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Accounting for Small and Medium Sized Enterprises in Sweden

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Abstract

- Title** : Accounting for small and medium sized enterprises in Sweden
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- Problems** : The area of measurement principles is considered one of the most controversial aspects of the Exposure Draft for Small and Medium sized enterprises. Although fair value measurement has been mandated for some assets and liabilities under IFRS for SMEs, the issues of when fair value accounting is appropriate and when is not is still far from resolved. Generally, the effect of application of fair value accounting varies among different countries. Based on IASB's statement and Swedish economic and accounting environment, we find interesting to find out whether the fair value measurement principles in proposed IFRS for SMEs is suitable for companies in Sweden. The investigation will address specific questions about measurement simplifications that the board adopted on which the Exposure Draft seeks guidance.
- Purpose** : The main aim of this study is to examine the accounting measurement principles for SMEs under IFRS for SMEs and Swedish accounting standards. We are interested in finding out which measurement principles are suitable for small and medium sized enterprises in Sweden. Using Sweden as the case study, this paper offers data and useful information on the perceptions of internal users on accounting valuation issues and therefore has significant research implications for

standard setters and policy makers. The findings from this research could also offer implications on financial reporting issues to countries with similar economic and accounting environment

Methodology : As the nature of our thesis required direct contacts with our respondents and the fact that our subject considered as difficult for most people, we chose to use the *Strategic Approach*. This approach offered us with the possibility to work with a small number of respondents, which suited us well given the time limit of this thesis.

Based on the character of our thesis, to get an understanding rather than to calculate, we chose to build our research strategy on *qualitative interviewing*. Of several interview methods that Malcolm Smith (2003)¹ depicted, we applied the *semi-structured interview* which offers researcher to have a list of questions that cover a fairly specific topic.

Conclusions : Outgoing from the practical analysis, the conclusion can be drawn that historical cost accounting is more suitable for non public private entities than fair value accounting in Sweden. In addition, most SMEs do not have sufficient accounting knowledge and practices, and they do not have resources for preparing financial statements in compliance with IFRS for SMEs. However, the implementation of historical cost accounting is not without any problems due to difficulties in revenues and expenses matching. In many situations, historical prices become irrelevant in evaluating company's financial position.

Keywords : Fair value accounting, historical cost accounting, IFRS for SMEs, accounting measurement principles in Sweden, K2 regulations

¹ Smith, Malcolm, *Research Methods in accounting*, 2003

Abbreviation

BFN	the Swedish Accounting Standards Board (Bokföringsnämnden)
RR	Redovisningsrådet (The Financial Reporting Council)
ÅRL	Årsredovisningslagen (The Accounting Act)
SMEs	small and medium-sized enterprises
FAR	föreningen för revisionsbyråbranschen (The Swedish Institute for Authorised Public Accountants)
IASB	the International Accounting Standard Board
IAS	the International Accounting Standard
IFRS	International Financial Reporting Standard
ED-IFRS for SMEs	Exposure Draft of International Financial Report Standards for Small and medium-sized enterprises

Table of Contents

1 <i>Introduction</i>.....	7
1.1 Background.....	7
1.2 Differential reporting.....	9
1.3 Problem statement and research questions	12
1.4 Aims of the study	14
1.5 Limitation	14
1.6 Thesis structure	15
2 <i>Methodology</i>.....	17
2.1 Theoretical perspective.....	17
2.1.1 The approach.....	17
2.1.2 The method.....	17
2.1.3 Interviewing in qualitative research.....	19
2.1.4 Comparative aspects of accounting	19
2.2 The procedure	20
2.3 The Interviews	22
2.4 Reliability	22
2.5 Validity	23
3 <i>Theories, policies and institutional arrangements</i>.....	24
3.1 Small and medium sized entities (SMEs).....	24
3.1.1 Definition and characteristics of SMEs	24
3.1.2 Users of SMEs Financial statements	25
3.1.3 Usefulness of SMEs financial statements	27
3.2 Historical Cost Accounting	30
3.2.1 Definition of Historical Cost Accounting	30
3.2.2 Advantages of historical cost accounting	32
3.2.3 Disadvantages of historical cost accounting	33
3.3 Fair value accounting	35
3.3.1 Fair value: Definition and estimation	35
3.3.2 Benefits of fair value accounting	38
3.3.3 Drawbacks of fair value accounting	42
3.4 IFRS for SMEs.....	48
3.4.1 Scope of IFRS for SMEs.....	48

3.4.2	Objective of financial statements of SMEs.....	49
3.4.3	Financial position	49
3.4.4	Recognition of the elements of financial statements	50
3.4.5	Measurement of the elements of financial statements.....	50
3.4.6	Measurement principles.....	51
3.4.7	Measurement at initial recognition	51
3.4.8	Subsequent measurement.....	51
3.5	Accounting Environment in Sweden.....	52
3.6	Swedish True and Fair View	54
3.7	Swedish K2 accounting standards.....	54
3.7.1	Precautionary principle	55
3.7.2	Preparing annual reports according to K2.....	55
4	<i>Empirical Findings and Analysis</i>	57
4.1	Background of the enterprises and the interviewees.....	57
4.2	Users of SMEs' financial reports.....	58
4.3	Usefulness of SMEs' financial reports.....	59
4.4	Measurements for Accounting Subjects.....	61
4.5	Summary.....	65
5	<i>Conclusions</i>	66
6	<i>Suggestions for future studies</i>	69

1 Introduction

In this chapter we outlined the background of our study and our research question. Furthermore, a guideline of the objectives for this study will be provided.

1.1 Background

The extent to which the recent financial crisis prevails is determined by among others Small and Medium-sized enterprises (SMEs) as the backbone of the economy where the job opportunities are created (Nordmark Nilsson, Företagarna, 2009). It was estimated in 2008 that, in Sweden, where there are 965 987 business enterprises, a majority of 99.7% are considered to be private entities (generally referred to as small and medium-sized entities) and have fewer than 250 employees (Business Register, 2008). Within the European Community micro, small and medium-sized enterprises represent 99 % of all enterprises, while then constitute 65% of employment in the private non-primary sector (European Commission Enterprise and Industry, 2009).

Unfortunately under certain circumstances, people tend to overlook the importance of SME. As when the Swedish government announced its spring budget on April 16th 2009, there was no space in the budget to stimulate SME (Sydsvenskan Dagbladet, 2009). However Small and medium-sized enterprises (SMEs) are potentially the most dynamic sector of the global business economy and represent the majority of entities preparing financial reporting in all countries. SMEs have also been an important focus of government policies everywhere.

In recent years, the development of financial reporting has been rapid and designed primarily to achieve harmonization and reduce differences between the financial statements of public listed and multinational corporations (Wittsiepe, 2008). The question about whether or not accounting standards should apply equally for all

entities that do not have public accountability and publish general-purpose financial statements for external users has been the subject of much debate and concern in many countries. Motivated by a concern that “Small and Medium- sized enterprise regulations, if left to other regulators, might not be consistent with IFRS or the IASB’s Framework and it might not be best suited to meet user needs and ensure international comparability”, the IASB has taken a major role in attempting to harmonize financial statements of private enterprises (Jarvis et al, 2008, page 28).

In February 15th, 2007 the IASB introduced an Exposure Draft: “International Financial Reporting Standards for Small and Medium-sized entities” with an intention to develop a set of financial reporting standards that are suitable to entities which do not have public accountability and publish general purpose financial statement for external users (IASB, 2007). The objective of the proposed standards is to provide a simplified, self-contained set of accounting standards derived from the full IFRS to be used by private, non-listed companies (Epstein et al, 2007). In May 2008 the name of the standard was changed to IFRS for Private Entities. The IASB changed the name of the standards again to IFRS for Non-publicly Accountable Entities, NPAEs (IASB, 2007). Currently the Board is undertaking re-deliberation of the proposals in the Exposure Draft for SMEs.

The Exposure Draft for SMEs addresses three important aspects of accounting systems including disclosure requirements, presentation of financial report and recognition and measurement principles. The area of measurement principles is considered one of the most controversial aspects of the Draft standards (Epstein et al, 2007). Over the years, there has been considerable debate on whether fair value measurement should be applied for the financial reporting of listed companies rather than historical cost. Theoretical research on fair value measurement so far has been mostly limited to financial instruments, notably the relevance of fair value as an accounting measurement attribute (Hitz, J.M., 2007)

The ED- IFRS for SMEs proposed simplifications to the measurement principles included in the full IFRS with the aim to provide relief for SMEs, in particular small one. The IASB advocates fair value measurement on the ground of relevance, but the measurement simplifications of the ED- IFRS for SMEs are generally considered as very minor (Jarvis et al, 2008). Financial instruments satisfying specific criteria are measured at amortized cost less impairment, other financial instruments are measured at fair value through profit or loss (IFRS for SMEs, 2007). Only two categories of financial assets are provided, the available-for-sale and held-to-maturity classifications in IAS 39 are not available. For some non-financial assets, the draft permits or requires subsequent measurement at fair value such as investment property that an entity measures at fair value, or investment in associates and joint ventures that an entity measures at fair value (IFRS for SMEs, 2007). The ED-IFRS for SME specifies the conditions which have to be met before instruments (receivables, payables or loans) may be measured at amortized cost (Jarvis et al, 2008).

1.2 Differential reporting

Although fair value measurement has been mandated for some assets and liabilities under IFRS for SMEs, the issues of when fair value accounting is appropriate and when is not is still far from resolved (Penman, S.H., 2007). Generally, the effect of application of fair value accounting varies among different countries. So far there is lack of empirical research on the costs and benefits of statutory accounting requirements including measurement principles. Moreover, previous studies do not address the specific questions raised by the board as to whether there are specific measurement problems for SMEs under IFRS (Jarvis, 2008).

Meeting statutory accounting requirements is not without cost for the companies, such as direct costs for collecting and processing financial information, and associated opportunity costs for use of limited resources as well as indirect costs resulting from disclosing information to competitors (Carsberg et al., 1985).

Costs and benefits arising from statutory accounting requirements including measurement principles are not the same for all companies in each country. Financial reporting is intended to inform users and protect those dealing with business enterprises, but not all entities face the same audience and principal-agent relationship may differ among business enterprises. For example, smaller entities are quite often managed by their owners, and the number of external users of financial statements is usually very limited. Therefore, the degree of outside interest in financial reporting information and the demand for publicly available financial reporting information differs among different companies. (Murray and Johnson, 1983) Finally, the benefits for the users of financial information may not be the same in all enterprises, and may differ regarding different ownership structure, company size, and the organizational complexity of a company. (Eierle, 2008) Moreover, costs raised from providing financial reporting information to the public may also vary among enterprises. Small firms may incur higher costs for providing financial information than their larger counterparts, because they are not able to benefit from economies of scale, unlike larger enterprises. (Hossain et al., 1995)

Require all firms to apply with the same financial reporting standards may impose a disproportionate burden on some enterprises. Thus, the smaller the user groups of a company's financial statements, the greater their ability to gain access to information in addition to which included in financial statements, the greater the likelihood that the costs of providing accounting information in financial statements will outweigh the result benefits. (Canadian Institute of Chartered Accountants, 2002) Additional arguments for differential reporting are that, small companies have narrower user groups, financial information is useful for a narrower range of decision makings, less complex transactions and less need for sophisticated analysis of highly aggregated information (Collis et al., 2001).

As can be seen from the discussion, cost/benefit trade-offs may be perceived differently among different enterprises, and there are arguments both for and against

differential financial reporting. However, due to the problems involved in identifying and measuring the costs imposed on business derived from statutory accounting requirements, and the benefits of publicly available financial statements for the users, regulatory decisions based on cost/benefit considerations are usually not capable of precise resolution. (McCahey and Ramsay, 1989) Differential reporting frameworks are finally the result of conventions, which are in turn strongly influenced by the socio-economic environment as well as prevailing political objectives, priorities and convictions. (Eierle, 2008 a)

Therefore, environmental factors, particularly culture, have been considered to have an essential influence on a country's financial reporting system and practice (Hofstede, 2001) However, if one accepts cultural influence on a country's financial reporting system and practice, it follows that in a more general sense, cultural values will impact perceived costs/benefits trade-offs of firms and regulators, and therefore also influence national regulations on accounting requirements and accounting practice of business entities. Thus, different accounting patterns for business enterprises should be revealed for countries ranking differently according to different cultural values. (Eierle, 2008 a) The larger the business, the more likelihood the management will want formal rather than informal information systems to help them plan, monitor and control the activities of the enterprises (Perera et al., 1990).

By contrast, Wittsiepe Richard argues that financial accounting and reporting is locally oriented and do not meet international information requirements, therefore, it must be adjusted substantially. This adjustment process is not only a mere translation of a financial report from one language to another language or a currency conversion, but also requires an adjustment and restatement to reflect different accounting standards. However, there are some problems derived from restatement, such as they are typically performed on summary data instead of restating all individual transactions because it is usually too costly and time consuming. Thus, restatements usually include some degree of statistical bias and may lead to problems with

information content. Besides, if accounting numbers are measured and stated differently, financial ratios calculation based on this data are not comparable from one country to another. (Wittsiepe, 2008)

1.3 Problem statement and research questions

In most countries, non-listed private companies have to prepare its financial reports according to a required set of accounting principles or local General Accepted Accounting Principles in that country. There is an on-going controversy on measurement principles adopted for small and medium sized companies. The debate has focused on whether, when and how fair value measurement should be applied to small and medium sized companies' financial reports.

Accounting in Sweden has experienced major improvements since harmonization in accounting rules and norms within EU has become one of the main purposes (Justitiedepartementet, 2006). In Sweden, the basic idea of the Swedish accounting legislation is that all companies should apply one and the same accounting principle. The Swedish Accounting Standards Board (Bokföringsnämnden or BFN) is the authority responsible for issuing accounting standards for non-listed public companies in Sweden. In 1998, the Swedish Accounting Board (BFN) decided to change this basic rule and started a project known as the K project. In response to IASB questionnaire on the issue of should IASB develop accounting standard for SMEs, BFN defined its accounting regulation framework, and categorized firms in four divisions K1, K2, K3 and K4. Each category of firms will apply different sets of accounting rules according to respective sizes. The aim of the new regulation is to offer firms with different prerequisite regulations that fit their needs.

K1 is the regulation for the smallest firms. It offers simplified annual report and started to be in use since 2007. K2 is purposed to serve unlisted firms which meet following criteria; total assets during two latest years are not exceeding 25 million

SEK, the average numbers of employees for the last two years are not exceeding 50 persons and reported net sales during the last two years are not exceeding 50 million SEK.(ÅRL 1:3). K3 is still under development but the idea is to replace RR 1-29 (Accounting Standards Council) and BFN recent norms. K3 regulation will be adaptable internationally. K4 contains special regulation for firms drawing up consolidated annual report in accordance with IFRS. It is fully allowed for firms to apply higher level regulatory but not from a lower category than the firm's position.

Sweden has developed its own accounting system and regulations that is quite different with ED-IFRS for SMEs in all aspects. Under the K2 accounting standard issued by Swedish General Council in December 2008 for the preparation of the annual reports of Swedish smaller limited liability companies, historical cost measurement is applied in majority with some exceptions using fair value. (K2, 2008).

Although fair value measurement has been mandated for some assets and liabilities under IFRS for SMEs, the issues of when fair value accounting is appropriate and when is not is still far from resolved (Penman, S.H., 2007). Generally, the effect of application of fair value accounting is varies among different countries. However, previous studies do not address the specific questions raised by the board as to whether there are specific measurement problems for SMEs under IFRS (Jarvis 2008). Based on IASB's statement and Swedish economic and accounting environment, we find interesting to find out whether the fair value measurement principles in proposed IFRS for SMEs be suitable for companies in Sweden. This fact has brought us to formulate the following question:

Which measurement principles are suitable for SMEs in Sweden? K2 with historical cost, or IFRS for SMEs with fair value?

The focus of this thesis is to find out whether the fair value measurement principles in proposed IFRS for SMEs is suitable for companies in Sweden. The investigation will address specific questions about measurement simplifications that the board adopted on which the ED seeks guidance.

1.4 Aims of the study

The main aim of this study is to examine the accounting measurement principles for SMEs under IFRS for SMEs and Swedish accounting standards. We are interested in finding out which measurement principles are suitable for small and medium sized enterprises in Sweden. The thesis will outline the problems and obstacles that might occurred when implementing fair value accounting for SMEs in Sweden. We wish to contribute fellow students, firms and those interested in this subject with our investigation. The study would create a better understanding of Small Medium Size Entities' need in terms of accounting measurement principles. And to examine how the IASB attempts to address this problem in the solution of a new accounting standard for small and medium size entities. Using Sweden as the case study, this paper offers data and useful information on the perceptions of internal users on accounting valuation issues and therefore has significant research implications for standard setters and policy makers. The findings from this research could also offer implications on financial reporting issues to countries with similar economic and accounting environment.

1.5 Limitation

There are several limitations that have been applied in this paper and these limitations are:

- As IASB have divided companies to two main categories namely unlisted and listed companies, therefore the literature review in this paper will only discuss

the need in term of accounting treatment for small and medium sized entities in general. It will not focus on the need of SMEs based on BFN categories such as K1-K4.

- Under the empirical data section, the focus is based on non-listed companies categorized as K2 because K2 project has been applied since December 2008. As Swedish K project is still in the development process, therefore, it is not viable to establish the interviewees' point of view based purely on speculation concerning Swedish K1, K3 and K4.
- This thesis will examine and discuss the accounting measurement principles under IFRS for SMEs and K2 regulations. It will not discuss any other specific items or accounting treatments on financial statements.

1.6. Thesis structure

Chapter 1 Introduction

This chapter discusses problem background and research questions in this thesis. It also provides guideline of the objectives for this study.

Chapter 2 Methodology

This chapter will describe and clarify the approach and method that was used in this study. It will describe the steps on how this thesis plans to answer its central research question. Further, it explains the theoretical perspective, research strategy and approach and data collection.

Chapter 3: Theories, policies and institutional arrangement

This chapter presents definition and characteristics of SMEs, users and usefulness of SMEs' financial statements, advantages and disadvantages of historical cost accounting, benefits and drawbacks of fair value accounting, IFRS for SMEs, Swedish K2 standards and accounting environment in Sweden.

Chapter 4: Empirical findings and Analysis

This chapter examines which accounting measurement principles are suitable for SMEs in Sweden. We collect data from face to face interviews with the staff in Swedish SMEs. After collecting the data, the empirical findings are analyzed by combining the theories in the literature part.

Chapter 5: Conclusion

This chapter summarizes pros and cons of different measurement principles for SMEs, and looks back at the research problem and the objectives stated at the beginning of this paper, and answer the research questions.

Chapter 6: Suggestion for future studies

This chapter provides suggestions for further studies of accounting for SMEs in Sweden.

2 Methodology

This chapter is dedicated to describe the method and approach we used in our research. The steps on how we planned our work to find an answer to our central question will be described. Further we will explain the theoretical perspective, research strategy and approach and our data collection.

2.1 Theoretical perspective

The aim of our study is to investigate the measurement principles that are suitable for Swedish SMEs; whether the accounting principle historical cost as the new regulation K2 represents or IFRS for SMEs with fair value principle. In order to find the answer, we decided to apply certain approach and strategy.

2.1.1 The approach

As the nature of our thesis required direct contacts with our respondents and the fact that our subject considered as difficult for most people, we chose to use the *Strategic Approach*. For most of our respondents, knowledge in accounting is not the main business focus. That was why we decided that the direct contact considered crucial, as we must explain certain terms in accounting such as fair value principle and historical cost accounting to our respondents. The respondents were mainly firms that we already had contact with, both commercially and privately.

By using this approach, we explored the field of our study to get as many aspects as possible. This approach also offered us with the possibility to work with a small number of respondents, which suited us well given the time limit of this thesis.

2.1.2 The method

Two different methods in doing research are very widely popular; qualitative and quantitative. One can easily find the difference between the methods in method literatures. Most of the authors use a similar viewpoint when reviewing the methods. Holme and Solvang (2007) stated that the difference between the methods lies in the extent to which numbers and statistics influence and being use in the research. In the quantitative method, numerical information is crucial to conduct the statistical analysis. The quantitative method is formalized and standardized with more general information as follow. The benefit of this method is the high level of reliability from the outcome. On the other hand, the qualitative method serves a deeper understanding of the research field and to describe the overall picture of the context of the study (Holme & Solvang, 1997). The qualitative method offers a high level of validity.

In the same way Bryman & Bell (2006) spotted the difference between qualitative and quantitative methods. The qualitative method puts a great deal emphasis on interviewees' point of view, whereas the qualitative research method described as to rely on words rather than quantifying data. In this way, the qualitative methods can also be constructed as research strategy. Furthermore, Bryman & Bell (2006) point out important characters regarding the qualitative research:

- It predominantly emphasizes an inductive approach to the relationship between theory and research, in which the emphasis is placed on the generation of theories;
- It rejects the practices and norms of the natural science model and how people interpret their social world individually

Based on the character of our thesis, to get an understanding rather than to calculate, we chose to build our research strategy on *qualitative interviewing*.

We followed the main steps in qualitative research that outlined by Bryman & Bell in figure 1 below.

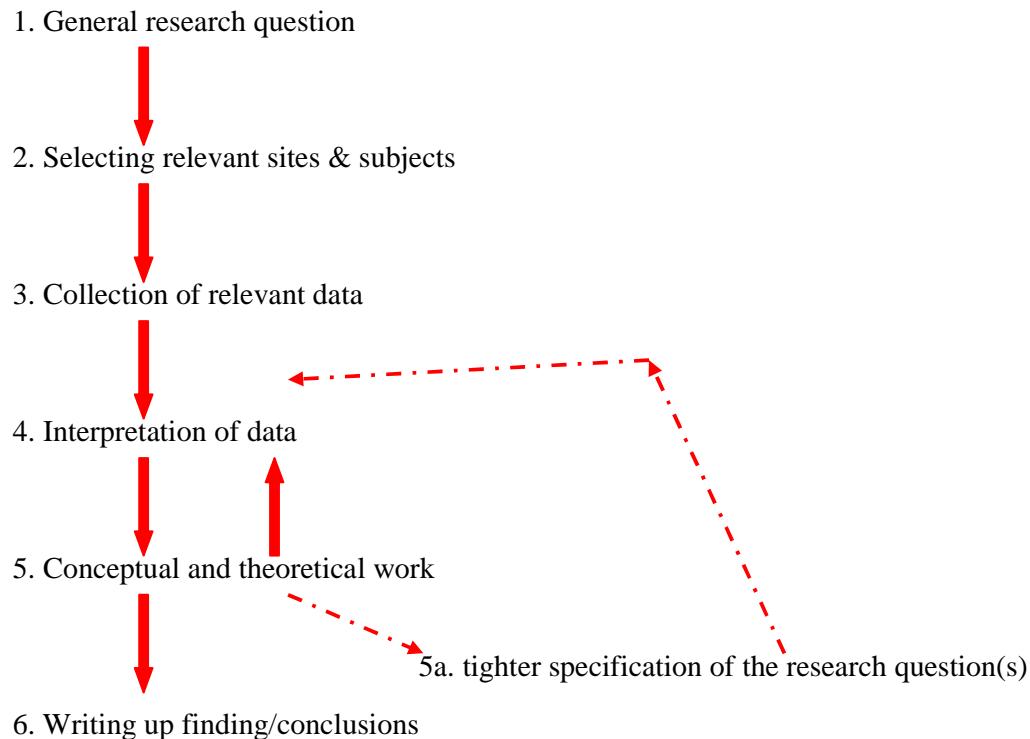


Figure 1 – An outline of the main steps of qualitative

2.1.3 Interviewing in qualitative research

Of several interview methods that Malcolm Smith (2003) depicted, we applied the *semi-structured interview*. Structured interview uses same questions in a same order with same cues and prompts permitted and all within a specific, closed-questions framework. In the contrary, the semi-structured interview offers researcher to have a list of questions that cover a fairly specific topic. The role of the question list is as an interview guide and the interviewee has a great deal of freedom to choose how to reply the questions. The questions may not follow on exactly in the way outlined on the schedule. In other words, the semi-structured interview is flexible.

2.1.4 Comparative aspects of accounting

Accounting is a technology which is practiced within varying political, economic and social context. (Nobes & Parker, 2006) The accounting development history showed us that certain countries/region had strong influence to its surroundings, mostly because the countries have made important contributions to the accounting development. Thus it is appropriate to use a comparative approach to study this topic as these three arguments stated:

- A comparative approach serves as reminder that the US and other Anglo-Saxon countries are not the only contributors to accounting as it is practiced today.
- A comparative approach demonstrates that the preparers, users and regulators of financial reports in different countries can learn from each others' ideas and experiences.
- A comparative approach explains why the international harmonization of accounting has been desirable but has proved difficult to achieve.

Our thesis used previous studies from Germany and Great Britain as comparative references. The accounting principle in Sweden and Germany follows the same basic principle and influenced by the continental style, whereas the UK is Anglo-Saxon based accounting. Although it is not our main purpose, we still think that by using previous studies from UK and Germany with different accounting principle may provide us with broader understanding. After all, we are not going to compare the studies. We are rather interested in seeing the great picture and see the facts from different angles.

2.2 The procedure

As we mentioned above, our study followed the procedure that Bryman & Bell described as the main steps of the qualitative research.

Step 1: Determine the general question of our research

Our main research question is which measurement principles that are suitable for Swedish SMEs.

Step 2: Select relevant sites and subjects

The relevant subject for our study is the Swedish accounting standard regulation for Small and Medium enterprises. Our focus is on small firms within different branch to get a broader understanding. We took a deeper look at the general standard by BFN and the new simplified regulation K2 which represent the historical cost accounting principle.

Step 3: Collection of relevant data

We used two data sources in order to collect the necessary information, namely primary sources and secondary sources. As our main empirical data, the primary sources provided us data in the form of answers, which based on their perception and knowledge of the subject. Our sources consist of an accountant firm, a dental clinic and a chocolate chain-shop.

The secondary sources here were the accounting theories, general praxis and K2. With a set of secondary sources in our hands, we were able to generate information from previous studies (as in the Germany study) and other relevant information. We collect our secondary sources from accessible scientific articles, courses literatures and also from electronic resources such as the official homepages of the IASB and the Swedish Accounting standard Board (BFN).

Step 4: Interpretation of data

After we got the data, both from primary and secondary sources, we analyze and interpret the information. Here we found interesting points from the data that we would like to look further.

Step 5: Conceptual and theoretical work

After interviewing three Swedish SMEs regarding two accounting measurements -historical cost and fair value, we analyzed the empirical findings by combining with the theories, policies and institutions arrangement.

Step 6: Writing up finding/conclusions

The final step is to conclude the analysis.

2.3 The Interviews

Holme & Solvang (1997) predicted a potential redundancy following the close contact between us and our respondents may create pre-determined expectations where the interviewee answers as he/she thinks it is expected by the interviewer. But in our study this problem has been avoided by the nature of our thesis. Although we had had direct contacts with our primary sources, mainly in the respondents' workplace, we know that the validity of the answers is quite high. We sent the list of questions in advance by dropping it by and we let the respondent to take a look at the questions. We explained some terms that they did not understand and at the same time we booked time for further interview. Most of them did not know which accounting standard they used, so they need some time to check it with their accountant. Within a week, we came back to collect the answers.

The interview questions are about the users and usefulness of SMEs' financial reporting, and which accounting principles SMEs prefer.

2.4 Reliability

Reliability and Validity are very important aspects to produce a trustworthy thesis. Patel & Davidson (2004) explained how a high level of reliability is crucial, which means that the study has to be done in a reliable way. As we explained in

methodology section, a qualitative method does not serve a high level of reliability. Thus one must augment the study as much as it allows.

2.5 Validity

Validity categorized into external and internal validity. Lundahl and Skärvad (1999) explained that internal validity is when the measures work properly. External validity is about achieving a match between the answers of our questioners and our presentation of the problem. High external validity required that we got the right study objects to best answer our questions. In our case, all of the interviewee own small firms and their role in the respective firm were as the owner, employee and manager. They are also in charge of the firms' day-to-day economic.

2.6 Criticism of our methodology

Because of the time limitation and the lack of possibility to get in touch with more companies that are willing to spend some time to help us, we are aware that our interview results cannot serve as our main tools as we wanted. To avoid generalizing the results, we decided to use our literatures not only as complementary sources. Instead, we will use the literature as much as it needed, with the interview results as our main focus. All of the articles are mainly from well-known and reputable published accounting journal, as well as study literatures used in Lund's University. In Chapter 3 we collected all relevance information regarding the theories, policies and institutional arrangement in accounting that will support our study.

3 Theories, policies and institutional arrangements

This chapter describes the theories, policies and institutional arrangements we used in our study, which includes definition and characteristics of SMEs, users and usefulness of SMEs' financial statements, advantages and disadvantages of historical cost accounting, benefits and drawbacks of fair value for small and medium sized enterprises in particular, IFRS for SMEs, Swedish K2 standards and accounting environment in Sweden.

3.1 Small and medium sized entities (SMEs)

3.1.1 Definition and characteristics of SMEs

SMEs have grown significantly over decades and have an important role in the financial and social development of modern societies. Different countries use different definitions and criteria to describe SMEs, mostly using parameters of the quantitative method, for example, receivable total, number of employees, etc. Those characteristics strongly depend on specific factors such as the socio- economic context of a country, business sector or industry development, institutional and historic conditions (Mantzari et al, 2008). Within the European Community, SMEs are defined as all enterprises employing less than 250 employees. Within SMEs, micro enterprises having a headcount of less than 10, and a turnover or balance sheet total of not more than 2 million euro. Small enterprises having a headcount of less than 50, and a turnover not more than 50 million euro or a balance sheet total not more than 43 million euro (Recommendation 2003/361/EC, published in OJ L 124 of 20.5.2003, p36). However, a typical 50 employee small enterprise that falls within the scope of the EC Recommendation may have different characteristics and needs from a typical entity in Sweden, where the majority of business are micro (European Investment Fund, 2007). These different characteristics may lead to the development of international standards which either are onerous and beyond the source of Swedish

small and medium-sized enterprises or would refer to a very limited number of entities.

In 2007, moving from the use of quantitative variables, the IASB has adopted the public accountability criterion in order to define SMEs in the exposure draft of the IFRS for SMEs (now known as the IFRS for private entities). Accordingly, SMEs are entities that do not have public accountability and publish general purpose financial statements for external users (ED- IFRS for SMEs, 1.1). A non-publicly accountable entity is defined as an entity (1) whose shares are not publicly traded, (2) that is not a financial institution or an essential public service,(3) that is not economically significant in its own country (ED-IFRS for SMEs, 1.2). The IASB leaves this definition to the national regulators to adjust more precisely using size criteria.

3.1.2 Users of SMEs Financial statements

While there is clear that the primary users of public listed entities are shareholders, there is uncertainty regarding the primary users and usefulness of SMEs' financial statements. As there are no statutory requirements for public disclosure for SMEs' financial reports, the number of users of SMEs' financial statements is recognized to be limited (Chittenden et al, 1990)

It is clear from the Exposure draft of IFRS for SMEs that the IASB intend to provide high quality, transparent and comparable information for investors' economic decision-making. The Exposure Draft of IFRS for SMEs gives examples of external users as "owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies" (ED IFRS for SME, 1.1). However, academic literature identifies key users of the financial statements of SMEs as banks, directors (owner-managers and non-owner-managers) and tax authorities (Flower, 2004, Eirle, 2008, etc). With the close link between commercial accounting and tax accounting in Sweden (Artsberg, 1996), the main user of SMEs financial statements are owners, tax authority, banks and entities' managements. German SMEs conceive

owners, banks, entities' management and the tax authority as the main users of their financial statements. Customers, vendors, credit rating agencies, employees and potential investors are less important users, even though IASB views them as main external users. (Eierle, 2008 , BC55, Preface 7 and 1.1b of ED-IFRS for SMEs)

The majority of small companies in UK are owned and controlled by the same individuals (Poutziouris, Chittenden and Michaelas, 1998). The directors of small companies are not merely managers, but also the major investors of the firm, therefore, there is seldom any divorce between ownership and control, and the directors of small enterprises might more accurately be referred to as 'owner-managers'. (Bolton, 1971) Most small enterprises are managed by their owners and there is seldom any divorce between ownership and control. But although the directors control the operations in small companies, they have little knowledge about accounting. (Page, 1984).

The main user groups of SMEs' financial statements identified by the UK literature are the managers, providers of loan finance, trade creditors and the Inland Revenue and, in certain instances, employees and venture capital providers. (Collis & Jarvis, 2000) Banks use SMEs' financial information for lending purposes and monitoring the loan agreement. The manager/owner uses the financial reports for planning, control and decision-making (Jarvis, 1996). Besides, the empirical evidences on the uses of SMEs' accounts indicate that SMEs' financial reports are often used as the basis for tax preparation, banking covenants and other reporting requirements (Collis et al., 2001) Moreover, Cosh and Hughes said that the majority of companies send a copy of their statutory accounts to the banks, because banks are the main finance providers for small entities (Cosh and Hughes, 1998). In addition, in Barker and Noonan' research, they found that the owner-managers are the main users of the annual accounts (Barker and Noonan, 1996). Finally, Page argued that the main users of the annual accounts are the management, followed by the banks and other lenders. (Page, 1984)

3.1.3 Usefulness of SMEs financial statements

SMEs and large public companies have different financial reporting needs. SMEs have shorter term assets than liabilities, and depend much on bank loans and equity, and short-term creditors. Users of SMEs financial statements need information on profitability, future prospects, and the quality of management in order to assess SMEs ‘credit rating and their ability to pay their loans (ICAS, 1998). Empirical research shows that the managers- owners use the financial statements of SMEs for controlling, planning and decision- making (Jarvis 2003). The financial reports provide a clear picture of financial position for the management. Information provided in the financial statements of SMEs are also influential in decisions about dividend payouts, directors’ compensation, budget and capital expenditure (Keasy & Short, 1990). However, when compared with other available sources of management information such as management accounts, budgets and bank statements, the financial reporting undertaken by SMEs are not proved to be very useful (Collis et al, 2001).

Management of a SME is often held by several individuals. Such managers are familiar with most aspects of the business and can obtain any source of information for management purpose. Unlike external users, managements therefore are not dependent upon information in statutory financial statement. (Eirle, 2008). Studies suggest that for small companies, the three most useful sources of information for management are the management accounts for the period, the annual reports and accounts, and cash flow information. For medium-sized companies, they are the management accounts for the period, cash flow information, and budget (Dugdale et al, 1998). The weak role of SMEs financial statement is probably due to the lack of emphasis on the provision of timely and relevant information to managers for the purposes of sound financial management. (McMahon et al, 1994)

Since SMEs do not act on capital market and many of these companies are not exposed to market demands in a comparable manner as their counterparts in large

businesses, banks and other short-term creditors are perceived as the main source of finance for small and medium sized companies (Chittenden et al, 1990). It is found that the main uses of financial statements of SMEs by banks and creditors are to determine SMEs' capacity to repay, to make lending decisions and to assess profitability, security and liquidity.

Moreover, empirical evidence reveals that the separate financial statements of SMEs are high significant for the computation of income taxes in certain countries.(Mantzaris et al, 2008) The connection between financial and tax accounting has a long tradition in many countries for a long time. With the goal is often to minimize taxation payable, SMEs' historical financial reporting have a heavy emphasis on annual statements to satisfy tax authorities and other statutory reporting requirements (Holmes et al, 2003). The research suggests that the major use of SME financial statements by the tax authorities includes (1) determining gross profit, (2)evaluating directors' fees, tax provisions, (3) ensuring that expenses are reasonable and (4) checking for clean audit report (Lungu C et al, 2007).

Germany

IASC focuses on general purpose financial statements for external users, and does not consider the information needs of owner-managers and tax authorities in their costs/benefits considerations. However, empirical research shows that information for owner-managers and for calculating taxable income is the major usefulness of financial statements in German SMEs. A considerable number of SMEs have material cross-border business activities in terms of export/import goods and services as well as investments in foreign subsidiaries, but they seldom get finance from foreign borrowings, which influences on the attitude of the enterprises concerning their need to provide internationally comparable financial information, and most of them think international accounting standards is not very useful for them. (Eierle, 2008)

Concerning external information needs, German SMEs view the following rules are useful for them: revaluation of property, plant and equipment if a market value is available, the specific treatment of assets held for sale under IFRS for SMEs, the percentage of completion method to account for construction contracts, and the capitalization of development costs. However, at the same time, the costs increase when apply these rules. Moreover, concerning disclosures required by IFRS for SMEs, German SMEs assess information about transactions with related persons (such as key managers or owners) and information on the cost of a business combination is useful. Besides, the separate disclosure of assets held for sale, as well as the information required to be given when the percentage of completion method is applied, are viewed as more useful than the treatments under German GAAP. Further, if a precise market value is not exist, the revaluation option in the accounting standards is not useful in German SMEs' opinions. (Eierle, 2008 b)

United Kingdom

In UK, the statutory accounts of small companies are not viewed to be useful in comparison with other sources of information that might be available for management purpose, since financial reports are designed to provide information that is useful to a wide range of users and have been developed from a large company perspective where investors' needs are paramount (Collis and Jarvis, 2000). The most useful sources of information for management are the periodic management accounts, cash flow information, bank statements and budgets; in contrast, published industry data, credit rating agency data and the statutory accounts are not viewed to be useful, although they are used by the majority of companies. And the most useful purpose of the annual accounts is to decide directors' remuneration, comparing performance with previous periods and in connection with loans/finance. (Collis and Jarvis, 2002) The directors of small companies consider the main benefits of financial reports are the confirmation and verification of the annual financial results, by contrast, the main

disadvantage of financial reporting is the cost, in monetary terms as well as in terms of time and inconvenience. (Collis, 2008)

Financial statements are multipurpose documents and they serve different functions for different groups of people. Private companies cannot offer their shares to the public and are usually owner-managed. And the private firms whose directors send their accounts to the bank are those who consider the statutory accounts are useful for management purposes.(Carsberg et al, 1985) The majority of small companies considered the annual accounts are useful in managing the business and obtaining credit facilities. (Keasey and Short, 1990) The most common uses of their accounts were to inform the Inland Revenue and the executive directors, and to provide the company's bank with information. (Pratten, 1998)

3.2 Historical Cost Accounting

3.2.1 Definition of Historical Cost Accounting

One of the most debated topics in accounting is valuation principle; whether assets and liabilities should be evaluated and accounted at its historical value or fair value. This section will discuss about Historical Cost Accounting principle; the misinterpretation, anomalies and benefits. The next section will be dedicated to fair value principle.

Historical cost accounting is an accounting principle where the most assets and liabilities of a business is valued for balance sheet purposes on the basis of their original acquisition cost. Some of the assets and liabilities are subject to write-offs in the form of amortization or depreciation (Powers, 1991). To handle the drawbacks of this accounting principle, the authoritative bodies within accounting profession created standards that comprise generally accepted accounting principle, well known as GAAP. Several possible measurement attributes for both assets and liabilities also

acknowledged by the Financial Accounting Standard Board (FASB) in its statement 1984.

Penman (2007) mentioned how historical cost accounting often misinterpreted in debates. The criticism is that this principle reports a balance sheet with old, historical costs rather than current value. In short the principle means that value generated by purchasing inputs, transforming it into a product and selling the output (product) to the customers over cost.

This also means that firms gain their value by arbitraging input and output market s for goods and services. The problem is that this principle does not provide the present value of expected outcome from the whole consequent activities. The main focus lies on the progress of executing the plan and recognizing the value added from the arbitrage (output minus input). This value recognition can be seen in the income statement with a matching of revenues with costs. With this prerequisite, the balance sheet is a by-product of the matching. Given the definition and meaning of historical cost principle, Penman stated that the term historical cost accounting is pejorative. The essence of this principle is that the accounting reports a history of transactions, and it is that history of engaging with markets from which valuations are made and management performance evaluated.

Some remarkable characters about historical cost accounting are as follows (Penman, 2007):

- Under historical cost accounting, information to shareholder is presented primarily in the income statement, whereas the fair value accounting using balance sheet as its primary conveyor
- Under historical cost accounting, earnings show how well the firm performed from its arbitrage activity (Output price minus input costs). In the contrary,

earning is a measure of the risk of the equity investment. Volatility is informative for risk assessment.

- Under historical cost accounting, current income forecasts future income on which a valuation can be made.
- Under historical cost accounting, earnings report shocks to trading in input and output markets.
- Under historical cost accounting, the P/E ratio is calculated by taking current earnings as a base and multiplies it according to the forecast of future earnings. The book value of equity typically does not report the value of equity.
- Under historical cost accounting, earning measure the stewardship of management in arbitraging input and output market, while for fair value accounting income reports the stewardship of management in adding value for shareholder.

3.2.2. Advantages of historical cost accounting

Due to its unique features and conventions, the historical cost accounting method is the standard form of accounting that has been widely recognized and accepted by many corporations all over the world.

The historical cost accounting system plays an important role in providing necessary and reliable information for managers to forecast future operational costs (Thompson, 2007). The basic function of historical cost accounting is to tell the user the acquisition cost of an asset and its depreciation in the following years. It does not provide information about the current market value of the asset. As historical cost accounting technique is based on recording actual transactions, the traditional income-statement approach provides information that has been found to have a

sufficient level reliability and is verifiable. The traditional approach also minimizes the use of estimates and judgments in providing accounting figures.

In many cases, only historical cost accounting method provides reliable and verifiable figures and information (Krumwiede, 2008). As Powers mentioned in his article (1991), certain assets are subject to appraisal valuation, such as intangibles and items of equipment and machinery. The validity of such appraisals can be questioned, while other type of assets, goodwill and other intangible assets like trademark, cannot be appraised. Instead, we should derive the value of assets like goodwill from the degree of their usefulness in business. In other words, how useful those assets in generating value to the business. Forcing companies to value certain assets, such as intangibles, at given point in time to some extent will violate and contradict the basic accounting concept of going concern. Krumwiede (2008) also discussed about this. He stated that long-term and intangible assets should be reported at historical cost with adjustment for amortization and depreciation. Goodwill and other intangible assets reported under exceptional rules, Statement of Financial Accounting Standards (SFAS) No. 142 (Goodwill and Other Intangible Assets) and SFAS No. 144 (Accounting for the Impairment or Disposal of long-lived Assets). Krumwiede (2008) argued that estimating fair value of goodwill or other indefinite-life intangible assets would be difficult for management.

3.2.3. Disadvantages of historical cost accounting

Although the historical cost accounting principle is dominant in valuing assets and liabilities, there are some deficiencies in the principle. There has been a great deal of criticism of historical cost accounting over past decades.

Historical cost accounting and accounting transparency

In order to have transparency, financial statements must be of high quality and represent the results of past operations and the financial position of the entity. Much of the criticism of historical accounting model has been associated with its distortion of financial statements. This is due to movements in general price level, changes in the structure of prices and effects of changes in interest rates on the value of debt that are not being considered in the historical accounting paradigm (Barlev, 2003). Under historical cost accounting system, the book value of liabilities does not represent their market value, and unrealized losses or gains are not recognized. The expenses of depreciation and amortization of property, plant and equipment and intangibles are usually overvalued in the earlier periods and undervalued in latter period. The same is true for the process of determining the cost of manufactured inventory that based on historical cost numbers, but does not consider fair values and opportunity costs. As a result, the balance sheet misrepresents real figures (Barlev, 2003). The income statement and its components are distorted too and do not reflect on the quality of earnings. The historical cost accounting paradigm distorts many figures in the income statement and the balance sheet and thus diminishes the value of accounting information (Barlev, 2003).

Relevance of accounting figures

Historical cost accounting is blamed to be a source of irrelevant accounting figures which obscure real financial position and the results of management operation. Often the historical book value of assets and liabilities does not reflect market values. This situation permits management to have dominant power over the process of preparing financial statement. They are able to manipulate reported earnings, generate hidden-reserves and to distort the statement of financial position. It is widely known that historical cost accounting based financial statements conceal information on current values of many assets and liabilities and distort income figures. Thus, the relevance of the balance sheet and of the income statement to investment decision making has been diminished.

The implementation of historical cost accounting

Ijiri (1975) explained in his article that the importance of historical accounting principle was because of firms' accountability. By accountability Ijiri referred to the idea that historical value is necessary because the historical value serves reliable and undisputed facts. However, the historical principle contains some anomalies in practice, among others inventories. One principle in valuing inventories is at its lowest value, which is very common and is the main rule in Sweden (ÅRL, 4 kap, 9 § first part). This principle means that firms should value their assets at their lowest historical cost and net sales on the balance day. This principle is contradictive with the historical cost principle.

3.3 Fair value accounting

3.3.1 Fair value: Definition and estimation

Since the mid 1980s, the US Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB) has systematically substituted market-value and event-based reporting model for cost-and transaction-based model. The ongoing shift of financial reporting standards towards fair value- based reporting, notably the increasing importance of fair value as an accounting measurement attribute is driven by the presumed decision relevance of market-based measures (Hitz, 2007, 324).

The general IASB definition of fair value can be found on standards level “Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”(IAS41, para 8, IFRS 3).

Taking into account the relevant interpretations, the IASB concept endorses fair value as exit value (Penman, 2007, 33). Assets and liabilities are remarked each period to current exit price but without actual exit of the product or service to the market.

(Penman, 2007,33). Fair value is the specific hypothetical exit market price that would be under idealized market conditions, in a transaction between knowledgeable, independent and economically rational parties, which interact on the basis of an identical information set. Knowledgeable parties are defined as market -place participants representing unrelated buyers and sellers that are reasonably informed about factors relevant to the transaction. They should be willing and able to transact in the same market and have the legal and financial ability to do so. “A willing buyer is motivated, but not compelled, to buy. This buyer is neither over-eager nor determined to buy at any price. The assumed buyer would not pay a higher price than a market comprising knowledgeable, willing buyers and sellers would require”.(IAS 40, para 42)

The estimation of fair value follows, in principle, a three-tier process with a strict preference for market-based measures. To the extent that fair value estimations are grounded in market prices or market data, most individuals would agree that the estimations are informative and reliable. The relevant quality of market prices is evaluated on the basis of the active market criterion, that is, regular trading of the identical item on a sufficiently liquid market is required for the market price to qualify as an estimate of fair value (Hitz, 2007, 326). For example, a financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency. (IAS 39, AG71). If the entity has access to multiple markets the reference market is the most advantageous one to which the entity has immediate access. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the asset or liability (IAS 39, AG 71).

When bid and asked prices are more readily available than closing prices, fair value should be estimated using current bid price for and asset held or liability to be issued and asking prices for and asset to be acquired or liability held. The appropriate quoted

market prices for assets and liabilities with offsetting market prices are mid-market prices for the offsetting risk positions and the bid or asking prices for the net open position. If current bid and asking prices are not available, the price of the most recent transaction should be used as a basis for establishing fair values as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have significantly changed since the time of the transaction, the entity determines fair value by reference to current prices or rates for similar items, as appropriate. (IAS 39, AG72)

An observed market price encompassed the consensus view of all market-place participants about an asset or liability's utility, future cash flows, the uncertainties surrounding those cash flows, and the amount that market-place participants demand for bearing those uncertainties.(SFAC No 7 para 26)

If market prices are not available or not sufficiently reliable, the second level of the estimation process requires observing market prices of similar and comparable items, where comparability naturally refers to the cash flow profile. The quoted prices for similar assets and liabilities in active markets used for establishing fair value could be adjusted as appropriate for differences, whenever that information is available. Only when the first and the second level of fair value estimations cannot be used either, fair value is mandated to be measured using internal estimates and calculations (Hitz, 2007, 326). Thus level 3 of the fair value measurement process represents the lowest priority of input combinations to be used. The inputs are not observable but are instead derived through extrapolation or interpolations, and these inputs cannot be corroborated by other market data (Campbell et al, 2008, p35)

The fair value of assets or liabilities that do not have quoted market prices in an active market is estimated on the basis of the results of an appropriate valuation technique that makes maximum use of market inputs including observable market data about the market conditions, quoted prices generated by actual market transactions and other

factors that are likely to affect the fair value and relies as little as possible on entity-specific inputs. A valuation technique would be expected to reflect a realistic estimate of the fair value if it reasonably reflects how the market could be expected to price the asset or liability and the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the asset or liability. Therefore, a valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing the asset or liability (IAS 39, AG75-76, 82).

The fair value of the asset or liability using level 3 estimates is reliably measurable if the variability in the range of reasonable fair value estimates is not significant for that asset or liability or the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value (IAS39, AG 80, IAS 40, para 29). In most cases, the second and the third level of estimation will be used for long term and intangible assets because the market prices are not available.

Putting aside measurement issues, fair value accounting conveys information about managements' efficiency and stewardship by disclosing the current value of all assets and liabilities on the balance sheet. The income statement reveals economic income because it is simply the change in value over a period. And it provides information about risk exposure and management performance. (Penman, 2007)

3.3.2. Benefits of fair value accounting

The relevance of accounting figures

Both FASB and IASB stress the capacity of the fair value accounting paradigm to contribute value relevance figures to financial accounting reports. Relevance and reliability are fundamental criteria of accounting items that should be recognized and contained in an entity's financial statements (IAS 8). An accounting policy should

results in information that is relevant to the economic-decision making need of users (IAS 8, para 10). Relevance of financial reports covers the function of stewardship which is at the root of accounting. Management stewardship refers to evaluation of managers' efficiency and compensation, decisions to hire or fire managers. (Barlev et al, 2003).

Those in favor of fair value measurement argue that the market value of an asset or liability is more relevant than historical cost because it provides more timely information and reflects the amount at which that asset or liability could be bought or sold in a current transaction between knowledgeable, willing parties. The measurement system that reflects the transaction prices would therefore lead to better insights into the current risk profile of firms so that investors, creditors and rating agencies could exercise better market discipline and corrective action on firms' decisions. (*Hitz, 2007, Rechtman, Y., 2006*).

Other proponents of fair value accounting argue that fair value is a superior economic measure to historical cost because it reports assets and liabilities in the way that reflect true economic substance. (Barlev, 2003)

Fair value accounting and transparency

Supporter of fair value accounting believe that the fair value model or mark-to-market reporting system in which market prices are employed in valuations as much as possible provides the necessary grounds for accounting transparency that is true, accurate and complete information as it reports and reflects economic reality. The fair value accounting paradigm could be expected to enhance market discipline that may lead to lower cost of capital, greater liquidity and more efficient markets. The fair value accounting system brings managers closer to the goal of adopting "a philosophy of complete transparency", that is, to disclose to the users of financial reports all internally management measures (Eccles et al, 2001)

Fair value accounting and the reliability of financial reports

Proponents of fair value accounting believe that under the paradigm of fair value accounting, the potential of managing and manipulating profitability indexes is much lower than the historical cost accounting system. Theoretical studies (Barlev, 2003) show that the fair value paradigm may enhance management efficiency and decrease costs of the principal-agent conflict. Investors, owners or shareholders could assess the outcome of managers' decision regarding (a) selection of assets and liabilities for current operations, (b) selection of assets and liabilities for hedging, (c), hedging activities and (d) operational activities. Fair value accounting allows owners or shareholders to evaluate the level of efficiency at which the operation manager has utilized the firm's assets. By revealing the current value of assets placed in the hands of the firm's managers, fair value accounting prevent obscurity of real economic value and hidden reserves in financial statements and this decrease the principal-agent conflicts. (Barlev, 2003)

Other proponents of fair value accounting argue that market-based measure is not affected by factors specific to a particular firm; as a result it represents an unbiased measurement that is consistent over period and across entities. (Penman, S.H., 2008)

Moreover, proponents argue that nowadays the real assets of any companies are soft assets such as brand name, concepts and ideas and not physical resources. These soft assets require measurement and valuation techniques that are beyond the scope of historical cost. (Campbell, 2008, 36)

Fair value accounting and creditor

In countries that belong to continental accounting system, the main users of small and medium sized entities' financial statements are owners, banks, entities' management and the tax authority. The information for owner-managers and for calculating taxable income is the major usefulness of financial statements. Customers, vendors, employees and potential investors are less important users (Eierle, 2008).

The main user groups of SMEs' financial statements identified by the UK literature are the managers, providers of loan finance, trade creditors and the Inland Revenue and, in certain instances, employees and venture capital providers. (Collis & Jarvis, 2000) Banks use SMEs' financial information for lending purposes and monitoring the loan agreement. The manager/owner uses the financial reports for planning, control and decision-making (Jarvis, 1996). Besides, the empirical evidences on the uses of SMEs' accounts indicate that SMEs' financial reports are often used as the basis for tax preparation, banking covenants and other reporting requirements (Collis et al., 2001) Moreover, Cosh and Hughes said that the majority of companies send a copy of their statutory accounts to the banks, because banks are the main finance providers for small entities (Cosh and Hughes, 1998). In addition, in Barker and Noonan' research, they found that the owner-managers are the main users of the annual accounts (Barker and Noonan, 1996). Finally, Page argued that the main users of the annual accounts are the management, followed by the banks and other lenders. (Page, 1984).

Creditors rely on accounting figures such as measures of risk and return, market value of debt to assess the firm's ability to repay their debts as promised and the risk of default. Under the fair value accounting system, the fair value of risk and return indicate real profitability. Market value of debt, information regarding income, gains and losses provide information that serves the purpose of assessing potential payment of the firm. (Barlev, 2003)

A fair value accounting paradigm characterized by more disclosure and better transparency also contributes power to stakeholders and improve the balance of power between stakeholders and managers (Barlev, 400)

Fair value accounting and management of the company

The fair value accounting paradigm will influence the managers' attitude toward risks since they jeopardize their business and reputation. Managers will utilize derivatives and other techniques to secure the value of the firm assets. Managers are required to understand derivatives and option-pricing models, the structure of interest rates and their meaning to options and future cash flows. Fair value accounting "intensifies and sharpens the manager's cognition" that he conducts in an open and dynamic business environment which characterized today's local and global markets. (Barlev, 2003)

3.3.3. Drawbacks of fair value accounting

Over the years, there has been considerable intense debate and discussion on whether the asset-liability approach requires measurement based on fair values rather than historical cost. In any case, the approach stresses the role of the balance sheet as a primary vehicle for conveying decision useful information. There are also many barriers to and difficulties of implementation of the fair value paradigm. The fundamental problems surrounding the fair value implementation can be discussed as following:

Fair values not based on observed market prices are costly and difficult to identify and verify

When fair value estimations are not grounded in observed market prices, the values must be estimated on the basis of imaginary prices that might be offered by hypothetical asset buyer and liabilities assumers who are participants in non-existent markets. Company accountants will have to identify and assume the prices that might be offered by hypothetical independent acquirers of its assets and liabilities. Managers would have to determine the highest and best use to which an asset might be put as an input to estimating fair value. Also, the managers would have to "determine how these hypothetical market participants might use the assets in their own operations and the assets' values in use to those firm", so that the price they might pay can be evaluated (Benston,2008, 103). Auditors then must verify the

assumptions and documents. This is likely a costly informational undertaking. The cost incurred to generate and to determine that the historical-cost numbers are not fraudulent or significantly incorrect (Benston, 2008).

Research from Germany shows that, the majority of small and medium sized German enterprises ranked the usefulness of the revaluation model for property plant and equipment higher than the cost model for providing information to external financial statement users. However, the cost was also expected to be very high. Little benefit and high costs were expected for fair value valuation, suggesting that the costs and benefits of SMEs associate with the revaluation model for property, plant and equipment depend largely on the existence of current market prices. (Eierle and Haller, 2008) Botosan et al. suggest that where this is not addressed by market forces, the IASB should consider providing relief for private entities. However, they also argue that where private enterprises enter into complex transactions, they should also be expected to have the expertise to account for these transactions. (Botosan et al., 2006)

Plantin et al (2008) argue that the prices at which transactions of many types of assets take place do not match up well to the ideal of the hypothetical competitive market. For example, loans do not trade in deep and liquid markets, but trade primarily through the OTC market where prices are determined via bilateral bargaining and matching. Therefore finding fair value of a loan is an exercise in finding the hypothetical price which can be inferred from discounted rates implied by transactions prices of related securities, but OTC are often illiquid markets and do not conform to the ideal of hypothetical frictionless competitive market.

Krumwiede (2008) argues that measurement of the long term and intangible assets is not always practical and possible because level 1 input won't be available. Management must exercise judgment in predicting about the future that are difficult to make and even more difficult to verify, for example estimating the life of goodwill or

other indefinite-life intangibles. Even well-intentioned management may be wrong when determining value to the extent that their predictions and assumptions are wrong.

Fair value not based on market prices could be readily manipulated and difficult to verify

Opponents of fair value measurement criticize the questionable reliability of fair value measures, especially for fair value estimates relying on management's expectations and assumption (Benston, 2008). Fair values other than those taken from quoted prices could be readily manipulated by dishonest and opportunistic managers to archive desired earning numbers. It would be very difficult if not impossible for external auditors to verify and validate the fair value figures that are derived from managers' expectation and challenge management estimates. The managers can reasonably claim that they know their own business and industry and therefore, they know the amounts for which assets could be sold and liabilities assumed and they are in the best position to make predictions. Although the auditors could hire experts or consultants, they may be sued if their clients' stock price decrease substantially and, in retrospect, the numbers to which they verify turn out to be incorrect and are seen as negligently misleading (Benston, 2008). If management predictions turn out to be materially incorrect, it is difficult to determine if the estimates were honest errors or the result of dishonest management (Krumwiede, 2008)

Fair value is not appropriate when the firm arbitrages market prices

Penman (2007) argues that fair values are inappropriate when the firm adds value (earnings) from buying raw material at input market price and selling it at output market price. As an input into a manufacturing process, raw material adds value to its market price by producing a product and selling it to customers. Raw material does not get its value from a change in its exit market price, "*a change in earnings value is not one-to-one with the change in the market price of the input*" (Penman, 2007, 39).

Penman points out cases where the one-to-one conditions for fair value applies such as investments in securities in a trading portfolio and derivative instruments on such securities, investment by an insurance companies, pension assets, etc. Penman also suggests some cases where the one-to-one condition for fair value does not apply such as inventory, investment in a subsidiary where the firm has influence, performance obligation, etc.

Fair value is not appropriate when they replace historical cost information and prices rely on historical cost information

Penman argues that carrying investments in a subsidiary at market prices obscures the profitability of the subsidiary and the value of the parent which is based on that profitability. Fair valuing loans and borrowings obscure the value of an intermediary function- adding value from the spread between borrowing and lending rates- if those exit values do not incorporate the firm-specific intangibles in customer and depositor relationships. Moreover, the replacement of historical cost accounting can lead to inefficient prices (Penman, 2007).

Fair values inject excessive volatility into transactions price

Fair value accounting can lead to the emergence of an additional, endogenous source of volatility that is purely consequences of the accounting norm. To a large extent, it determines the efficiency of the price mechanism in guiding real decisions. As a result, real decisions may be distorted by inefficient prices due to fair value measurement paradigm (Plantin et al, 437). Penman suggests that in a price bubble, , inefficient prices are booked on the balance sheet, with bubble gains flowing through to the income statement.

For trading portfolios where investments are held long-term, this is a large problem. For example, pension assets “*marked to bubble prices may give the appearance of*

satisfactory funding of future pension obligations and insurance assets may give the appearance of adequate or even excess reserves against future insurance losses”
(Penman, 2007, 40).

According to Jermakowicz and Gornik-Tomaszewski (2006), the IASB advocates its fair value measurement based on the grounds of relevance, but this measurement is expected to bring increased volatility in the reported values of assets as well as earnings. In the Italian context, where the accounting system is based on historical costs, the use of fair values to evaluate assets and liabilities seems to be one of the main reasons for SMEs' reluctance to switch to IFRS.

Fair value accounting fails without asset and liability matching

Penman argues that fair values of individual assets and liabilities may not be matched if price changes of the associated liability are negatively correlated with those of the asset. The case of negative correlation produces excess volatility in earnings. There are some cases where mismatching can occur. Core deposit intangible asset is an example. It is difficult to estimate values of intangible assets for banks which represent the ability to obtain relatively inexpensive funds from demand, savings and small denomination time deposits. However their value is negatively related to the value of the loan portfolio. When interest rates rise, the value of the loan portfolio decrease but the value of the intangible asset typically increases. According to the one-to-one condition, customer deposits should not be fair valued. If the loan portfolio is fair valued but the value of core deposits intangible asset is not marked-to-market, earnings and book value will be artificially reduced (Penman, 2007).

The relevance of fair value measurement can only be supported for securities traded on high liquids markets

Fair value accounting expressed in terms of exit value will be primarily useful to some creditors and investors of companies. Transaction costs, which could be substantial for assets and liabilities that are not regularly traded in liquid markets, reduce the amounts available for distribution to creditors and investors. (Benston, 2008, 105).

The empirical research on the value relevance of fair value numbers to investors show that fair value numbers that are trustworthy (e.g, treasuries and equities) were found to be value relevant, while those with difficult-to-obtain market prices (e.g, loans) were not. (Benston, 2008, 106)

Paoloni suggests that the IFRS for SMEs' most relevant simplification, in addition to the redefinition of the scope of the financial statement, concerns the definition and the use of fair values. However, it is arguable whether IFRS for SMEs' simplifications are perceived as sufficient. Paoloni argues that SMEs' shares are not publicly traded, strategies are controlled by owners, and the main users of financial statements are finance providers such as banks, as a result, fair-value-based accounting loses importance and user needs are different, being satisfied by a more limited range of information. (Paoloni, 2006; Jarvis et al. 2008)

Santucci suggests that providers of credit finance, in particular, may be more focused on information about the ability of an entity to repay its financial debts by means of its ordinary capacity, rather than on unrealized fair-value based measurements. On one hand, the information given by fair value measurement may even be misleading when unrealized gains lead to an increase in equity, without any effect on free cash flows, for instance, the result from revaluation. On the other hand, it is argued that fair value measurement does not provide additional information to a lender, whose main interest is in the information about enterprises' ability to meet debt repayments or the value of the enterprises' assets as security in case of liquidation. Further, fair values rarely derive from market values, which are often calculated in the form of discounted

cash flows, the result of this calculation is influenced by the variability of the discount rate used (Santucci, 2007).

Campbell et al, 2008, argue that many companies have to deal with specific valuation issues when establishing fair value estimates. For example, a company with several divisions may concern about the uniformity in valuation of policies across these divisions.

3.4. IFRS for SMEs

The International Accounting Standards Board (IASB) was established in 2001 as part of the International Accounting Standards Committee (IASC) Foundation, and it is the standard-setting body of the IASC Foundation. IASB develops and publishes International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs), and specifies the qualitative characteristics of information in financial Statements are understandability, relevance, materiality, reliability, substance over form, prudence, completeness, comparability, timeliness, balance between benefit and cost. (IFRS for SMEs, 2007)

3.4.1 Scope of IFRS for SMEs

The IFRS for SMEs is intended to be used by small and medium-sized entities (SMEs). SMEs are entities that:

“do not have public accountability; and publish general purpose financial statements for external users.” (IFRS for SMEs, 2007:14)

IASB also give examples of external users, such as owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies. However, which entities are required or permitted to use IFRS for SMEs could be

decided by national regulatory authorities and standard-setters. An entity has public accountability if:

- (a) “it files, or it 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
- (b) 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.” (IFRS for SMEs, 2007:14)

If a publicly accountable entity uses IFRS for SMEs, its financial statements shall not be described as conforming to this standard, even if national law or regulation permits or requires publicly accountable entities to use it. (IFRS for SMEs, 2007)

3.4.2. Objective of financial statements of SMEs

In IFRS for SMEs, the objective of financial statements of SMEs is to provide information about the financial position, performance and cash flows of the entity, which is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. In meeting that objective, financial statements also show the results of management’s stewardship of the resources entrusted to it. (IFRS for SMEs, 2007)

3.4.3. Financial position

IFRS for SMEs specifies the financial position of an entity is its assets, liabilities and equity at a point in time, which means that the elements of financial statements directly related to the measurement of financial position are assets, liabilities and equity. They are defined as follows:

“An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Equity is the residual interest in the assets of the entity after deducting all its liabilities.” (IFRS for SMEs, 2007:18)

3.4.4. Recognition of the elements of financial statements

Recognition is the process of incorporate an item in the balance sheet or income statement. This item should satisfy the following criteria:

“It is probable that any future economic benefit associated with the item will flow to or from the entity; and the item has a cost or value that can be measured reliably.”
(IFRS for SMEs, 2007:21)

The failure to recognize an item maybe that there are no future economic benefit inflows or the value of the item couldn’t be measured reliably. (IFRS for SMEs, 2007)

3.4.5. Measurement of the elements of financial statements

“Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expenses in its financial statements.” (IFRS for SMEs, 2007:22) Measurement involves the selection of a basis for measuring. IFRS for SMEs specifies which measurement basis an entity should use for many types of assets, liabilities, income and expenses. There are two common measurement bases-historical cost and fair value:

For assets, “historical cost is the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition.”

For liabilities, “historical cost is the amount of proceeds of cash or cash equivalents received or the fair value of non-cash assets received in exchange for the obligation at the time the obligation is incurred.”

“Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.” (IFRS for SMEs, 2007:22)

3.4.6. Measurement principles

The principles for recognizing and measuring assets, liabilities, income and expenses in IFRS for SMEs are pervasive principles, which are derived from the IASB Framework for the Preparation and Presentation of Financial Statements. (IFRS for SMEs, 2007)

3.4.7. Measurement at initial recognition

According to IFRS for SMEs, an entity shall measure assets and liabilities at historical cost at initial recognition, unless this standard requires initial measurement on another basis such as fair value. (IFRS for SMEs, 2007)

3.4.8. Subsequent measurement

After initial recognition, an entity generally measures financial assets and financial liabilities at fair value, with some exemptions that require or permit measurement on another basis such as cost or amortized cost. (IFRS for SMEs, 2007)

Mostly, an entity initially recognized non-financial assets at historical cost, and subsequent measurements often use other measurement bases. For instance, “an entity

measures property, plant and equipment at the lower of depreciated cost and fair value less costs to sell, and measures inventories at the lower of cost and selling price less costs to complete and sell. Measurement of assets at those lower amounts is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.” (IFRS for SMEs, 2007:24-25) For some non-financial assets that an entity initially recognized at historical cost, IFRS for SMEs permits or requires subsequent measurement at fair value. (IFRS for SMEs, 2007)

3.5. Accounting Environment in Sweden

Accounting in Sweden is characterized by *God redovisningssed phenomenon* (Good Accounting Practice). This concept is aimed to be a complement to the Swedish accounting rules and the Swedish law suggests that the concept must be followed (Gustafson, 2006). God redovisningssed contains laws, recommendations and practices and is developed by the Swedish Accounting Standards Board as the responsible organ. Many factors affect the development of this concept such as political, economic and practical matters around accounting problems. With regards of those facts, god redovisningssed concept is very complex.

Based on culture in different perspectives, Sweden categorized as a country that is strongly influenced by the Continental Accounting System (Nobes & Parker, 2006). The system is based on civil law, which in turn relies on the written laws. Smith (2006) explained that in this system, companies legislation is part of the civil law, thus the accounting has been regulated in the companies' law. The main character of this system is that it is used mainly by countries with small capital markets and banks and governments as the main financial providers. Financial report is mainly to serve credit providers and the link between accounting and taxation is very close. In this context, the system requires legal aspects to be treated as important factors when

producing accurate financial information. The law system is codified and contains accounting rules in very detailed manners.

Blake et al (2007) shows that the Swedish accounting system has become influenced by the Anglo-Saxon system. Within decades, the accounting system developed in order to response the situations in the world. Many events affected the development progress, and may also be the reason of the changes. Prior to the World War II, the Continental accounting system was the main influence factor in Swedish accounting because Germany was the main trading partner of Swedish industry (Jönsson, 1996). Kruger crash in the 1930's spotted the term *interest* to become a major topic for banks and investment firms. As a successful Swedish business man, Kruger manipulated the accounting system. During that time a power shift took place from business to government because the need of stronger economic regulation that could only be provided and created by the government. The reason was that the accounting profession had no significant influenced as it was small Jönsson & Marton, 1994). With this situation as the background, the Continental system best suited Swedish accounting system.

The Swedish industry bloomed rapidly post World War II. Export increased, companies grew and international trade became more intense. The new condition gradually changed the economic as a whole, including the accounting system. Trading between Swedish firms and firms using Anglo-Saxon accounting system such as UK and US brought new issues into spotlight. Anglo-Saxon has no strong connection to taxation. The difference between the systems meant difference from true value should be presented in the balance sheet and income statement. In order to answer the new problem, in the 1970's the government took the new influence in the Swedish's Companies Act and the Accounting Act, where the concept god redovisningssed introduced for the first time (Smith, 2006). God redovisningssed consists of generally accepted bookkeeping principles (Heijtz & Rydström, 1977).

A decade later another issues emerged, namely the globalization. As the world getting smaller and lot of restrictions removed, trading and financial market activities go beyond any borders. Swedish firms took the advantage of this new era by opening subsidiaries or merging with and buying local firms abroad. To maintain the international growth firms must be able to adapt the challenges and demand, such as the harmonization process that took place in 1995. To implement the EU Fourth and Seventh Directives on accounting harmonization, a new Act was created in 1995 by the Swedish government (Artsberg, 2003).

3.6. The Swedish True and Fair View

The first attempt that the Swedish government made in order to adjust the Swedish accounting legislation (redovisningslagstiftning) toward the EU standard was the Årsredovisningslagen (ÅRL) which applied from January 1st 1997.² The new law is adapted to the EU's 4th, 7th and 11th directives which refer to establishing, auditing and public announcement of the annual report. The ÅRL was originally applied to Aktiebolag and handelsbolag. A new law in accounting which was announced in January 2000 stated that the ÅRL should apply to all companies regardless of their company form.

The true and fair value concept was introduced in Sweden through ÅRL. The accounting tradition in Sweden and Europe emphasize the importance of carefulness rather than fairness when it comes to valuation of a company's assets. This accounting tradition reflected in accounting law (Bokföringslagen), FAR's recommendation and also *god redovisningssed*. The concept of fair view (rättvisande bild) considered as having a higher authority than the concept of god redovisningssed, but still the legislation (lagstiftningen) is the prime principle in Sweden.

² Thomason, J et. Al *Den nya Affärsredovisningen* 16 uppl.2005

3.7. Swedish K2 accounting standards

K2 is a simpler accounting standard set by Swedish General Council, and it was implemented in December 2008 for the preparation of the annual reports of Swedish smaller limited liability companies. Now it is not compulsive for the companies to use, the companies can choose either the previous standard or K2, but it is forbidden to combine the two standards for preparing the annual reports. (K2, 2008)

3.7.1. Precautionary principle

Under precautionary principle, K2 bases the evaluation on historical cost with some exceptions using fair value. (K2, 2008)

3.7.2. Preparing annual reports according to K2

According to K2, the annual reports should include director's report, income statement, balance sheet and notes:

The minimum requirement for the director's report is that the firm's activities must be mentioned. Special circumstances (for instance, important external factors that affect the firm's result) and changes of activities should also be reported here. Besides, a summary of previous three years should also be reported, including: net turnover, result after deductions of the financial posts, and solidity.

In income statement, historical cost measurement is applied with some exceptions using fair value. For instance, in revenue, commission for contract assignment and entrepreneur can be measured by either historical cost or fair value. Certain costs, such as cost for löpande accounting and cost for establishing annual report, should be measured by using fair value.

In balance sheet, depreciation for the asset applies the residual principle. A tangible asset which is bought at a price of more than 10 000 SEK should be booked directly.
(K2, 2008)

4. Empirical Findings and Analysis

In this chapter, the empirical findings are analyzed and interpreted together with the theories, policies and institutions. We collected primary data from face to face interviews. We interviewed three small and medium-sized enterprises in Sweden.

4.1. Background of the enterprises and the interviewees

The three selected enterprises for the interviews are as following:

Watrang Economic AB

Watrang economic is an accounting firm, founded in 2006 by Anna Watrang, and locates in Malmö, Sweden. It has eleven employees. The firm offers not only economic related consulting, but also other services within administration and organization. Their main clients are owner-lead firms. The firm financed by the owner herself, and she is also in charge of both managerial and economical questions. The interviewee is the owner Anna Watrang. As an accountant with long working experience within this area, Anna has pretty good knowledge regarding the IFRS for SME and K2.

WiiSmile Dental Clinic

The dental clinic established for about two years ago in central Malmö. There are four dentists and several dental nurses working there. Some of the dentists are also the owners and partners of the clinic. The business activities are financed by both their own funds and bank loan. The interviewee is one of the owners Christer Wihlborg.

Ahlgrens Confectionery

Ahlgren Konfektyr is a chocolate company selling own chocolate and praline products. Ahlgren has two shops located in Malmö and Lund, and has twelve employees totally. It is financed mainly by bank loan. The interviewee in this firm is the owner Stefan, who is also the manager of the firm.

Criticism for the interviews

We selected Swedish SMEs qualified for both IFRS for SMEs and Swedish K2 regulation, the criterions are as following:

1. Total assets: not exceed 25 million SEK;
2. Net sales: not exceed 50 million SEK;
3. Employees: between 10 to 50 persons.

In the beginning, we sent email to 27 Swedish SMEs to ask them whether they could accept face to face or questionnaire interviews from us. The 27 SMEs were selected from different industries, because we wanted to investigate in varies industries and enterprises as more as possible to get more reliable and valuable interview results. But only 2 of the 27 SMEs replied our email, and they refused the interviews.

After that, we selected another 18 Swedish SMEs from different industries and called them. Luckily, 3 of the 18 SMEs were willing to accept interviews face to face. Most of Swedish SMEs do not have accounting departments and they don't know much about accounting, so they are reluctant to accept interviews about accounting. Therefore, we got interview results from only three firms which limited our thesis's reliability.

4.2. Users of SMEs' financial reports

All of the three companies answered that the owners, managers, tax authority and finance providers are the main users of the firms' financial reports. Besides, the accountancy firm Wattrang viewed the employees are also the users of the financial reports. By contrast, German SMEs also consider the owners, managers, tax authority and finance providers are the main users of the financial reports. However, in Britain, SMEs view trade creditors are the main users as well.

Sweden has a formal legal accounting system based on a binding tax-accounting link and an accounting profession that is responsive to the needs of the international capital markets (Blake et al, 1999). The tax- accounting link keep tax rules and accounting principles have a strong connection in terms of the tax amount that is generated from the result of accounting methods. The government uses the tax system for implementing political and economic policy, and the tax authorities implement the policy decisions of government (Blaket et al, 1999). The Swedish Parliament has the executive power over the taxation legislation. Regulations in K2 are much connected to Swedish tax legislation. As a result, Swedish tax authorities are considered key recipients of financial statements of small and medium sized companies.

4.3. Usefulness of SMEs' financial reports

All of the three enterprises mainly get finance from self-financing or bank loan. And all of the three interviewees consider financial reports are useful for the owner-managers, banks and tax authorities, because from the financial reports they knew how the capital worked and how to calculate the tax. By comparison, in Britain and Germany, financial reports are also viewed useful for owner-managers, banks and tax authorities.

The owner-managers use the financial reports for planning, controlling, monitoring performance, capital expenditure and decision-making. The banks use them for lending purposes and monitoring the loan agreement. The Swedish tax authorities use SMEs' financial statement to determine gross profit, ensure that expenses are reasonable and check for clean audit report. Tax rates are determined via legal and political process. The economic and political policy of government has direct influence on tax system, which in turn, affects accounting principles and quality (Sodestrom and Sun).

Because of the close linkage between tax regulations and accounting principles, Swedish SMEs only have to prepare one set of financial statements which also serve

taxation purposes. Every year, companies are obligated to fill in a tax return form as an annual declaration and submit the forms to the Swedish Tax agency. The information in the tax return is the same with information in financial statements which are based on the Swedish GAAP (Goransson, W, 2008). Further, under the Swedish Annual Accounting Act, all limited companies are recommended to send their annual financing report to be register at the Swedish Companies Registration Office. Adopting the IFRS for SMEs may be the cost burden for Swedish SMEs because they would have to produce two financial statements: one for investor and one for the tax authority.

Blaket et al argue that the tax –accounting link is an obstacle to the application of international accounting standards in Sweden. Swedish small companies find it difficult to comply with IAS when the tax system, designed at the national level, dominates accounting practices. Further the cost of implementing IFRS for SMEs far exceed benefits because Swedish K2-companies are not the types of associations which usually have complicated transactions and those companies which are operating only in their home country's market have a limited need in term of international compatibility.

Most of interviewed companies do not have an economic department. They don't have knowledge of financial statements as well as IFRS for SMEs. There is concern that the IFRS for NPAEs has not been simple enough for small entities to apply (BFN). It will be costly for K2-companies to switch to the IFRS for SMEs in terms of new standards education and application. Further small and medium sized companies may want to apply K2-regulations because of cultural, political and economical reasons.

There is also a concern that the objective of financial statements to assess the performance and financial position of the enterprise could not be achieved if the financial statements are prepared to comply with the tax regulations or to minimize

tax liabilities. A Swedish accountant explained: "The larger the reported income, the more income tax, so we maximize reported expenses within the provisions of law" (Davisson and Kohlmeier, 1966, p208). As a result, tax incentives given to companies have a distorting effect on the financial reports, making them less relevant to user groups other than the tax authorities (Blaket et al, 1999)

It is believed that the three Swedish State inquiries "The connection between accountancy and taxation", "Simplified accountancy" and "The abolition of the audit obligation for smaller companies" are likely to cause changes in the Swedish taxation and accountancy regulations (BFN).

4.4. Measurements for Accounting Subjects

When it comes to the measurements for accounting subjects in Balance Sheet and Income Statement, the results from the interviews are quite interesting. Although Swedish SMEs could choose either the new regulation K2 or the old standard for preparing the financial reports of 2008, all of the interviewed companies chose the old standard and use historical cost measurement.

The interviewee from WiiSmile Dental Clinic and Ahlgrens Confectionery answered they prefer historical costs as the measurement principle. Historical cost accounting provides reliable information in financial statements. The interviewees are familiar with historical cost accounting principles and think that the historical cost paradigm is suitable for Swedish SMEs because historical cost accounting principles are designed in accordance with Swedish economic, cultural and political conditions. As historical cost accounting technique is based on recording actual transactions, the traditional income-statement approach provides information that has been found to have a sufficient level reliability and is verifiable. Additionally, the income statement approach using historical cost accounting minimizes the use of estimates and judgments. The interviewee agrees with Tim Krumwiede's opinion that in many

cases, only historical cost accounting produces reliable and verifiable information, especially for goodwill and other indefinite-life intangible assets.

Because of the close link between tax and accounting in Sweden, the companies need to consider the possibilities of tax amount when applying measurement principles. The interviewees also express the concern that applying fair value accounting may negatively affect the amount of income tax. It would also raise cost because of a need to prepare one set of reports to tax authority in addition to IFRS report for stakeholders.

But the interviewee from the accountancy firm Wattrang answered they preferred fair value for the accounting subjects, except intangible assets, deferred tax liabilities and deferred tax asset. The interviewee opinions are consistent with Stephen H. Penman (2007) who mentioned that fair value is a superior economic measurement to historical cost, investors are concerned with value, not costs, and thus fair value is preferred. With the passage of time, historical prices become irrelevant in assessing an entity's current financial position. Prices should provide up-to-date information about the value of assets, and fair value reflects the true economic substance. Moreover, fair value is a market-base measurement which is not affected by factors specific to a particular entity, and it represents an unbiased measurement which is consistent from period to period and across entities. (Penman, 2007)

When we asked about the problems they might meet when applying fair value measurement, the interviewee from WiiSmile Dental Clinic and Ahlgrens Confectionery answered they didn't know much about the problems, which indicate that they know little about fair value and its influences on the companies' financial reports. Applying fair value measurement adds more burden to the preparation of financial statements. The implementation of fair value accounting would cause costs in terms of an increase in the information collection and processing work in the company, increasing audit costs. Accounting firms would incur costs due to the need

of training accountants and bookkeepers, the additional work load of accounting firms, including personnel training, separate tax financial statement , renewed and upgraded reporting system (Ikaheimo et al., 2008).

By contrast, the interviewee from the accountancy firm Wattrang answered that there will be not much problems when applying fair value accounting, and he believed that fair value measurement is better than historical cost measurement for most of the accounting subjects because fair value presents the true value of the assets and liabilities at present.

The Wattrang interviewee also raises the concern about valuation of equipment and long term and intangible assets. Once the company has modified equipment and used them for a long time, it may be happened that no observed market prices exist for identical or similar assets. Additionally, market values for intangible assets are generally not available. When fair value estimations are not grounded in observed market prices, the values must be estimated on the basis of imaginary prices that might be offered by hypothetical asset buyer and liabilities assumers who are participants in non-existent markets. Company accountants will have to identify and assume the prices that might be offered by hypothetical independent acquirers of its assets and liabilities. Managers would have to determine the highest and best use to which an asset might be put as an input to estimating fair value. Also, the managers would have to “determine how these hypothetical market participants might use the assets in their own operations and the assets’ values in use to those firm”, so that the price they might pay can be evaluated (Benston,2008, 103). Auditors then must verify the assumptions and documents. This is likely a costly informational undertaking. The cost incurred to generate and to determine that the historical-cost numbers are not fraudulent or significantly incorrect (Benston, 2008).

Krumwiede (2008) also stated that measurement of the long term and intangible assets is not always practical and possible because level 1 input won’t be available.

Management must exercise judgment in predicting about the future that are difficult to make and even more difficult to verify, for example estimating the life of goodwill or other indefinite-life intangibles. Even well-intentioned management may be wrong when determining value to the extent that their predictions and assumptions are wrong.

From the interview results, we knew that many Swedish SMEs think that historical cost measurement is more suitable for them, and there are many problems of applying fair value accounting. Tim Krumwiede analyzed why the enterprises are reluctant to apply fair value measurement. In his opinion, even well-intentioned management estimates of fair value will be wrong to the extent that the various predictions and assumptions are wrong. Opportunistic and dishonest management can take advantage of the judgments, and estimates used in the process to manipulate the numbers will result in desired earnings numbers. Further more, fair value accounting for long-lived and intangible assets could reduce the reliability of financial reports. Finally, different entities use different assumptions and procedures in estimating fair value, the comparability could be decreased. (Krumwiede, 2008)

The switch from historical costs accounting to fair values affects the information function of the financial statements, and poses complexities for quantitative determination, with obvious consequences for financial statement results, particularly when enterprises operate in volatile markets (Superti Furga, 2005; Jarvis et al., 2008). Uncertainties about whether valuations are timely, whether necessary write-downs are too conservative or too aggressive, and whether companies have too little discretion in setting the parameters and estimates used to value assets are weaknesses of the implementation of fair value paradigm (The CPA Journal, Jul, 2008, p9).

4.5. Summary

After presenting the empirical findings in three Swedish SMEs, we found that the users and usefulness of Swedish SMEs' financial reports are very similar as the cases in Germany and Britain. Regarding historical cost and fair value measurement, some Swedish SMEs think historical cost measurement is more suitable for them, because it is consistent with the old standards and they are familiar with it. The close link between tax legislations and accounting rules also favor the application of historical cost accounting as national accounting standards. Moreover, fair value measurement has been criticized because of the questionable reliability of fair value measures, especially for fair value estimates relying on management's expectations and assumption, the increased compliance and auditing costs, potential financial reporting errors and potential abuses by dishonest management.

5. Conclusions

In this chapter, we present our conclusions from summarizing advantages and disadvantages of historical cost accounting and fair value accounting for small and medium-sized enterprises, and answering the research question.

The thesis thoroughly analyses advantages and disadvantages of historical cost accounting and fair value accounting with particular focus on the effect for small and medium sized enterprises. Due to its unique characteristics and advantages, the historical cost accounting method is the standard form of accounting that has been widely recognized and accepted by many corporations all over the world. Historical cost accounting shows the acquisition cost of an asset and its depreciation in the following years. Long-term and intangible assets should be reported at historical cost with adjustment for amortization and depreciation. Additionally, historical cost accounting is based on recording actual transactions and minimizes the use of estimates and judgments in providing accounting figures. And in many cases, only historical cost accounting method provides reliable and verifiable figures and information. The loss of historical cost information can lead to inefficient prices booked on the balance sheet.

Although the historical cost accounting principle is dominant in valuing assets and liabilities, there has been a great deal of criticism of historical cost accounting over past decades. First, historical cost accounting does not provide information about the current market value of the asset, therefore, it distorts many figures in the income statement and the balance sheet and thus diminishes the value of accounting information. Second, changes in the structure of prices and effects of changes in interest rates on the value of debt that are not being considered in the historical accounting paradigm. The book value of liabilities does not represent their market value, and unrealized losses or gains are not recognized. Third, under historical cost accounting, the expenses of depreciation and amortization of property, plant and

equipment and intangibles are usually overvalued in the earlier periods and undervalued in latter period.

The increasing importance of fair value as an accounting measurement attribute is driven by the presumed decision relevance and benefits of market-based measures. Empirical evidences indicate that fair value accounting contributes value relevance figures to financial accounting reports. It provides more timely information and reflects the amount at which that asset or liability could be bought or sold in a current transaction between knowledgeable, willing parties. Additionally, fair value accounting prevent obscurity of real economic value and hidden reserves in financial statements and this decrease the principal-agent conflicts. Further, fair value accounting enhances market discipline that may lead to lower cost of capital, greater liquidity and more efficient markets, and brings managers closer to the goal of adopting “a philosophy of complete transparency”, that is, to disclose to the users of financial reports all internally management measures. Moreover, market-based measurement is not affected by factors specific to a particular firm; as a result it represents an unbiased measurement that is consistent over period and across entities.

The implementation of fair value accounting is not without its problems, and many criticism of fair value accounting are well taken. First, some subjects' fair values do not have observed market prices, and they are costly and difficult to identify and verify. Fair values which not taken from quoted prices could be readily manipulated by dishonest and opportunistic managers to achieve desired earning numbers. Second, measurement of the long term and intangible assets is not always practical and possible. Estimate fair value of goodwill or other indefinite-life intangible assets would be difficult for management. Third, fair values inject excessive volatility into transactions price. It is not appropriate when the firm arbitrages market prices. Fourth, the cost of applying fair value accounting is high. Little benefit and high costs were expected for fair value valuation for SMEs.

The aim of this thesis is to investigate whether fair value measurement in proposed IFRS for SMEs is suitable for Swedish SMEs. Using the strategic approach with limited number of respondents, we found that historical cost accounting (K2) may be more suitable for most of SMEs in Sweden because it is consistent with the old standards and they are familiar with it. The close link between tax legislations and accounting rules in Sweden is also a significant obstacle to the application of applying new measurement principles. In addition, most SMEs do not have sufficient accounting knowledge and practices, and they don't have resources for preparing financial statements in compliance with IFRS for SMEs. Further, Swedish SMEs mainly focus on local market, therefore, providing international comparable financial reports are not very useful for them. However, the implementation of historical cost accounting is not without any problems due to difficulties in revenues and expenses matching. In many situations, historical prices become irrelevant in evaluating company's financial position (Penman, 2007).

For some Swedish SMEs, fair value measurements seem to be more suitable because fair value presents the true value of the assets and liabilities at present. In many cases, fair value accounting can be seen as a superior measurement than historical cost. The interviewee from the accountancy firm Wattrang has a lot of knowledge about fair value and IFRS for SMEs. He has strong preference to fair value accounting. Fair value reflects true economic substance of the assets and liabilities. It represents a consistent and unbiased measurement principle as it is based on market price rather than based on a particular entity which is influenced by specific factors. Fair value provides timely and relevant information, and provides a better overview of the company's financial situation. However, the application of fair value measurement faces many challenges, for instance, the lack of reliable measuring methods when applying fair value measurement, and the uncertainty in measuring risk. In addition, revaluation for every individual asset or liability is not always possible, and the use of judgment and assumptions in fair value measurement could provide opportunities for dishonest managers to manipulate earning or asset values.

6. Suggestions for future studies

In our study, due to time limitation we only interviewed three companies in three different industries. We believe that the result would be more useful and reliable if conduct the same study in more enterprises and industries. In addition, our study focused on the recent accounting standards that Swedish SMEs used for preparing the financial reports of 2008, we think it will be interesting and useful to do a study on the old standards that Swedish SMEs used for preparing previous years' financial reports and to find out how it influences Swedish SMEs' choices nowadays.

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Interviewees

Anna Wattrang: Owner of Wattrang Economic AB

Christer Wihlborg: Owner of WiiSmile Dental Clinic

Stefan: Owner of Ahlgrens Confectionery

Appendix

Interview questions

1. What is your position in this company?
2. Who is in charge of the firm?
3. Are the owners of the firm also managers of the firm?
4. Who are the users of the firm's financial reports? E.g. Owners / managers / tax authorities / banks /investors / customers / employee, do you have other users?
Who are the main users?
5. Do you think the financial reports of the firm are useful for the users? Why?
6. How does your company get finance? E.g. Swedish banks, private investors, foreign banks, self-financing...
7. Which accounting standard did you apply for the financial reports of 2008?
8. Do you know "International Financial Reporting Standards for Small and Medium sized enterprises (IFRS for SMEs)"? Do you think it is useful for your company?
Why?
9. For the following assets and liabilities, if you can choose either historical cost or fair value measurement, which measurement would you like to choose for preparing the financial reports? Why?

Balance Sheet:

- (a) Cash and cash equivalents;
- (b) Trade and other receivables;
- (c) Financial assets;
- (d) Inventories;
- (e) Property, plant and equipment;
- (f) Intangible assets;
- (g) Biological assets;
- (h) Investments accounted for using the equity method;

- (i) The total of non-current assets classified as held for sale, and assets included in disposal groups classified as held for sale;
- (j) Trade and other payables;
- (k) Financial liabilities;
- (l) Liabilities and assets for current tax;
- (m) Deferred tax liabilities and deferred tax assets;
- (n) Liabilities included in disposal groups classified as held for sale.
- (o) Provisions;
- (p) Minority interest, presented within equity separately from the parent shareholders' equity; and
- (r) Equity attributable to shareholders of the parent.

Income Statements:

- (a) Revenue;
- (b) Finance costs;
- (c) Share of the profit or loss of investments in associates and joint ventures accounted for using the equity method;
- (d) Tax expense;
- (e) A single amount comprising the total of the post-tax profit or loss of discontinued operations;
- (f) Profit or loss.

What problems you might meet if you apply historical cost / fair value measurement for measuring the assets and liabilities?