THE DEVELOPMENT OF FINANCIAL REPORTING FOR SMEs IN SOUTH AFRICA: IMPLICATIONS OF RECENT AND IMPENDING CHANGES

Lesley Stainbank[1]
University of KwaZulu-Natal, South Africa
stainbankl@ukzn.ac.za

ABSTRACT

South Africa has become the first country in the world to adopt the International Accounting Standards Board's proposed *International Financial Reporting Standards for Small and Medium-sized Entities* in its exposure draft form as a transitional standard for limited interest companies without public accountability. Previously, all South African companies, irrespective of their form, size and to whom their financial statements were available, were required to prepare financial statements in accordance with South African Generally Accepted Accounting Practice (aligned with the International Financial Reporting Standards since 1 January 2005). South Africa is currently undergoing a period of corporate law reform. Phase 1 has been completed with the publication of the Corporate Laws Amendment Act, No. 24 of 2006. Phase 2 is underway with the publication of the Companies Bill, 2007 which will probably be enacted in 2008.

The importance of this corporate law reform is that differential reporting has been introduced in South Africa. The objective of this study is therefore to examine the development of accounting standards for small and medium-sized entities (SMEs) in South Africa. The present position and the implications of recent and impending corporate law changes with respect to financial reporting for SMEs are also discussed.

Keywords: Financial reporting, differential reporting, SMEs, corporate law reform
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[1] Other contact details: Dr. Stainbank is a Professor of Accounting, School of Accounting, University of KwaZulu-Natal, Private Bag X54001, Durban 4000, South Africa.

1. INTRODUCTION

When South Africa adopted the International Accounting Standards Board's (IASB) proposed *International Financial Reporting Standards for Small and Medium-sized Entities* (IASB, 2007a) in its exposure draft form as a transitional standard for limited interest companies without public accountability in 2007, it became the first country in the world to do so. Previously, all South African companies, irrespective of their form, size and to whom their financial statements were available, were required to prepare financial statements in accordance with South African Generally Accepted Accounting Practice (SA GAAP) (aligned with the International Financial Reporting Standards since 1 January 2005). South Africa is undergoing a period of corporate law reform. Phase 1 has been completed with the enactment of the Corporate Laws Amendment Act, No. 24 of 2006 (DTI, 2006a). Phase 2 is underway with the publication of the Companies Bill, 2007 (DTI, 2007a) which is currently issued for public comment.

The importance of this corporate law reform is that differential reporting has been introduced in South Africa. This means that the reporting requirements for limited interest companies without public accountability are different to the reporting requirements for widely held companies. The objective of this study is to examine the development of accounting standards for small and medium-sized entities (SMEs) in South Africa, with emphasis on the current position and the implications of recent and future changes. Section two of this paper provides discussion on the justification for differential reporting. This is followed by section three which examines differential reporting in selected developed countries as well as the deliberations of the IASB. Section four outlines the development of accounting standards for SMEs in South Africa, discusses the present position and uses the responses to a questionnaire issued by the South African Institute of Chartered Accountants (SAICA) as a basis for discussion on the implications of recent and impending changes with regards to financial reporting for SMEs. The definitions of public accountability which are being used in different jurisdictions are also contrasted. Section five provides the conclusion to this study.

11. JUSTIFICATION FOR DIFFERENTIAL REPORTING

The justification for differential reporting lies in the consideration of firstly users' needs, and secondly, the cost/benefit constraint. According to the *Framework for the Preparation and Presentation of Financial Statements*, the objective of general purpose financial statements is "to provide information about the financial position, performance and the changes in financial position of an entity that is useful to a wide range of users in making economic decisions" (IASCF, 1989:12). Although the IASB has the preliminary view that the objectives of general purpose financial statements are the same for all entities, it acknowledges that the types and needs of users of SMEs' financial statements may be different to those of users of financial statements of larger entities (IASB, 2004:15).

With regards to the cost/benefit constraint, the IASB believes that the cost-benefit trade off should be assessed in relation to the nature, number and information needs of the users of an entity's financial statements (IASB, 2004:15).

Studies in South Africa (Hattingh, 1999; Cleminson and Rabin, 2002; Wells, 2005; Van Wyk, 2005; SAICA, 2006b) confirm that the cost of compliance with general purpose accounting standards such as SA GAAP or IFRS exceed the benefits for SMEs, while internationally, this has also been recognized in the United States of America (USA) (Mosso, 1983) and in the United Kingdom (UK) (Carsberg, Page, Sindall and Waring, 1985). More recent studies in the international arena have also identified the complexity of IFRS (AICPA, 2005) and the time it takes to achieve compliance as challenges for SMEs rather than the costs of compliance (Maingot and Zeghal, 2006).

With regards to users needs, Schiebel (2008) argues that there is no evidence concerning the common information needs of external users of SMEs' financial statements. To substantiate his position, Schiebel (2008:11) examines the literature on common information needs of external users of SMEs' financial statements and concludes that the research so far has focused on "one group of external users and one region or country at a time", and that "[n]o information is available about the common information needs of various external groups on a national or international level.". He argues furthermore that the IASB failed to determine the information needs of external users of SMEs financial statements and the kind of information those external users require from SMEs, and instead has relied on the responses by the accounting regulators, profession and academics when the IASB should have focused on the users and preparers of SMEs' financial statements (2008:18).

111. INTERNATIONAL DEVELOPMENTS

Differential reporting already exists in many countries. In the USA, private companies are permitted to prepare their financial statements in accordance with an 'other comprehensive basis of accounting' (OCBOA), commonly the tax basis or a modified cash basis of accounting (Edwards, 2004:40). In Australia, when it is reasonable to expect that no users are dependent upon information contained in general purpose financial statements for economic decision-making about an entity, an entity need not prepare financial statements that are compliant with Australian GAAP (Stainbank and Wells, 2005). In New Zealand, a quantitative and qualitative threshold for differential reporting exists which permits either a full exemption from selected New Zealand financial reporting standards and partial exemption from others (Baskerville and Simpkins, 1997:17), or depending on a quantitative test, may only have to comply with minimal corporate reporting requirements. In the UK, differential reporting became effective when the Accounting Standards Board issued its *Financial Reporting Standard for Smaller Enterprises* (FRSSE) (Walton, 1998:3). Progressive differential reporting options became effective for non-publicly-accountable Canadian private companies when the Canadian Accounting Standards Board (ACSB) introduced Section 1300- *Differential reporting* into the Canadian Institute of Chartered Accountants' (CICA) Handbook in 2002 (CICA:2002).

The threshold (or cut-off) for determining which entities may adopt differential reporting standards can thus be either quantitative or qualitative. A summary of differential reporting thresholds in the UK, Australia, New Zealand and Canada is shown in Table 1.

Table 1
International differential reporting thresholds

	United Kingdom	**Australia**	**New Zealand**	**Canada**
Qualitative:	Specific exclusions: public companies, banks, insurance entities	Not a reporting entity (that is, no external users who depend on the financial statements for economic decision making)	No public accountability and all owners are members of the governing body or	Non-publicly accountable enterprise and all owners are members of the governing body
Quantitative:	Does not exceed two or more of - Revenue £2,8m - Assets £1,4m - Employees 50 -	Does not exceed two or more of - Revenue $10m - Assets $5m - Employees 50	No public accountability and does not exceed two or more of*: - Revenue $20m - Assets $10m - Employees 50	n/a

* - The quantitative test does not apply where the entity does not have public accountability and at balance sheet date all of its owners are members of the entity's governing body.
Note: All amounts are denominated in the currency of the country concerned.

Source: Adapted from Stainbank and Wells (2005)

The form and content of financial reports of SMEs as well as the threshold for differential reporting differs from country to country. The proposals of the IASB, discussed next, would bring some uniformity into the financial reports prepared by SMEs if they were to be adopted by individual countries.

The IASB began developing accounting standards appropriate for small and medium-sized entities (IASB SME Standards) in 2003. In June 2004 the IASB issued a discussion paper - *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* (*DP SME*). *DP SME* invited public comment on the preliminary views of the IASB regarding the development of IASB SME Standards.

The preliminary view of the IASB was that IASB SME Standards should take the form of a separate volume of financial reporting standards derived from the existing IFRS. The objective that financial reporting standards for SMEs should be based on the same conceptual framework as IFRSs and allow easy transition to full IFRSs for those SMEs that become publicly accountable or choose to switch to full IFRSs reflected the IASB's intention that IASB Standards for SMEs should be a modified version of full IFRSs rather than a body of standards developed independently of full IFRSs (IASB, 2004:19). DP SME envisaged deviations from IFRS based only on user needs and the cost/benefit constraint, resulting in presentation and disclosure modifications, but with a rebuttable presumption that no modifications were to be made to the recognition and measurement principles in IFRS.

Subsequently, the IASB published a *Staff Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities* in 2005 in order to identify issues to be discussed at meetings with the preparers and users of SMEs' financial statements. A preliminary draft of an Exposure Draft (ED) of an *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)* was issued in 2006 (IASB, 2006). The IASB has now issued its ED of a proposed *IFRS for SMEs* (IASB, 2007a). Regarding cut-off for the use of *IFRS for SMEs*, the IASB envisages national jurisdictions determining which, if any, entities should be permitted to use *IFRS for SMEs* and expressly excludes quantitative 'size tests' and instead applies the principle of 'no public accountability' as the overriding characteristic for the application of *IFRS for SMEs*.

The IASB define an entity as having public accountability if:

1. It files (or is in the process of filing) its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; or
2. It holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance entity, securities broker/dealer, pension fund, mutual fund or investment banking entity.

The modifications found in the ED of the proposed *IFRS for SMEs* are based on user needs and cost-benefit considerations and are in three areas: (1) Standards which have been omitted as they are not relevant to SMEs, such as Interim Reporting (but with a cross-reference to full IFRS if they are needed), (2) where full IFRS offers an accounting policy choice, only the simpler option is in the *IFRS for SMEs*, although an SME is allowed to use the other option by cross-reference to the relevant IFRS, and (3) some recognition and measurement simplifications (for example, to expense all development costs) (IASPLUS, 2007). The IASB have requested comment on any aspect of the ED as well as answers to a number of specific questions. The comment deadline was 1 October 2007.

1V. SOUTH AFRICA

In South Africa, initiatives for differential reporting have come from both the profession and the Department of Trade and Industry (DTI).

SAICA's *Discussion Paper 16 (DP 16) - Limited Purpose Financial Statements* (SAICA, 2000) proposed differential reporting requirements for companies that are closely held and controlled by owners and whose financial statements are only available to a limited user audience. DP 16 proposed that qualifying companies be exempted from certain disclosure requirements but that no recognition and measurement concessions be granted. A subsequent paper issued by SAICA (2001:6) on the small/large enterprise distinction concluded that qualitative measures (i.e. user information needs) are the appropriate criteria for determining which entities should qualify to prepare financial statements in accordance with limited purpose financial reporting standards rather than size-based criteria.

In 2003, SAICA issued ED 163 – *Limited Purpose Financial Reporting Standards* (SAICA, 2003) which, if adopted, would allow companies that, in accordance with the draft Financial Reporting Bill issued by the DTI in 2002, qualify to prepare limited purpose financial statements to elect not to: (1) present a cash flow statement; (2) prepare consolidated financial statements; (3) provide for deferred tax; and (4) split compound financial instruments into their equity and liability components. Furthermore ED 163 proposed that qualifying entities be exempt from certain limited disclosure requirements of SA GAAP. SAICA, in its attempts to keep in line with the IASB issued the IASB's *DP SME* (IASB, 2004) as ED 181 - *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* (SAICA, 2004a), and the IASB's *Staff Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities* (IASB, 2005) as *Questionnaire: Possible Recognition and Measurement Modifications for Small and Medium Sized Entities.*

Subsequently, the IASB's ED of an *IFRS for SMEs* was issued by SAICA as ED 225 (SAICA, 2007a). SAICA invited comments on a proposed process as SAICA's view is that limited interest companies could, in the interim period, either continue to comply with IFRS, or early adopt the IASB's ED of a proposed *IFRS for SMEs.* On 7 August 2007, the Accounting Practices Board (APB) approved the IASB's exposure draft on *IFRS for SMEs* without any change to the text as the *Statements of GAAP for SMEs* for all 'limited interest' companies provided they do not have public accountability as defined in Section 1 of the *Statements of GAAP for SMEs*. Limited interest companies may apply the *Statements of GAAP for SMEs* to annual financial statements for financial years ending on or subsequent to 31 December 2005 that are issued on or after 1 October 2007 (SAICA, 2007b). This is only for the transitional period until the Financial Reporting Standards Council is established in terms of the Corporate Laws Amendment Act, No. 24 of 2006 and issues standards for limited purpose companies (SAICA, 2007a).

The South African Department of Trade and Industry (DTI) has addressed the issue of differential reporting in its corporate law reform program which commenced in 2004 (DTI, 2004). The DTI envisages that a single South African formal business vehicle, i.e. the company, will be recognised in the future (DTI, 2004:32). However, multiple tiers of companies would be distinguished which would determine their reporting requirements (SAICA, 2004b). The proposals of the draft Financial Reporting Bill, which acknowledged that it is neither reasonable nor practicable to require small enterprises to comply with reporting standards that are based on general purpose international financial reporting standards (SAICA, 2002:4), for differential reporting were incorporated into the Corporate Laws Amendment Bill issued in April 2006 (DTI, 2006b), and subsequently enacted as the Corporate Laws Amendment Act, No. 24 of 2006 (DTI, 2006a). This Act represents Phase 1 of a two-phase process in reforming corporate law in South Africa. It provides interim amendments to the current Companies Act and includes the introduction of two types of companies for purposes of financial reporting, the widely held company and the limited interest company. The DTI subsequently issued the Companies Bill, 2007 which represents Phase 2 of the corporate law process in South Africa (DTI, 2007a).

The objectives of the Companies Bill, 2007 (DTI, 2007a) are to modernise the legislation so as to align it with best international practice and to promote entrepreneurship and enterprise development (DTI, 2007b). To achieve this, the procedures regarding forming and maintaining a company will be simplified and the regulatory burden for smaller companies reduced. For large corporations, the Companies Bill, 2007 will enhance their governance and accountability.

The Corporate Laws Amendment Act defines widely held and limited interest companies as follows (DTI, 2006a: section 1):

"A company is a widely held company: if –

(i) Its articles provide for an unrestricted transfer of its shares;
(ii) It is permitted by its articles to offer shares to the public;
(iii) It decides by special resolution to be a widely held company; or
(iv) It is a subsidiary of a company described in subparagraph (i), (ii) or (iii)."

"A company with two or more types of classes of shares is a widely held company if its articles provide for the unrestricted transfer of shares in one or more of these types or classes."

"A company is a limited interest company if it is not a widely held company."

As the public and private company distinction is retained, widely held companies are mainly public companies and their subsidiaries. Private companies could, by special resolution, choose to be widely held companies. All other private companies will be limited interest companies. The Act introduces differential reporting by requiring a widely held company to (a) comply with financial reporting standards, (b) comply with the provisions of this Act (i.e. the Corporate Laws Amendment Act) and Schedule 4 that are applicable to public interest companies and (c) prepare financial statements that fairly present the financial position and the results of operations of the company (and its subsidiaries, if applicable) in accordance with paragraph (a). Limited interest companies must (a) comply with the accounting standards developed for limited interest companies under section 440S (1)*(b)*, (b) comply with the provisions of this Act and Schedule 4 that are applicable to limited interest companies, and (c) prepare financial statements that fairly present the financial position and the results of operations of the company (and its subsidiaries, if applicable) in accordance with paragraphs (a) and (b) (DTI, 2006a: section 285A).

Because accounting standards have not yet been developed for limited interest companies, section 56(3)(a) of the Corporate Laws Amendment Act provides the following transitional provision: "Prior to the development of accounting standards contemplated in section 285A(2)*(a)*, a limited interest company must prepare its financial statements in accordance with a set of accounting practices adopted by that company, which must comply with the framework for the preparation and presentation of financial statements included in financial reporting standards." SAICA's view therefore is that limited interest companies could, in the interim period, either continue to comply with IFRS, or early adopt the IASB's Exposure Draft of a proposed *IFRS for SMEs* (SAICA, 2007a).

This corporate law reform has implications for SMEs and their auditors in four areas: the threshold (or cut off) for differential reporting; whether two tiers of financial reporting standards are sufficient; its effect on close corporations; and the relaxation of the audit requirement for limited interest companies. The discussion which follows also uses, where appropriate, responses to the comment letters received by SAICA from its questionnaire survey on *The Audit of Small Companies* (SAICA, 2006a). A limiting factor in the discussion that follows is that the majority of the respondents (82%) were members in public practice which provides support for Schiebel's (2008) viewpoint that not all users of SMEs' financial statements are being consulted for their opinions on the development of SME financial reporting standards.

The threshold (or cut off) for differential reporting

The proposed definitions focus only on widely versus closely held shareholdings (SAICA, 2006a:5). This may mean that some economically significant companies which should fit into the public interest category may fall into the limited interest definition. SAICA thus solicited views on whether the existing distinction between public interest and limited interest was acceptable, and if not, what the distinction should be. The results of the SAICA survey (2006b) indicate that 50% of the respondents agreed with the existing distinction between widely held and limited interest companies and 20% of the respondents thought that the distinction should be expanded to include other criteria (for example, nature and size of the company's activities, the gearing ratio, and the role the company plays in the community). The remaining 30% did not answer this question. These responses provide some support for the Companies Bill, 2007 which designates a closely held company as a public interest company if it meets two out of three quantitative criteria (monetary asset value of not less than R25 million, an annual turnover threshold of not less than R50 million and an employment threshold of not less than 200 employees) (DTI, 2007a:49 – 50). Developed countries (as shown in Table 1) have tended to use both qualitative and quantitative thresholds, while the IASB uses "public accountability" and expressly excludes quantitative criteria. One disadvantage of quantitative criteria in that in an inflationary economy, quantitative criteria may require revision on a regular basis. The experiences of developed countries which already have quantitative criteria may prove useful to guide South Africa.

The threshold for differential reporting – are two tiers of financial reporting standards sufficient?

As a result of the Corporate Laws Amendment Act, public companies, which are mainly widely held companies, will continue to comply with IFRS, and private companies, mostly limited interest companies without public accountability, will comply with the *Statements of GAAP for SMEs.* Although a recent study (Stainbank and Wells, 2007) supports a private – public company differential threshold, the study found significant differences between the perceived applicability of IFRS to a big private company with users and all other entities examined. This may indicate that practicing accountants (the target group) perceive unique reporting requirements for big private companies that have users. The Stainbank and Wells (2007) study concluded that multiple differential corporate reporting thresholds each with their own reporting requirements may be the most comprehensive solution.

Currently SAICA are conducting a survey to establish if there is a need for a South African Micro GAAP framework as it believes that the ED of the proposed *IFRS for SMEs* has not gone far enough to satisfy the needs for small and micro businesses. This would support the contention of Stainbank and Wells (2007) that a single threshold for differential corporate reporting may not adequately address the South African differential corporate reporting needs.

The IASB indicated it used a 50 employee guideline when deciding on the content of the ED of the proposed *IFRS for SMEs* and that it considered the *IFRS for SMEs* suitable for entities with less than 50 employees. Furthermore, many jurisdictions require full IFRS for most companies, including micro entities (IASB, 2007b:19). The IASB therefore believe that more simplified financial statements would not meet the objective of decision-usefulness and would impede the SMEs' ability to attract capital (IASB, 2007b:20).

The question of whether the proposed *IFRS for SMEs* will be suitable for the smaller entities within the SME arena has been raised by Roberts and Sian (2006) in their paper entitled *Micro-entity Financial Reporting: Perspectives of Preparers and Users.* Roberts and Sian define a micro-entity as having less than 10 employees but concede that the definition needs to take into account both quantitative and qualitative factors. The ED of the proposed *IFRS for SMEs* indicates that an SME would have a "broad range of users" and that the financial statements of an SME should "also show the results of management's stewardship of the resources entrusted to it" (IASB, 2007a:para2.1). Roberts and Sian (2006) are of the opinion that in reality the users of micro-entity financial reports are probably only the owner, financial institutions and the tax authorities. Roberts and Sian (2006) are also concerned that the low level of literacy, lack of accounting education, and an absence of computerised accounting systems may further impair the ability of such entities to produce financial information in accordance with IFRS in less developed economies.

The future of close corporations

In South Africa, a legal entity known as a close corporation also exists. A proposal of the Companies Bill, 2007 is to repeal the Close Corporations Act, and provide arrangements whereby close corporations can convert into companies. As close corporations do not have to comply with SA GAAP but with GAAP relevant to their businesses, this proposal will cause those close corporations which convert to companies to become subject to the *Statements of GAAP for SMEs* if they are limited interest companies without public accountability. The number of entities in South Africa at 31 December 2006 is shown in Table 2.

Table 2
Number of entities in South Africa

Registered entities	Number	%	(% registered)
Close corporations	1 276 157	40.51	75.02
Private companies	412 233	13.09	24.23
Public companies	3 757	0.12	0.22
Incorporated companies (professional)	7 976	0.25	0.47
External companies	1 056	0.03	0.06
Total registered entities	1 701 179	54.00	100.00
Unregistered entities			
Informal economy	749 500	23.80	
Sole proprietorships	699 166	22.20	
Total enterprises in economy	3 149 845	100.00	

Source: DTI, 2007b

Table 2 shows that close corporations are the most common entity form in South Africa and thus the *Statements of GAAP for SMEs* will have the greatest impact on that entity form should the proposals of the Companies Bill, 2007 be implemented. Respondents to the SAICA (2006b) questionnaire felt that the introduction of a form of company that did not require an audit was unnecessary, as the close corporation model already catered for that possibility, and it was unnecessary to introduce a third tier. As the stated aim of the corporate law reform is to simplify the company entity structure, if close corporations can be accommodated in this simplified company structure, then a third tier of entity structure will become superfluous. However, in view of the large number of close corporations in South Africa, it is imperative that the members of this entity form be consulted.

Relaxation of audit requirement for limited interest companies

The relaxation of the audit requirement for limited interest companies will mean that smaller firms will need to refocus their business as many of their clients will no longer require an audit. This also affects the capacity of public practice firms to train new accountants (SAICA, 2006b). Respondents to the SAICA survey (2006b) were of the opinion that the new generation of Chartered Accountants (CAs) are not going to get the experience that CAs previously received as having trained in a small firm was better than training in a large firm. Smaller audit firms may also have some difficulty in meeting the requirement of the Independent Regulatory Board of Auditors (IRBA) that a trainee accountant must receive at least 40% of all training in auditing.

V. CONCLUDING REMARKS

This study has examined the development and implications of accounting standards for SMEs in South Africa. The simplification of the company entity structure is a priority for the South African corporate environment. Relief has been provided to limited interest companies without public accountability from preparing financial statements in compliance with full IFRSs. Future developments may see the abolition of the close corporation entity form in South Africa and the removal of the audit requirement for limited interest companies without public accountability. However, in view of the number of close corporations in South Africa, it is important that all stakeholders are consulted to ensure that any decisions are based on the correct information.

Research in South Africa has shown that a single threshold for differential corporate reporting may not adequately address the South African differential corporate reporting needs and that multiple thresholds each with their own reporting requirements may be the most comprehensive solution (Stainbank and Wells, 2007).

Currently, the IASB has embarked on a process of field testing the proposals of the *IFRS for SMEs.* The results of these field tests will provide evidence of the suitability of the proposed *IFRS for SMEs* to smaller entities and allow the identification of any aspects which may need modification

(IASB, 2007c:1). SAICA too has embarked on a questionnaire survey addressed to both owners of small and micro entities and small practitioners to assess the need for a South African Micro GAAP framework. This may provide further evidence on whether there is a need for a third tier of financial reporting standards.

Future developments on this topic from a South African and international perspective will continue to provide areas for debate and research. The efforts of the IASB in developing financial reporting standards for SMEs are commendable, but research is required to ensure that these developments are firmly placed within a theoretical framework which ensures that the needs of the users of SMEs' financial statements are met.

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