NATIONAL AND INTERNATIONAL FINANCIAL REPORTING STANDARD CONVERGENCE AND THE RELEVANCE FOR NON-PARTICIPANTS IN CAPITAL MARKETS: A PREPARER PERSPECTIVE

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This study presents some implications of recent policy moves to enhance the harmonisation of financial reporting and disclosure by adopting international financial reporting standards. In particular the impact on small organisations that do not participate in capital markets is considered. The results of a survey of practitioners indicate a perception that the non-capital market sector is likely to be significantly affected by the additional reporting burden that convergence with international financial reporting standards imposes. On the whole the results show there was concern that the traditional users of the financial reports of organisations who do not participate in capital markets, would have limited if any, use for financial reports that conformed to international financial reporting standards. The results of this study have implications for nations such as Malaysia and New Zealand, which are currently engaging in the differential reporting debate.

Keywords: *Convergence; Differential Reporting; Harmonisation; International Financial Reporting Standards*

Introduction

As capital market participants embraced the concept of globalisation over the last three decades, investors have found comparing the financial reports of organisations of different nations to be a frustrating and onerous task. This has created calls for increased harmonisation of financial reporting standards so as to improve comparability of financial reports across national borders. One suggestion to enhance harmonisation is to adopt a consistent language for financial reporting such as that provided by the international financial reporting standards. This approach is referred to as *convergence* which has been referred to as the, "outright adoption" (Knapp and Kemp 2004: xviii) by a nation, of international accounting standards.

International financial reporting standards are primarily designed for financial reporting by companies that have their securities quoted and traded on capital markets (*capital market participants*) as a means of providing relevant information to interested users. Companies that do not have securities traded on capital markets (*non-participants*) tend not to use capital markets to raise finance. Therefore the needs of the users of financial reports of capital market participants are likely to be different to the needs of the users of the financial reports of non-participants. Further, evidence from research indicates that capital market participants tend to be large while non-participants are small suggesting that financial reporting requirements could be differentiated on the basis of size. Differential reporting is an approach to financial reporting wherein some organizations are exempted from the application of particular accounting standards, or from specific components of accounting standards (HKSA 2002; Nair and Rittenberg 1983).

Literature Review

Brailsford and Ramsey (1993) asserted that the issue of differential reporting is multinational and arises as a response to the problem of compliance overload. Typically, they argued, the issue has been tackled by the introduction of exemptions from particular disclosures, standards and legislative requirements on the basis of size or ownership of an organisation. Dixon (2003) predicted that the form of differential reporting in the future may move to a European proposal which differentiates between quoted companies and other entities.

[1]The cost/benefit implications of convergence need to be considered as cost/benefit provides a conceptual underpinning for differential financial reporting. The reporting implications for non-participants under a convergence regime could be quite onerous. The findings from a CPA Australia survey (Carroll 2003) indicated that large organisations will bear the greatest impact of convergence, but that smaller organisations would not be exempt. Buffini and Hepworth (2004) reported that financial report preparers are already struggling with conflicting rules – in the law, accounting standards and stock exchange guidelines. The potential reporting burden resulting from convergence makes investigation of the issue important. Practitioner opinions that provide a direction to this issue are important so that calls for submissions to government, the international financial reporting standards setters, professional organizations (by CAPA 2003) and educational institutions (Hancock and Ngiam 2003 noted professional education as an area in need of urgent attention) can be provided on an informed basis. Research in this particular area is both relevant and timely as Australia moves towards a 2005 implementation deadline (Alfredson 2003) for convergence and a number of other nations (Malaysia, New Zealand and the EU) move towards a 2007 convergence horizon.

Consideration of the advantages and disadvantages of convergence of national with international financial reporting has been evident in the literature since the 1960s (Watson 1962; Mahon 1965). If organisations could avoid the costs of complying with national accounting standards and practices then security analysts would not need to acquire costly specialised expertise in order to interpret the financial reports of separate nations. Yet research exists to suggest that capital market participants are capable of adjusting financial reports prepared using national financial reporting standards to reflect numbers that would be determined under another nation's financial reporting standards (Lev and Sougiannis 1996). Brown and Clinch (1998) provide a useful discussion of this issue. More recently Yong (2003) identified the underlying trend towards convergence as a result of increasing globalisation of financial markets.

Much of the discussion on convergence with international financial reporting standards has been focused on the alleged benefits of improved consistency for capital market participants. Buffini (2004) suggested that the result of the introduction of a single global accounting standard may be an increase in profit volatility and that this might confuse users of financial reports, affect the ability of capital market participants to borrow and, in this way, damage their international competitiveness. There are also likely to be a significant number of impacts on small organisations. Parker (2003) predicted that all small organisations in particular would be adversely affected by a policy move to converge with international financial reporting standards. In the face of such mixed predictions and uncertainty as to the benefits of convergence there is room for further consideration of the importance of this issue for non-participants in capital markets.

Non-participants are likely to have fewer resources available to deal with financial reporting compliance than larger, capital market participants, thus concerns regarding the relatively heavy financial reporting burden on non-participants are justified. Some evidence supporting this contention appears in the literature. For instance Hartcher (2004) reported the results of a national survey of the Australian small business sector that showed the sector has difficulty in keeping abreast of compliance changes and understanding financial reporting obligations. Hartcher recommended that compliance costs be measured by all levels of government and reviewed on a regular basis. Earlier Carsberg *et al*. (1985) and Abdel-khalik (1983) concluded that small USA firms appeared to have a substantial problem in keeping up-to-date with changing and new accounting standards; and that the costs of keeping up-to-date with changing accounting standards are relatively higher for small firms than for large firms. Knutson and Wichmann (1984) found that accounting costs were twice as high for small companies as for large companies.

Research Question and Approach

The main objective of this study is to investigate perceptions of financial report prepares in the non-capital market sector of the impact of convergence with international financial reporting standards. In particular, the study seeks to answer the following question:

What is the likely impact on the financial report preparation process of the policy move to converge national with international financial reporting requirements?

An internet-based survey of practitioners involved in financial report preparation for the non-capital market sector was conducted to determine their perceptions of the impact on the sector of convergence of national financial reporting standards with international financial reporting standards. Participation was invited from accounting practitioners through the electronic newsletter of their professional accounting organization. Fifty-two members provided usable responses to the survey. In order to protect the privacy of the practitioners, demographic details of respondents were not made available to the researchers. Additionally, as the use of the electronic newsletter as a means of access to practitioners is restricted it was not possible to repeat the administration of the survey to improve the response rate.

The data obtained provides some important indicators that the policy choice to converge national with international financial reporting standards may result in the financial reports of the non-capital market sector having limited relevance for the traditional users of those reports.

Results

The aim in this section is to provide an initial picture and understanding of the data obtained. Descriptive statistics for the key variables involved in the analysis of the issues in this study are presented. The statistics were obtained by performing the summary descriptive analysis in the SPSS computer package. Frequencies and percentages, and means and standard deviations were calculated for the variables. These include the degree of the perceived effect on the preparation of financial reports for the non-capital market sector of the policy to converge national with international financial reporting standards.

Perceived Impact of Convergence

Most respondents (75%) perceived that the financial reporting process would be either significantly or moderately affected by convergence. This outcome supports concerns expressed in the media (Buffini 2004; Fenton-Jones and McLachlan 2004; Fenton-Jones 2002; Wiesenthal 2004) and warnings in the professional literature (Carroll 2004; Carroll and Dixon 2003) of the need to prepare for transition to the proposed convergence regime. The results are presented in Table 1.

Table 1: Effect Of National and International Convergence on Financial Reporting for the Non-participants in Capital Markets

Effect categories	Frequency	Percentage
Significant	17	32.7
Moderate	22	42.3
Minor	8	15.4
No impact at all	1	1.9
Missing	4	7.7
Total	52	100.0

Purpose of Financial Reporting for Non-participants in Capital Markets

The respondents were asked to provide their views on the purpose of financial reporting for the sector. They ranked the need to comply with taxation requirements as the most important purpose. They also indicated a belief that financial reports for this sector were used heavily for internal management of organisations. Respondents ranked investment as the least compelling reason for financial reporting by the sector. Financial reports of this sector are probably of limited relevance to capital market participants as other banks engaged in direct lending to the sector. The low ranking for stewardship may also be reflecting the limited relevance of the agency problem that, theoretically, arises when ownership and management are separated. These outcomes tends to support Dixon's (2003) prediction that differential reporting may move to a European model which differentiates between quoted companies (capital market participants) and other entities. The data is summarised and presented in Table 2.

Table 2: Perceptions of the purpose of financial reporting for the non-capital market sector

Question	Mean	SD	Rank
Taxation	4.38	.644	1
Management	4.19	.762	2
Accountability	3.98	.911	3
Stewardship	3.92	.895	4
Investment	3.77	1.047	5

Advantages and Disadvantages of Differential Reporting

A further aim of this study was to explore the perceptions of financial report prepares to the advantages and disadvantages of differential reporting for non-participants in capital markets. Descriptive statistics are presented in Table 3.

The data presented in Table 3 do not indicate whether respondents are reacting to perceived advantages or disadvantages associated with convergence. A further statistical assessment was used to evaluate whether there was any grouping of advantages and disadvantages.

Using factor analysis with varimax rotation, scales of advantages and disadvantages were established. Scale reliability was measured using Cronbach's alpha. The advantage scale has an alpha of 0.78, and the disadvantage scale an alpha of 0.90. Both statistics indicate a high level of scale reliability. A MANOVA calculation was performed to determine if there was a significant difference between the variables. Box's ($p = .004$) and Levene's (*Advantage*, $p = .075$; *Disadvantage*, $p = .651$) homogeneity tests have been satisfied with regard to this calculation. The multivariate test indicated a significant difference at the 10% level between the perceptions of respondents to convergence with international financial reporting standards on non-participants (perceived effect as determined by the *Wilks' Lambda* = .809 $F(4, 76) = 2.124$, $p = .086$).

Having established that there was a difference, a between-subjects test was undertaken to determine whether the difference was caused by the advantages or disadvantages of convergence. A significant difference in respect to the advantages of convergence and the perceived effect on non-participants was noted ($F(2, 39) = 4.159$, $p = .023$, refer to Table 4). There was no significant difference in respect to the disadvantages of convergence and the perceived effect on non-participants ($F(2, 39) = .142$, $p = .868$). A conclusion that can be drawn from this data is that convergence with international

Table 3: Advantages and Disadvantages for Non-participants in Capital Markets

Question	Mean	SD
Convergence with IFRS* will provide entities with better access to international capital markets	3.29	1.099
Convergence with IFRS is being driven by the needs of large entities	4.00	1.185
Convergence with IFRS will enhance measurement consistency	3.67	1.078
Convergence with IFRS will enhance disclosure consistency	3.64	0.987
Convergence with IFRS will primarily benefit large entities	3.96	1.184
Convergence with IFRS will improve small entity financial reports	2.75	1.101
IFRS are more complex than national standards and so will be costly to apply correctly	3.60	1.144
Small entities are already over-burdened with financial reporting requirements that are beyond their users' needs	3.90	1.153
It is not practical for small entities to apply IFRS as their accounting records are not sufficiently sophisticated to provide the necessary financial information	3.31	1.257
IFRS compliant financial reports of small entities should be audited	2.52	1.148
Small entity compliance with IFRS will be costly to enforce (audit; surveillance)	3.71	1.071
It is simple to classify entities as small/large for reporting purposes	3.08	1.127
The existing definition of entities as small or large for financial reporting purposes is easily understood	3.29	0.898
Convergence with IFRS imposes a compliance cost on all entities	4.00	0.825
The compliance burden is greater for small than for large entities.	3.96	1.0423
Differential reporting would be beneficial for small entities	3.21	0.967
Choice of different levels of disclosure is appropriate for small entities	3.54	0.988
Standardised financial reports based on IFRS are not used by users of small entity financial information	3.56	1.029
Financial reports are not used 2.13	1.024	

* IFRS – International Financial Reporting Standards

accounting and financial reporting standards is perceived to have some advantages for financial report preparation by non-participants. The between-subjects effect establishes the advantages of convergence as the reason for the significance as previously determined by the Wilks' Lambda.

Table 4: Multivariate Tests of Between-subjects Effects

Factor	Dependant Variable	Sum of Squares	df	Mean Squares	F	Sig.
Perceived	Advantages	131.480	2	65.740	4.159	0.023
effect	Disadvantages	30.432	2	15.216	0.142	0.868

Relevance of Standardised Financial Reports

Respondents were also asked to provide feedback on their beliefs as to the relevance of standardised financial reports that would be the product of the convergence of national with international financial reporting standards, to conceptually different organisations, institutions and nations. This data is summarised and presented in Table 5.

The possible response range is 1-5 indicating that the top three responses are relatively strong. This indicates a perception that convergence of national with international requirements will be most relevant to (1) Publicly owned entities; (2) Financial institutions; and (3) Large entities: and that it would be least relevant to (4) Small entities; (5) Privately-owned entities; and (6) Not-for-profit entities. An implication of this outcome is that compliance with international financial reporting standards is likely to have limited relevance for users of the financial reports of non-capital market participants.

Table 5: Relevance of Convergence to Conceptually Different Organisations

Question	Mean	SD	Rank
Developed nations	3.85	1.185	4
Developing nations	3.67	1.018	6
Large entities	4.15	1.042	3
Small entities	2.69	1.188	10
Publicly owned entities	4.21	.898	1
Privately owned entities	2.90	1.189	9
Not for profit entities	2.98	1.211	8
Financial institutions	4.15	.899	2
Non-financial institutions	3.54	1.184	7
National economy reporting	3.77	1.115	5

Summary and Conclusions

The main objective of this study was to investigate financial report prepares' perceptions of the likely impact on the financial reporting process of the policy move to converge national with international financial reporting requirements. In the process, an investigation of the purpose of financial reports of non-participants in capital market, of the advantages and disadvantages of convergence, and of the relevance of convergence to conceptually different organisations were also undertaken.

The findings indicate that convergence is likely to have a significant impact on the financial reporting process for non-participants. This is consistent with the predictions noted in the literature. The investigation of the purpose of financial reporting by non-participants pointed to compliance with taxation requirements and internal management needs as providing the strongest incentive for financial reporting. Information for investment purposes was regarded as providing only a weak incentive for financial reporting by this sector. In respect to the relevance of international financial reporting standards to conceptually different organisations, the data indicated that convergence would be most relevant to: publicly owned enterprises; financial institutions; and large companies and least relevant to small, privately-owned and not-for-profit organisations.

While there exists much debate about the willingness of financial report prepares to accept the concept of a single integrated set of standards, the results of this study support the view that international financial reporting standards are perceived as having some advantages for both capital market participants and non-participants, but as having less relevance for non-participants. As capital market participants tend to be characterised by size, this characteristic may provide a conceptual basis for the development of a differential financial reporting framework that could resolve the conflict caused by the relatively high cost burden as a result of convergence. This is an issue of importance for financial reporting policymakers and regulators and particularly relevant to the differential reporting debate presently occurring in Malaysia and New Zealand.

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Note

[1] Hancock and Ngiam 2003 noted professional aducation as an area in need of urgent attention.

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