response rate. Our reasoning was that everyone is likely to have an opinion about small businesses and their financial reporting, even if it is not directly relevant to their current role. It would also give us a control group, when it came to analysis of the results.

The revised questionnaire (see Table 1) asked some general background information (e.g. about sector, size, nature of business). It then asked about accounting skill and training. Finally, it asked about the costs, benefits, requirements for change and potential usefulness of an international dimension to: the valuation of goodwill; taxation incidence; financial reporting for small entities; corporate governance procedures; information disclosure; risk reporting; conclusion of contracts; and the valuation of intellectual property. This new questionnaire was sent to a pilot sample of 200 from the ICAEW database, and subsequently to the whole sample. The results below are based on a preliminary investigation of 50 responses.

In terms of methodology, what we aimed to do was to construct an index of net benefit/ net cost, using the attitudinal data we received from the postal questionnaire returns (see 3 and 4 of Table 1 above). The relevant questions asked were as follows:

7. What are your perceived costs of implementing the following? [please circle]

....

8. What are your perceived benefits of introducing the following? [please circle]

....

In each case, one of the items to be evaluated was:

*Financial reporting for small entities*

Answers to both Questions 7 and 8 on perceived costs and benefits were returned using the following five point scale:

*Extreme* | *High* | *Medium* | *Low* | *Zero*

This qualitative scale of perceived costs/ benefits was converted into a quantitative scale by mapping from the categories *Extreme* | *High* | ... | *Zero* into the integers 4, 3, 2, 1, 0, respectively.

Let us call the response to the cost question (expressed as an integer)  $I_C^i$  for the  $i$ 'th respondent. Similarly, the response for the perceived benefits is the integer  $I_B^i$ . Then, from the standpoint of that individual the ratio  $I_B^i / I_C^i$  ( $I = 1, 2, \dots n$ ) where  $n$  is the sample size, is the proposed measure of efficacy, it being a benefit/cost ratio. With this way of calibrating efficacy we lay the basis for our statistical work.

Our basic hypotheses are twofold.

#### *Hypothesis 1*

Adopters of FRSSE should show greater benefit/ cost ratios than do non-adopters:

$$(I_B / I_C)_A > (I_B / I_C)_{NA}$$

(where the subscripts A and NA denote 'adopter' and 'non-adopter')

This is based on the argument that both adopters and non-adopters are rational, and driven by efficiency considerations. Thus 'adopters' reveal their preferences by their actions, and therefore should enjoy higher benefit/cost ratios than rational non-adopters. This does involve, as in so much benefit/cost analysis, inter-personal comparisons of preference across adopters and non-adopters. The advantage of the

approach adopted, which looks at net benefit in ratio (viz. benefit ÷ cost), rather than difference (viz. benefit – cost), form is that ratios thus calculated ‘wash out’ scale differences across respondents. That is, what counts is not the absolute ranking of benefits and costs, but heir relative ranking, for any given respondent.

### *Hypothesis 2*

Adopters of FRSSE should, on average, show a greater benefit than cost and non-adopters should, on balance, show a greater cost than benefit. Formally

$$(I_B / I_C)_A > 1$$

$$(I_B / I_C)_{NA} \leq 1$$

which conveniently sets a boundary value of unity, separating adopters from non-adopters.

Hypothesis 2 sets a higher hurdle than does Hypothesis 1. Not only is one asking that adopters should be better off, in terms of benefit/cost, than non-adopters; one is setting a kind of ‘breakeven’ ( $I_B = I_C$ ) at the margin of adopters/non-adopters. The hypotheses have been put in ratio, rather than different form for two reasons. First, this is consistent with modern measurement methods in cost/ effectiveness analysis, and provides a useful benchmarking value for the benefit/ cost ratio of unity. Second, it seems to us more plausible to use the benefit/ cost ratio rather than benefit-cost difference when using attitude measurement scores. Specifically, it normalizes any specific respondent’s choice, thus washing out effects like individuals tending to score responses in an extreme way. We are not interested in how extreme (or moderate) an individual respondent is, but rather in what the *relative* attitude is to costs and benefits of adoption (or otherwise) of the FRSSE.

The next section considers some general results, overall, and then split by adopters and non-adopters of FRSSE. It then goes on to confront Hypotheses 1 and 2 with our preliminary body of data.

#### 4. Findings

Just over half (53%) of our respondents had undergone some training in the area of financial reporting for smaller entities. We have therefore divided our results amongst those respondents who had upgraded their skills in this area (and classed those ‘FRSSE adopters’), and those who had not (‘non adopters’). Key characteristics are contained in Table 2. First, FRSSE adopters are slightly more likely to be working in practice (18%), compared to non-adopters (15%). Most of both adopters (68%) and non-adopters (56%) worked in business. The remainder of our FRSSE adopters (14%) worked for charities. However, 15% of non-adopters also worked for charities, and a further 19% of non-adopters worked in the public sector. Just under one third (30%) of FRSSE adopters worked primarily in the manufacturing sector, compared to 12% of non-adopters.

**Table 2: Descriptive information on FRSSE adopters versus non-adopters**

	<u>Adopters</u>	<u>Non-Adopters</u>
<i>In Practice</i>	18%	15%
<i>In Business</i>	68%	56%
<i>Charity</i>	14%	15%
<i>Public Sector</i>	0%	19%
<i>Manufacturing</i>	30%	12%
<i>Services</i>	70%	88%
<i>Headcount</i>	114	370
<i>Turnover</i>	£10.7m	£16.6m
<i>Balance Sheet Total</i>	£4.4m	£33m
<i>Total Assets</i>	£8.4m	£13.9m
<i>Year of Qualification</i>	1981	1982
<i>Most Recent Training</i>	2006	2002

Headcount amongst FRSSE adopters was, unsurprisingly, much smaller, on average, at 114, compared to non-adopters (average = 370). This is highly statistically significant (Prob. Value = 0.045). Similarly the financial measures (viz. turnover, balance sheet total and total assets) of those who had upgraded their FRSSE skills were all, on average, much smaller than the non-adopters. In general, the FRSSE adopters had qualified slightly earlier (1981) than the non-adopters (1982). The FRSSE adopters were more likely to have undertaken some training or upgrading of skills in the recent past. The requirement for CPD now means that most members of the ICAEW are likely to be upgrading their skills continuously, or at least claiming to do so. The non-adopters had last upgraded skills, on average, in 2002, compared to FRSSE adopters, who claimed more recent skills upgrades (2006). This result is noteworthy, and highly statistically significant (Prob. Value = 0.087). It suggests FRSSE adopters are ‘early learners’ and possibly more flexible, and adaptive to change.

Figure 1 portrays the respondents’ perceptions about various implications of FRSSE adoption. The responses could range from zero (no agreement) through low, medium and high to 4 (complete agreement). Figures are again given for those who had upgraded their skills in financial reporting for smaller entities (‘FRSSE skills upgraded’), compared to those who had not (‘no FRSSE upgrade’).

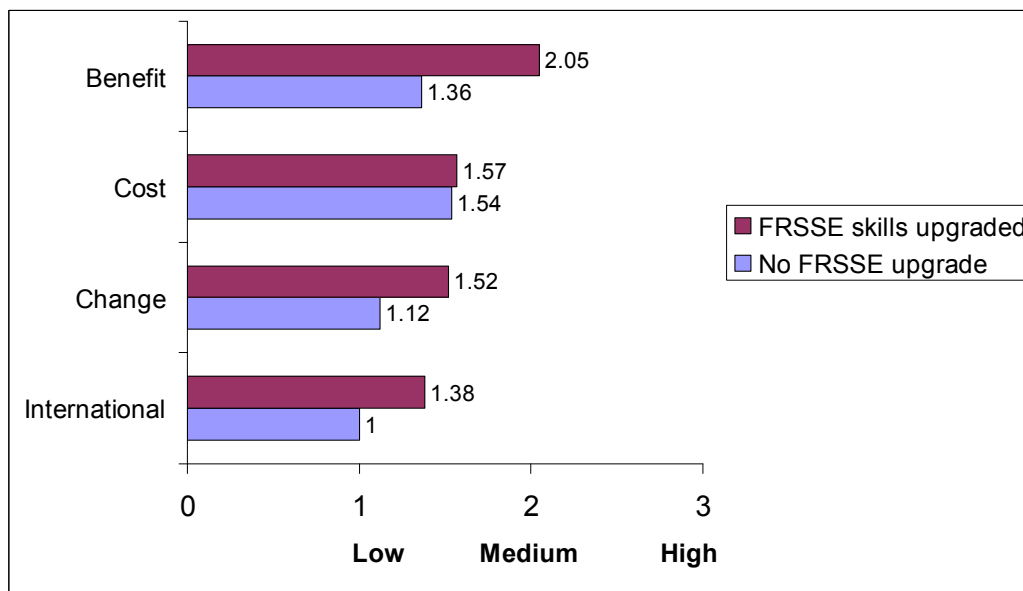
**[Figure 1 near here]**

On average, the strength of agreement with our various propositions is stronger amongst those who had upgraded their skills in the relevant area than those who had



not. First, FRSSE adopters thought implementing the FRSSE would have a ‘low’ to ‘medium’ impact upon costs (*Cost*). Non adopters thought the impact would be slightly lower. In terms of the effectiveness of FRSSE adoption (*Benefit*), adopters thought there was a ‘medium’ benefit to be gained, whereas non-adopters expected only a ‘low’ to ‘medium’ benefit. This result is highly statistically significant (Prob. Value = 0.010) and suggests that benefit/cost ratios differences between adopters and non-adopters (see below) may be more driven by benefit differences than cost differences.

**Figure 1: Strength of agreement about financial reporting for smaller entities**



There was little agreement amongst non-adopters that financial reporting for smaller entities was in need of an overhaul (*Change*); but adopters thought there was a slightly stronger (‘low’ to ‘medium’) case for change. This difference is statistically significant (Prob. Value = 0.095), and slightly modifies the view on benefit/cost ratios

immediately above, as all changes in procedures (including changes like the adoption of FRSSE) involve costs.

Finally, non-adopters could see barely any call for an international standard (*International*), whereas adopters thought there was a ‘low’ to ‘medium’ need for the internationalisation of financial reporting for SMEs. Again, this tends to characterise adopters as early learners, open to innovation.

Figure 2 will be used to address the key hypotheses of the data section. In this figure, the ‘box and whisker’ representations are provided; one for the ‘no skill upgrade’ case to the left, and the other for the ‘skill upgrade’ to the right. On the vertical axis, the benefit cost ratio ( $I_B / I_C$ ) is given. When this ratio has a value unity (which is marked upon this figure with a solid horizontal line), we have, on average, benefit equal to cost  $I_B = I_C$ , or  $I_B/I_C = 1$ .

We note that the mean for this ratio is  $\mu_1 = 1.5$  for adopters and  $\mu_0 = 0.93$  for non-adopters. That is, the benefit/cost ratio of adopters exceeds that of non-adopters, as indicated by the two horizontal dotted lines in the diagram. This difference between means is statistically significant, using a t-test, without assuming equality of variances [t (30.946) = -2.505; prob. value = 0.018]. Thus Hypothesis 1 is accepted, that adopters of FRSSE show greater benefit-cost ratios than non-adopters.

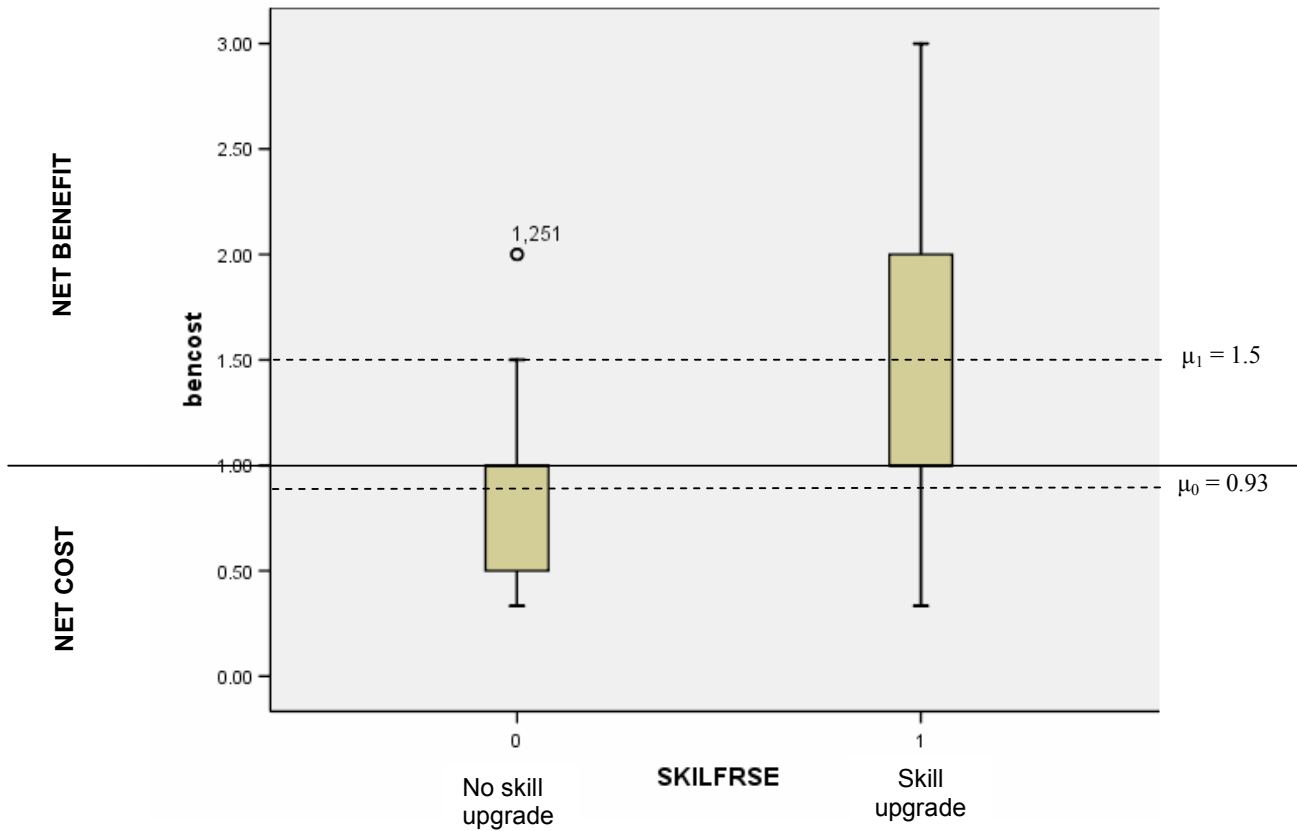
The box, of each box and whisker construction, embraces 50% of each sample. We see that the solid horizontal line through the value unity just touches the upper end of the box for non-adopters, and just touches the lower end of the box for adopters.

Some non-adopters do achieve high benefit-cost, but never more than the mean of the adopters (barring one extreme value observation, or outlier, namely respondent coded 1251). And, even though some adopters have greater costs than benefits (the lower whisker of the right hand side box and whiskers), this is only true of a quarter or fewer of the adopters. Thus the data generally show that adopters find benefits exceed costs  $(I_B / I_C)_A > 1$  and non-adopters find costs exceed benefits  $(I_B / I_C)_{NA} < 1$ . Thus Hypothesis 2 is supported. This implies, because  $I_B / I_C > 1$  implies  $I_B > I_C$  which implies  $(I_B - I_C) > 0$  that adopters, on average, enjoy positive net benefit. Symmetrically, as  $I_B / I_C < 1$  implies  $I_B < I_C$  which implies  $(I_B - I_C) < 0$  meaning non-adopters (for whom this result holds, on average) typically experience negative net benefit, or to put it another way, positive net cost.

It is to be noted again that Hypothesis 2 is really a stronger version of Hypothesis 1, as it adds an extra criterion [namely the ‘breakeven’ value  $(I_B / I_C) = 1$ ] to that which distinguishes an adopter from a non-adopter.

**[Figure 2 near here]**

**Figure 2: Boxplot of Cost/Benefit of FRSSE**



## 5. Conclusion

Our results are preliminary, and no doubt will require more analysis as further evidence unfolds. They are: (a) that it is possible to calibrate attitudinal responses in a way that makes the computation of benefit/cost ratios possible; (b) adopters of FRSSE enjoy a higher benefit/cost ratio than non-adopters; and (c) that, on average, adopters enjoy positive net benefits, and non-adopters negative net benefits (i.e. positive net costs). The results, we must emphasise, are preliminary.

In further work, we aim to delve much more deeply into the issues raised above, both by extending our sample, including to overseas responses, and by conducting a series of in-depth face-to-face interviews. We shall address in more detail the costs and benefits arising from adoption of the FRSSE. Further, we will gather information on proposed changes and improvements, and will consider the possible internationalisation of the standard. In due course, we hope to provide evidence that will enable the profession to assess effectively whether the FRSSE has been a success, or indeed whether any standard for small firms, which are so diverse in their needs, can ever hope to be designed on a ‘one stop shop’ basis, as originally intended.

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