Funding the Future

The IASB misses the point on small company accounting

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I've been writing about the inappropriateness of accounting standards that have been established for smaller enterprises in the UK and elsewhere for more than a decade now. Usually my approach has been based on two arguments. The first is that the UK standard, (the Financial Reporting Standard for Small Entities) has in all its forms to date been based on the idea that if you take UK Accounting Standards and cut out the bits that are unlikely to be relevant to smaller entitles then the remainder can be deemed fit for purpose for smaller businesses.

This has always seemed self-evidently wrong in both theory and practice, even when the UK standards in question had some suitability for the quoted companies for which they were really designed. The reason is simple. The process incorporates the false assumption that small businesses are simply smaller versions of big ones. That's not true for reasons that will, at least in part, be noted later.

My second argument has been that there are issues in small business accounting that never arise in large companies and that any standard based on larger entity accounting is bound in consequence to ignore many issues that are of great significance to smaller businesses, not least because of the different legal forms in which those enterprises are conducted.

I remain of the view that both these arguments are right and if they apply to the UK FRSSE then they certainly apply just as much to the proposed International Financial Reporting Standard for Smaller Entities (the IFRSSE, to use an inelegant term). That's not least because the logic underpinning the development of the IFRSSE is based in no small part on that used to produce the UK FRSSE, which is the only precedent of its type. The logical failing of the UK standard are in consequence replicated in full in international one.

Except it's not quite as simple as that. As I become increasingly familiar with the philosophy (if you can call it that) of International Financial Reporting Standards and the IASB that promotes them I realise that the IFRSSE is even more flawed than its UK precedent. The reason is simple to explain: the consequences are more worrying.

The principle inherent in UK accounting standards is that there is a unitary board of a company that has a mutual responsibility for the actions of the entity. They are obliged to report on that activity to those who own the enterprise and who have the power (at least in theory) to hold them to account for their actions. That report is prepared for the benefit of those owners even if at cost to the entity itself, with the auditors in consequence having a duty to critically appraise the conduct of the board in the exercise of its responsibilities. This implies that:

1. The company is owned by persons who it is assumed are distinct from it (i.e. a limited liability format is assumed to exist);
2. The owners appoint persons to act as stewards on heir behalf (the Board);
3. Those stewards might delegate their powers to managers (or not, the choice is there's) but the responsibility and accountability rests with that board none the less;
4. The board are therefore responsible for the management of the company;
5. They are also responsible for reporting on it, and cannot divest themselves of that power, whatever they would wish.

In summary this assumes that the board are responsible to the owners, owing to them a duty of care in a relationship of stewardship. This stewardship model of the corporation was chosen because it was assumed that there would be an ongoing, long term relationship between the parties.

Unfortunately, the relationships that underpin this model of the corporation are rarely found in smaller entities. In those entities there may be complete fusion between ownership and the Board. That must be the case for a partnership or sole trader. As a result the reporting responsibility is confused in these entities and the model appears to fail, despite which the UK FRSSE still applies. It is little better in the case of a small limited company where it is usually the case that there will be close relationships between the Board and the shareholders, and quite often they are synonymous.

That being said though there does remain one key element in the assumption underpinning UK GAAP that does translate to the smaller entity. The assumption of the ongoing, long term relationship between the owners and the entity remains valid because that is the expectation (if not the reality) for many of those who start small businesses. Some may be looking to make a quick buck but the majority will not. They will be investing heart, soul, body mind and credit card limit in an enterprise which represents in consequence much more than a financial asset. The human capital invested in creating the enterprise is frequently considerably greater than any financial outlay. It is wholly unaccounted for but is clear indication of the commitment inherent in such enterprises. In that sense the model does, to some degree work because that long term relationship is also assumed to underpin UK accounting standards.

But that is not the assumption inherent in the IFRSSE, being the cut down version of IFRS that it is. The inherent logic of IFRS is that it should supply what is called 'decision useful information'. This is a concept that appears to have been imported into IFRS from the USA even though IFRS do not apply there. Under the influence of American members of the IASB there has been a shift towards the US Generally Accepted

Accounting Principles (GAAP) in IFRS and away from the UK / European model. What is little appreciated though is that the logic of US and UK / European GAAP are fundamentally different.

Whilst it is true that US GAAP is, like UK GAAP based on the logic of the incorporated entity the US incorporated entity is very different from its UK counterpart. Each US state has its own rules of incorporation, but it's also true that a significant number of all US corporations are registered in Delaware and it is that model that therefore dominates US thinking. The Delaware corporate model assumes a completely different relationship structure than does the UK model. For example it assumes that:

1. The owners of the entity have few obligations and almost no rights. They may not have to disclose their identity, might not have the right to receive any information (including accounts), will have very limited rights to vote, and the audit report (if there is one) is not addressed to them;
2. The Board's main role is to delegate the task of running the company to managers. Those managers actually take responsibility for the entity. The Board does not have responsibility for that task unless they happen also to be managers;
3. If auditors are appointed they report on management to the Board unlike the UK model where the duty is to report on the Board to the shareholders.

In this model the shareholder is far removed from the company, and has little reason for interacting with it. The result is that in US GAAP the shareholder is assumed to have just one decision to make, which is to buy, hold or sell their shares. Nothing else matters. The need for information to actually indicate how the entity is managed, what it is seeking to achieve and its prospect for doing so is simply ignored because the shareholder has no chance of influencing that behaviour. This is fundamentally different from the stewardship model that underpins UK GAAP. This assumes a long term relationship; the US model assumes a transient shareholder relationship.

The last thing that exists between the owner of small enterprise and the entity they own is a transient relationship. And for the vast majority of smaller entities (even those of some size) the least likely transaction into which they well enter will be one where they issue shares or even approve a sale of them. In most small entities the people who start the company (in whatever form it is run) will be those who own it when it is wound up.

This is immensely important. If the whole logic of IFRS is to ensure that a user of the information produced can decide whether to buy or sell shares in the entity of which they might be a part owner and this almost never happens in smaller entities then the entire logic of the accounting process in IFRS, and by implication IFRSSE, is completely alien to the needs of smaller entities. In which case discussing the detailed provisions that are suggested by the standard, in all its three hundred or more pages is irrelevant.

There is only one possible response to the IASB proposal. That is to say it misses the target because it starts with a flawed conception of what a smaller entity is, what its

information needs are and how they can be met. In which case the proposed standard must be reworked from scratch.