Financial reporting challenges of small- and medium-capitalisation JSE-listed companies

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Purpose: The purpose of this article is to explore the financial reporting challenges faced by small- and middle-capitalisation (small- and mid-cap) companies listed on the Johannesburg Stock Exchange.

Design/methodology/approach: Fourteen interviews with auditors, academics, preparers and regulators were conducted and analysed using open, axial and selective coding.

Findings/results: Findings reveal that resource constraints, a lower ability to attract and retain talented staff, less interest from auditors and a perception that small- and mid-cap entities' financial statements are irrelevant, lead to tick-box attitudes towards financial statement preparation. These challenges are partially mitigated by the smaller size and less complex operations of these entities, where less expert accounting knowledge is required and staff feel valued due to their ability to be involved in the entire business and key decision-making, reducing staff turnover and increasing their knowledge of the business.

Practical implications: The findings of this research help to complete exchange regulators' and standard setters' understanding of the perceived complexity and impact of accounting standards. This improved understand may inform reforms in the financial reporting space.

Originality/value: Academics, auditors, preparers, regulators and standard setters maintain that accounting complexity in International Financial Reporting Standards is a significant concern. While there are many articles investigating the impact of complexity in large, listed entities, the impact on small- and mid-cap firms remains largely unexplored. This is despite the fact that small- and mid-cap firms are key to driving economic growth, especially in developing countries. This article begins to address this gap in the existing literature.

Keywords: high-quality; relevance; resources; IFRS; small-cap; mid-cap; JSE; financial reporting.

Introduction

The International Accounting Standards Board (IASB) seeks to create a global financial language through the International Financial Reporting Standards (IFRS), aiming to make financial information transparent and understandable for current and potential investors and lenders (IASB, 2018; IAS Plus, 2024). However, the very ambition of this goal creates an opposition in which the pursuit of global uniformity often leads to complex accounting standards that can be challenging for smaller companies to navigate and implement, adversely affecting capital availability (Baudot et al., 2018; Murphy, 2015). This research examines the unique challenges faced by smaller listed companies in South Africa in preparing IFRS-compliant financial statements.

Large, listed organisations are significant in size and are followed by analysts, institutional investors and the popular press. South Africa's Johannesburg Stock Exchange (JSE) Top 40 companies make up over 80% of its total market capitalisation (SA Shares, 2022). To reflect the size differentials in JSE-listed companies, the smallest company in 2023 had a net asset value of just over R700 000, while some of the largest companies had net asset values in excess of R1 billion (Simply Wall Street, 2023). Regardless of their size, small- and middle-capitalisation (small- and mid-cap) listed companies are pivotal to the economic success of countries, especially developing ones. They are essential for growth, reducing unemployment, improving skills development, and facilitating more people to participate in capital markets (Fooladi & Nikzad Chaleshtori, 2011; Zhou et al., 2017).

Despite the importance of smaller listed companies, there is little external monitoring and media coverage of these companies due to their lower financial impact (BizCommunity, 2004; Brick & Chidambaran, 2008). There is also limited academic research on financial reporting quality and challenges for this sector. Research focuses on large, listed companies (Atkins & Maroun, 2015; Lee & Yeo, 2016). Where research has been performed on small- and mid-cap companies, the analysis has concentrated on developed countries (Ahmed et al., 2020; Campbell & López, 2010; Filip et al., 2021) with a focus on financial reporting emphasis and earnings value-relevance, with little to no insight into the challenges faced by small- and mid-cap companies in preparing financial statements.

This research contributes to closing the gap in the existing literature by conducting interviews with preparers, regulators, academics and auditors to gain an understanding of the financial reporting challenges faced by small- and mid-cap JSE-listed companies. In doing so, the research provides a practical contribution to the accounting and reporting field by enhancing regulators' and standard setters' understanding of the perceived complexity and impact of accounting standards for small- and mid-cap companies' reporting. This increased understanding forms the foundation for future financial reporting reform projects. The study also provides insights to preparers on report weaknesses and areas for improvement, impacting information processing costs and access to capital.

The remainder of the article is structured as follows: the literature review presents the discussion and application of agency theory in the small- and mid-cap context. This is followed by a discussion of other financial statement preparation challenges in the small- and mid-cap space. The method is presented, followed by a discussion of results and a brief conclusion.

Literature review

Financial statements are required to satisfy the needs of current and potential investors, lenders, and creditors when making economic decisions (IASB, 2018). Comparable, high-quality financial statements enable effective decision-making and help reduce the cost of capital (Barth et al., 2017; Zhou et al., 2017). Smaller listed entities typically have fewer shareholders and shareholders holding key positions in the entity (SA Shares, 2020). Like private companies, the latter trait means these shareholders can access key financial information directly and are not as reliant on annual financial statements. However, unlike private companies, smaller listed companies must comply with a rigorous regulatory environment designed to prevent unequal access to financial information by investors. This results in challenges for financial reporting in smaller listed companies.

Agency theory and financial reporting quality

Agency theory explains how and why the interests of managers and shareholders are not always aligned (Jensen & Meckling, 2019). Financial statements partly address agency problems by providing shareholders with financial information that can be used to judge management's actions (Maroun & Van Zijl, 2022; Ravenscroft & Williams, 2009; Whittington, 2008). The quality of financial statements is important for effective decision-making. The increasing complexity of IFRS and business often necessitates highly qualified and experienced accountants, especially for listed companies (see Haswell, 2006; Morais, 2020). For example, the JSE's Proactive Monitoring Unit regularly highlights boilerplate disclosures and includes immaterial information as common concerns present in unqualified financial statements (JSE, 2019).

Exchange regulations prohibit listed companies from providing only some shareholders with price-sensitive information but not all (JSE, 2024). Accordingly, shareholders of listed entities must rely on publicly available information about the company such as financial statements to make decisions (Arnold et al., 2012). Smaller listed firms typically receive less scrutiny from analysts, investors and the press. These firms often have fewer shareholders with significant shareholders filling key management positions within the company. As such, there is less need to be secretive about what information is provided to shareholders because the risk of sensitive information being shared too widely is low (Demsetz, 1986). As a result, there is less incentive for these smaller listed entities to obtain and pay for technical accountants to prepare high-quality financial statements. Mere compliance is prioritised to preserve limited financial and human resources for income-producing activities.

More details on the factors affecting small- and mid-cap entities' financial statements are discussed in Section 2.2 below.

Factors affecting the preparation of financial statements

The preparation of financial statements requires the application of judgement (Haswell, 2006; Lennard, 2007; Morais, 2020). The IASB advocates a principles-based approach (Guerreiro et al., 2014; Schipper, 2003). As such, preparing IFRS financial statements requires, inter alia, appropriately qualified and experienced finance staff; continuous training to remain up-to-date and IT systems to collect and analyse information required to comply with IFRS. This is especially true as IFRS principles become increasingly onerous to apply as the IASB adapts accounting guidance in response to recent accounting failures (Morais, 2020). Compliance with IFRS requires substantial financial and human resource commitments which are more easily made by larger companies. Large companies also tend to have more complex structures, business segments and multinational operations where non-routine transactions are more frequent than is the case for smaller companies. Consequently, their investment in staff and IT systems is necessary and easily justifiable (Buitendag et al., 2017; Lee & Yeo, 2016).

Rezaee (2003) found that the board of directors; the audit committee; the competence and qualifications of top-level management; the internal auditors; the external auditors and the governing body of the entity affect financial statement quality. It is likely, given the resource constraints of smaller listed entities, that fewer resources are allocated to these factors, negatively affecting their financial statement quality. Moderating this risk of lower financial statement quality is the closer proximity between management and shareholders, easier access to company information and less public scrutiny and impact (see Section 2.1).

Smaller firms may have more difficulty attracting and retaining highly skilled staff. This may in part be due to the lower status, prestige and compensation typically associated with smaller firms (Appelbaum & Shapiro, 1991). Highly motivated and competitive staff may start at smaller firms to develop their skills and reputation. Once these individuals are established, the prestige of larger-cap entities may be too attractive to turn down employment opportunities. The result is high staff turnover and negative effects on retained staff skills and competence (Delfgaauw & Dur, 2010). Moreover, less competent or diligent staff may not be replaced, negatively affecting the company's financial reporting (Delfgaauw & Dur, 2010).

The impact of prestige and compensation is especially important from a corporate governance perspective. Cohen et al. (2004) emphasise that internal and external auditors as well as the board of directors are vital for company success and quality financial reporting. Companies benefit from non-executive directors that are highly experienced in a variety of roles and industries (Kakabadse et al., 2001). Smaller listed companies may struggle to attract such directors as they are too simple to excite esteemed directors and offer compensation too low in comparison to large-listed entities (Ettredge et al., 2011). In addition, being a director of a listed company, regardless of its size, subjects them to the same regulations and possible sanctions. Meaning smaller companies present the same regulation with less opportunity for reward. Smaller listed entities directors typically only hold one or two directorships. What these directors may lack in experience and qualification may be mitigated by the reduced size and complexity of smaller firms' operations and the time the directors have to spend on the company (Ghafran, 2013).

From an internal audit perspective, in addition to the issues around attracting and retaining highly skilled staff, smaller firms have flatter organisational structures. Internal auditors may become more familiar with operational staff and less likely to report significant issues (Abbott et al., 2016). Outsourced internal auditors pose less familiarity thread, but may not understand the entity as well as in-house auditors, reducing their effectiveness (Cohen et al., 2004). Weak internal audit functions and audit committees result in an increase in the risk that financial statements may be materially misstated.

Audit committees of smaller firms may rely heavily on external auditors to address financial statement risks stemming from staff and internal audit concerns as well as their own inexperience. So-called Big-4 auditors come with expectations of highly skilled and experienced auditors, but at great cost. There is also the concern that less experienced and skilled auditors may be assigned to smaller audits due to their lower risks. If smaller audit firms are engaged, higher quality audits may result as 'small' clients to Big-4 auditors may be 'large' clients to smaller audit firms (see Choi et al., 2010; Heo et al., 2021; Lopez & Peters, 2012). As such, more 'value-added' services including identifying system weaknesses and suggesting improvements to controls, systems and disclosure practices may be provided to these 'significant clients' (Dopuch & Simunic, 1982). These value-added services may be diminished where financial statements are of a lower technical quality, necessitating all time to be spend correcting statements rather than improving them.

Similar questions arise in relation to the experience, competence and independence of smaller audit firms as do in the smaller firms they audit (Herda & Lavelle, 2013). These risks are mitigated, to a certain extent, by the smaller, less complex operations of smaller audit clients. These may include identifying system weaknesses and suggesting improvements to controls, systems and disclosure practices (Dopuch & Simunic, 1982).

Methodology

Due to a lack of direct prior research on small- and mid-cap reporting challenges, an exploratory qualitative approach was most appropriate (Brennan & Solomon, 2008; Maroun & Van Zijl, 2016; O'Dwyer et al., 2011). Fourteen semi-structured open-ended interviews conducted between August 2020 and November 2021 were used to gather data. The intention of the interviews was not to create generalisable findings in a positivist sense. Rather, the experiences and perceptions of real world small- and mid-cap entity reporters were gathered in keeping with this study's exploratory approach.

Purposive and convenience sampling were used to identify potential interviewees with experience in financial reporting in the small- and mid-cap listed sector. This sampling method was used to identify interviewees who had the maximum probability of providing useful information about the financial reporting challenges small- and mid-cap firms face. Preparers from both financial and non-financial sectors of the JSE were interviewed to obtain perspectives from different regulatory environments. Only senior staff involved in financial statement preparation were interviewed as these staff members have knowledge of their own challenges as well as the challenges of less senior finance members. To reduce the potential of biased data, multiple perspectives were obtained, namely: preparers, regulators, auditors and technical accountants. To ensure focus on the article's objective, more preparers were interviewed than other categories. Details of the interviewees are presented in Table 1. The sample size was small-and was not intended to form generalisations. This is both typical of qualitative research and does not invalidate the study's purpose of identifying and discussing key financial reporting challenges (Alvesson, 2003; Creswell, 2009; Rowley, 2012). After the 14 interviews were conducted, no new insights were gained and data saturation was achieved (Leedy & Ormrod, 2019; Rowley, 2012).

Respondents were provided with a basic interview agenda to prevent rehearsed responses (see Alvesson, 2003; Pandya et al., 2021). Two pilot interviews were conducted to ensure the interview agenda gathered the information required, was non-leading and unambiguous (Leedy & Ormrod, 2013; Rowley, 2012). Interviews were conducted on MS Teams and were recorded. Recordings allowed the interviewers to pay attention to non-verbal cues such as tone and body language, and make detailed notes to enhance data analysis (Alvesson, 2003; Creswell, 2009; Onwuegbuzie et al., 2010; Pandya et al., 2021; Parker & Roffey, 1997). During the interviews, participants were regularly requested to reword their statements to avoid the risk of any rehearsed responses and misinterpretation (Alvesson, 2003; Maroun & Van Zijl, 2022). Following each interview, there was peer-debriefing to discuss key issues and themes and reflect on the interview in comparison to previous interviews (Maroun & Van Zijl, 2022).

The interviews ranged from 60 min to 90 min in length. Transcripts were analysed in combination with the detailed notes from each interview. Transcripts were read multiple times by the researchers to become familiar with their content. The transcripts were then coded on a line-by-line basis using manual open, axial and selective coding using Atlas.ti by the same researcher. This process was iterative, with codes being refined as more interviews were performed and analysed (Gibbs, 2010; Strauss & Corbin, 2008). No AI-coding was used. Axial coding was used to link the open codes and create categories of information that could be refined and interpreted further. Examples of open codes included financial reporting relevance, high-quality, users, finance staff competence and audit value-add. Examples of axial codes included internal audit function, external audit and perceptions of financial reporting. This formed the basis of selective coding where key themes from the interviews were grouped to provide greater insight into the challenges faced by small- and mid-cap entities (Gibbs, 2010; Strauss & Corbin, 2008).

Table 1 provides a breakdown of the interview participants.

Ethical considerations

An application for full ethical approval was made to the University of the Witwatersrand School of Accountancy Ethics Committee, and ethics consent was received on 31 July 2020. The ethics approval number is SOA-2020-07-17. Formal, written consent was provided by all interviewees of the study.

Results

The interviews revealed that small- and mid-cap preparers generally have a negative attitude towards financial statement preparation. All but one interviewee expressed concerns that IFRS-compliant financial statements are losing relevance. Negative attitudes were heightened where it was perceived that users placed minimal reliance on financial statements, favouring management accounts and other information sources. The exception, P1, works for a financial services company just below the large-cap threshold. The regulatory environment of financial service companies, coupled with P1's company's size, was seen as explaining many of P1's differing opinions. For example, P1's AFSs are scrutinised by a variety of regulators and investors which may explain why P1 sees great value in IFRS-compliance financial statements. Although P4, P5 and P6 also worked in the financial services sector, the company market capitalisations were smaller, attracting less attention from analysists, investors and the financial press.

The results start by focusing on participants' perceptions of the quality and relevance of IFRS-compliant financial statements to provide context for subsequent findings. This is followed by

TABLE 1: Respondent breakdown.

Respondent group	Respondent number	Experience in years	Role and business title	Sector experience (Financial/ Non-financial)	Length of interview in minutes (rounded)
Auditors	A1	12	Senior audit manager	Financial and non-financial	60
	A2	7	Audit partner	Financial and non-financial	60
	A3	5	Audit manager	Financial and non-financial	60
Preparers	P1	30	CFO	Financial	60
	P2	16	Group financial manager	Financial	60
	P3	17	CFO	Non-financial	60
	P4	±20	CFO	Financial	90
	P5	8	Financial manager	Financial	90
	P6	25	Head of finance and Company secretary	Financial	90
	P7	±20	Financial director	Non-financial	75
	P8	± 20	CFO	Non-financial	60
Regulators	R1	30+	Previously on IASB.	Financial and non-financial	60
Technical accountants	B1	20+	Previous technical partner	Financial and non-financial	60
	B2	10	IFRS technical director	Financial and non-financial	60
Total/Average	**14 participants**	**19**	-	-	**70**

CFO, Chief Financial Officer; IASB, international accounting standards board; IFRS, international financial reporting standards.

a discussion on the challenges faced by small- and mid-cap entities when preparing IFRS financial statements.

Perceptions of financial reporting

Financial statement quality and compliance

All interviewees discussed that financial statements could comply with IFRS but still be considered insufficient for users' information needs. Factors were discussed that, when adopted, enhance the usefulness of the financial statements. For example, A1 emphasised that if users' attention is not maintained:

> '[*T*]hen I go: "okay, well that's nice" [*and*] you put it down. Then that 300-page document does not become relevant because I don't finish it.' (A1)

Large and complex businesses, such as the conglomerate Bidvest, justify the time and effort needed to work through lengthy financial statements. However, 300 pages for small companies is likely to contravene a reasonable cost-benefit ratio for users (A1) and, while IFRS-compliant, reduces the understandability as '… material information [*is*] hidden by immaterial information' (A1; IAS 1:7[e]). Put differently, users are easily frustrated with financial statements that do not clearly identify material issues but include 'anything and everything' to ensure IFRS-compliance with minimal effort (A1, A2, R1 and B1).

Financial statement quality is maximised when financial statements present relevant information understandably and concisely (all interviewees). Consistent with Tang et al. (2008) and Elbannan (2011), quality is increased as financial statements effectively communicate the economics of the business in a manner users can easily comprehend. For instance, P2 illustrated that 'where the report is all over the place and not well thought out' users become frustrated. Instead, figures in the statements should be clearly linked and cross-referenced to notes to make following the story of relevant line items easy and logical.

The interviewees' comments are not revolutionary; on the contrary, they are codified within IAS 1 – Presentation of Financial Statements (IAS 1) as a requirement to present notes in a 'systematic manner' (IAS 1: 113) that gives:

> [*P*]rominence to the areas of [*the entity's*] activities that the entity considers to be most relevant to an understanding of its financial performance and financial position, such as grouping together information about particular operating activities. (IAS 1:114[a])

For example, presenting components in order of materiality can assist users to understand and appreciate key aspects of a company before the users become fatigued.

A2 provided the following example:

> 'On a lot of financial statements, you will find that going concern is one of the notes at the end of the financial statements, however, because of the situation that this company found themselves in [*with going concern issues*] - that actually became note two.' (A2)

The idea of simplicity and logical flow of financial statements is paramount (all interviewees), especially considering preparers' perceptions that their users lack the financial literacy to understand complex financial statements:

> 'It seems to me as an observer at our AGM, half the time you have to explain [*the financial statements*] to the investors anyway who don't necessarily get it off the bat when reviewing.' (P6)

Although there is a perception that financial statements are becoming increasingly complex, business activities cannot be oversimplified to aid understanding. This may result in incomplete or misleading financial statements (Conceptual Framework: 2.35). International Financial Reporting Standards is clear that understanding financial statements requires users to have a 'reasonable knowledge of business and economic activities' and that 'at times, … [*investors*] may need to seek the aid of an adviser to understand information about complex phenomena' (Conceptual Framework: 2.36).

Interviewees acknowledged that all relevant information must be included in the financial statements, but it is essential that financials remain short and to the point (A1, A2, P1, P3, P4, P5, P6 and P7). This requires the application of judgement to disentangle material from ancillary information. It also requires preparers to have the confidence to stand by and defend their decisions to omit immaterial information. Omitting immaterial, but mandatory, information per IFRS is not only acceptable but necessary to enhance the understandability of financial statements (IAS 1:31 & CFW 2.34). Education and experience enhance an accountant's confidence to defend their accounting decisions and judgements. Where small- and mid-cap firms have less experienced or educated finance staff, this weakness is especially prevalent. For these accountants, it is easier to rather 'dump' information into financials with little thought other than complying with IFRS and satisfying their auditors (A1, A2 and B1).

In addition, interviewees raised concerns that where new transactions or events are material and included in the financial statements, little effort is spent to remove them if they subsequently become immaterial or irrelevant. Small- and mid-cap companies often use Excel or template-based reporting systems where removing items can lead to significant reformatting and effort. The result is financial statements of increasing length and redundancy year-on-year:

> 'I think that those companies that continue to simply produce a template, they don't actually reduce any of those disclosures. They simply increase without thinking about whether that information is actually relevant or not.' (B1)

P1, B1 and A2 highlighted that although boilerplate templates may result in financial statements of a lower quality, these templates are useful to help less experienced staff gain a sense of how the IFRS requirements can be operationalised. P4, P5, P6 and P7 admitted to using templates without appropriate tailoring to the needs of their users despite this reducing the quality of their financial statements.

P7 animatedly pointed out that he felt auditors were often to blame for the inclusion of irrelevant information. He cited his auditors as saying, 'it must be like this' and felt that auditors lack the experience to judge what is material versus what should be omitted, especially at smaller audit firms. It may also be the case that auditors, seeking to avoid liability, prefer including everything to ensure compliance and no regulatory consequences for themselves. In addition, B1 added that regulators send mixed messages, exacerbating the use of boilerplate disclosure. On the one hand, regulators strongly discourage boilerplate disclosure (see JSE, 2019) while on the other hand 'say to companies: "It's interesting, we notice that you have not provided the disclosure required by paragraph 34. Please can you explain?"' (B1).

In considering whether timeliness enhances financial statement quality (Conceptual Framework: 2.23), interviewees were sceptical that time is associated with quality:

> 'I don't know if I would put [*timeliness*] under the quality heading. I've seen many companies produce fairly shocking financial statements one month after year-end. I've equally seen [*laughter*] companies produce fairly shocking financial statements six months after year-end.' (B1)

Although timeliness improves the relevance of the financial statements, this is of little concern to smaller entities where there is little, if any, external pressure from shareholders and analysts to publish financial statements expediently. Consequently, smaller entities are not concerned about what 'signal' they send by publishing financial statements months after their year-end (Dewi et al., 2019; SA Shares, 2020).

Relevance of International Financial Reporting Standards financial statements

Many interviewees agreed with the sentiments of Ball (2006), feeling that the IASB's pursuit of developing a global, high-quality accounting framework is over-complicating the accounting for many transactions. Increased complexity means finance staff need to regularly attend IFRS training and make frequent changes to their IT and reporting systems (P1). This is often associated with higher costs, without equivalent benefits. In line with Gea-Carrasco (2015) and Maxxia (2019), interviewees perceive that many IFRS adjustments are immediately reversed by users, raising the question of the relevance of the IFRS requirements and the expense required to operationalise complex accounting treatments (P1, P2, P4, P5 and P6).

The concerns regarding the relevance and useability of IFRS financial statements are intensified in the small- and mid-cap listed space. Respondents fear that their less sophisticated users only consider basic profitability, solvency and liquidity metrics. Unsophisticated users may struggle to perform additional analyses because of the jargon and complex adjustments required by IFRS:

> 'There is so much detail and long words included that I don't think anyone reads [*the financial statements*] anymore. So, I do think it has lost relevance because it has just got a little bit over the top … So, you know it has just become such a tick-box exercise. It has become so detailed. It has lost that focus.' (P3)

Often the onerous disclosure requirements of IFRS 7 and 9 were cited as examples of superfluous disclosures that are costly and time-consuming to prepare for little perceived benefit for the size of their company:

> 'I have never been asked a single question in a roadshow about the liquidity risk or sensitivity analysis on my trade receivables.' (P3)

Consequently, preparers of small- and mid-cap firms indicated a preference for the use of templates and boilerplate disclosure, finding it difficult to justify spending to improve financial statement quality (P4, P5, P6 and B1). Instead, small- and mid-cap firms direct their efforts towards income-producing activities:

> 'It probably is part laziness, it is probably part "I don't know how?" and it is probably part "This is going to take me two days to do", no one is going to look at the financial statements or no one is going to see the value in actually doing IFRS.' (A1)

As expected, A1 emphasised how the usual agency problems are not as relevant for smaller companies where major shareholders are often involved in company operations. As such, almost no one, including banks, needs to rely on financials as the primary source of financial information. Most investors and lenders can access financial information through other channels (see also Shapiro, 2005). It is also easier for shareholders to become non-executive board members or form close relationships with staff to access key information. P4 indicated they 'speak to about 80% of our shareholders quarterly'. P3 – P8 highlighted that where they do engage with shareholders, the focus is limited to whether the company received a clean audit opinion.

For the infrequent examples where small- and mid-cap firms do have analysts covering their company, they are only interested in limited line items with little analysis:

> 'If you look at analysts, they have got their own models… They look at your EBITDA and they understand your segment report and you don't get asked any more questions.' (P3)

Consequently, P7 summarised the sentiment of most preparers as follows:

> 'In the two years I've been here, I've never received any question on that whole annual report – not one. Not from an outsider… not from a shareholder or anything like that.' (P7)

Where preparers spend time tailoring their financial statements to enhance usefulness, they end up feeling despondent:

> 'A report of 105 pages long – it takes weeks and weeks to actually produce it and is it worth it?' (P7)

This despondency can lead to a negative feedback loop. Preparers feel any additional effort to improve their financials goes unnoticed, leading to boilerplate disclosures.

Users see boilerplate disclosures as providing limited decision-useful information and, as such, reduce their reliance thereon. This reinforces preparers' beliefs that users do not use their financial statements and that resources allocated to the process yield limited benefit to the entity. Figure 1 by Pandya et al. (2021, p. 229) summarises the interviewees' views:

Challenges small- and mid-cap Johannesburg Stock Exchange-listed firms experience in preparing high-quality financial statements

There is a complex interplay between the size of a company and the challenges experienced. Some challenges may, in part, mitigate the effect of the challenge. For example, a smaller finance team may mean less expertise and experience. However, the impact of this is mitigated, to a certain extent, by the close working relationship of the team and their intricate business knowledge. The three main financial reporting challenges experienced by small- and mid-cap companies are discussed next.

Size and qualification of the finance team

Most of the small- and mid-cap preparers interviewed had a CA(SA) qualification (6 of 8 preparers). The remaining preparers had BCom qualifications or lower. Preparers without CA(SA) qualifications expressed substantial reservations regarding their ability to fulfil their financial reporting role adequately:

> 'When I took the job, I thought it was just the financial managers' position but by the time I went there, I learnt the position was a full financial director position. On the first day, I went to the CEO and said, "I'm not a financial director, honestly I'm not". I only have a BCom, I'm not a CA(SA) … I have never drafted financial statements before.' (P7)

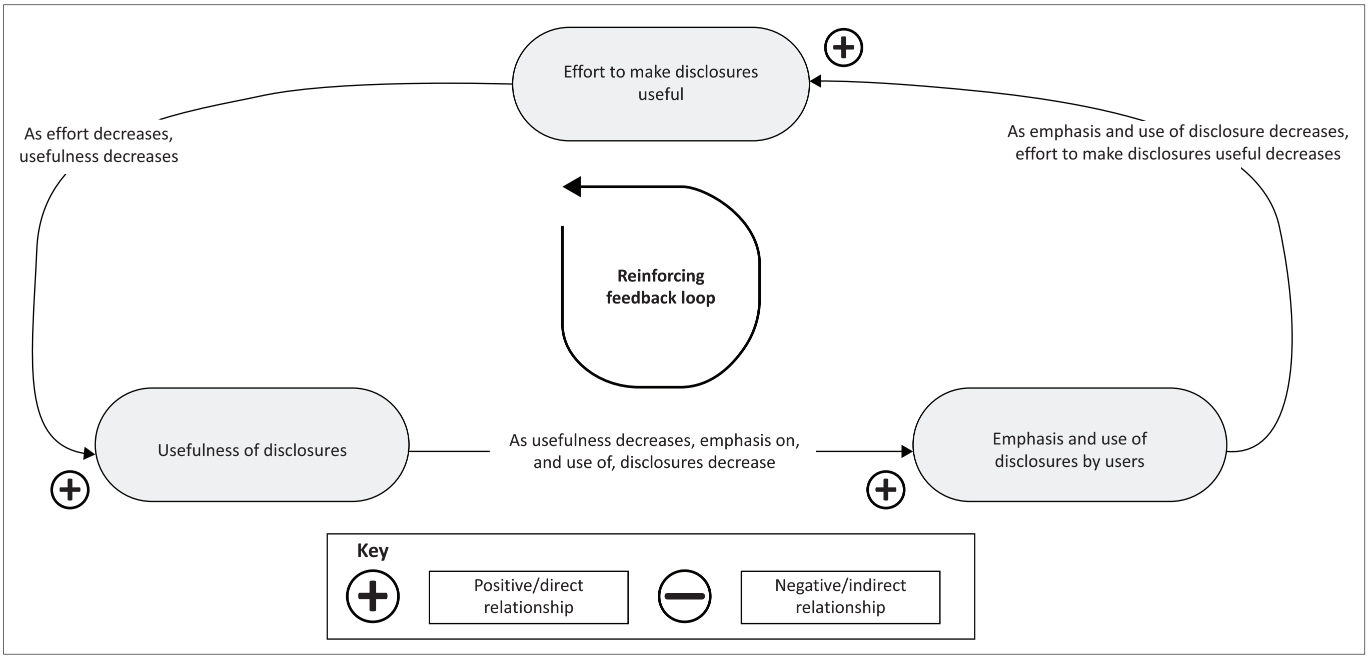
The lower qualification for a financial director position may be due to the lower prestige and financial benefit associated with working at a smaller company (Appelbaum & Shapiro, 1991; Delfgaauw & Dur, 2010). These factors negatively affect smaller companies' ability to attract and retain highly qualified accountants. Highly skilled, ambitious accountants often seek more competitive environments to develop their skills and network with influential people who can positively impact their careers (Bantel & Jackson, 1989):

> 'It does seem that there is a level of competitiveness amongst [*preparers of large-cap firms*]. Where there is a wanting to reflect that they are better than their peers and at the top of their game from an IFRS perspective … Most of them take personal pride in being strong in IFRS and it seems to be quite an important factor to them.' (A1)

In addition to the differences in qualifications, the finance teams of smaller listed companies are often also smaller, with teams of 3–4 people. This is substantially lower than the teams exceeding 30 people in large-listed companies as identified by A1, an experienced auditor in the large and small listed spaces.

The difference in the size of the finance team may be an indication of a lack of resources to employ larger teams (Buitendag et al., 2017). Resource constraints are apparent from P3's description of his company's finance team, noting that they 'outsource our drafting to a separate audit firm'.

Despite interviewees noting the potential need for increased technical resources, tension exists between hiring appropriately qualified staff and whether those skills are necessary beyond preparing financial statements. Non-routine transactions are uncommon, and consultants can be



Source: Pandya, A., Van Zijl, W., & Maroun, W. (2021). Fair value accounting implementation challenges in South Africa. *Journal of Accounting in Emerging Economies, 11*(2), 229. https://doi.org/10.1108/JAEE-01-2020-0013

FIGURE 1: Financial statement emphasis feedback loop.

employed more effectively on an ad-hoc basis to deal with those aspects without requiring a full-time professional:

> 'I don't think employing a person that knows all these things [*IFRS*] and to then pay them R100 000 a month is worth it for our company - because we would only use it when we have to do these wonderful calculations at year-end … I don't think for a small company like ours it's worth it.' (P7)

P7's lackadaisical attitude towards IFRS ('all these things') is telling. Financial statements are only seen as a concern when they must be prepared annually for compliance purposes.

Although resources may be scarce in these smaller companies, the need for increased expertise may be lower due to the smaller scale and complexity of their operations. Many preparers felt their finance teams had the required level of skills to complete their allocated tasks based on the complexity of the organisation and the tenure of the team (P1, P2, P4, P6):

> 'I think for the size of the group and the complexity, I think our team is actually over-qualified and we have been together for 4/5 years now.' (P4)

All interviewees noted a low staff turnover in their finance functions, potentially mitigating the challenges associated with some resource constraints. P4 indicated that the same finance team had worked together for 4/5 years, allowing for increased business understanding and synergies in financial reporting. P3 noted the importance of staff retention, with their organisation focusing on long-term incentives at a broad base.

Interviewees raised increased flexibility, lower competitiveness, prospects for growth and the opportunity to be involved in key organisation developments as drivers of lower staff turnover (P1-6). Specifically for ambitious accountants, the trade-off of not being exposed to more complex transactions such as in larger organisations is offset by being involved in key strategic decision-making and the development of autonomy where staff can take ownership of key initiatives and processes:

> 'Working for a small team in this type of office environment where there is maybe more flexibility, and trust and ownership that goes with that is quite different from working perhaps at [*a Top 40 listed company*] where you are in a silo who reports to someone who reports to someone else. So, I think that also comes into the equation in terms of attracting and retaining talent.' (P6)

Lower turnover results in great institutional and organisational knowledge remaining within the company. Such knowledge means that the underlying economics of transactions are well understood and used to inform IFRS accounting treatments (P3, P4, P5 and P6). Moreover, the IFRS requirements for routine transactions change infrequently. Once the appropriate accounting treatments are determined, finance staff simply need to replicate those treatments. This both reduces the anxiety associated with preparing financial statements based on judgements and the risk of error (Appelbaum & Shapiro, 1991; Yousaf et al., 2014).

Issues arise when there are changes to IFRS standards necessitating external assistance. For example, P7 discussed how she relies on her CA(SA) friends to help her understand and implement IFRS changes. There are risks associated with this kind of informal help, as there is no control over how much time and attention friends pay to queries. For significant IFRS changes, external consultants should be employed.

Qualifications and experience of the internal audit function and supervising audit committee

Seven preparers interviewed had small in-house internal audit functions (IAF). The inherent risk to IAF's independence is heightened at smaller firms with fewer staff and often flatter hierarchical structures (Abbott et al., 2016). At large-listed entities, the IAF may engage with a particular department's staff once every few years. At smaller firms, the IAF interacts with staff on a more consistent basis due to the smaller size of the firm and less segregation of duties (A1 and R1). With increased engagement, the IAF can gain a holistic understanding of the organisation allowing for the better detection and management of risk. However, closer relationships are forged with staff members, potentially compromising the IAF's objectivity.

Small in-house IAFs are appropriate for smaller companies with less complex operations. The lower complexity of operations, coupled with factors such as low staff turnover (P1, P2, P3, P4, P5, P6) reduces the risk of error. Although lower staff turnover decreases the risk of error, the risk of fraud is heightened. As people become familiar with the business, they develop the knowledge of weaknesses that can be exploited (A2). This may be less prevalent in smaller companies where simple operations offer fewer opportunities for nefarious activity. However, the power dynamics that exist in smaller companies cannot be ignored in the discussion of fraud risk. Smaller companies are often owned by a limited number of shareholders. These shareholders are often also involved in the management of the company and may take advantage of their position by blurring the lines between personal and business expenditures. For example, shareholders may use the company to purchase personal-use assets or pay certain daily expenses through the company (A2).

Preparers of the larger company, still falling in the small- and mid-cap classification, indicated that their IAF was outsourced. Although this does reduce the issue of decreased independence, this benefit should be weighed against the cost of a decreased business knowledge which may reduce the probability of identifying fraud and error (Abbott et al., 2016). P1 and P2 noted that even though they make use of an outsourced IAF, there was regular consultation and communication with the function.

The IAF is overseen by the audit committee. As is the case with the IAF and the finance team of small- and mid-cap companies, less emphasis is placed on the skills and experience of small- and mid-cap audit committees (A1, R1). This may in part be due to resource constraints, less scrutiny of activities and controls and reduced agency costs (Ettredge et al., 2011). R1 noted that 'the fees are very different. So, the motivation to take on the risk as a director in a small-cap firm has to be something other than money'. TA2 noted that although the qualifications of the audit committee may be comparable, the fundamental difference is in the experience. A1 emphasised the difference in audit committee experience depending on company size with the following statement:

> 'The large companies pride themselves in having an audit chair that is well versed, has got experience in various industries. Whereas the smaller firms are happy if they have an audit committee chair that mainly serves on one other listed company. Or, in some cases, don't serve on any other listed entities. So no, there is a difference.' (A1)

Generally, members of the audit committee of small- and mid-cap firms hold fewer directorships (A1, A2, RA1, TA2). This may allow increased time to be allocated to their role which partly mitigates the risk of lower experience (Ghafran, 2013). The auditors (A1 and A2) interviewed noted that the audit committees of small- and mid-cap listed companies, who are generally less experienced and qualified, are more defensive of their financial reporting practices and are reluctant to implement any external auditor recommendations. Experienced audit committee members are secure enough to acknowledge that there is always room for improvement whereas inexperienced audit committee members may feel it necessary to defend their reports and resist recommendations out of fear that it is tantamount to accepting that they are inadequate (see Eva et al., 2012):

> 'I would spend more time adding value on a large-listed client than small- and mid-cap clients because I know by the time that I go to them it will be a conversation that would be listened to, in the first place.' (A1)

Recommendations on financial statements, which are already viewed as irrelevant by their preparers, would place a further strain on limited resources without any perceived benefit. Implementing these recommendations would likely be viewed as a costly, non-value-adding activity.

The role of the external audit

All preparers interviewed shared a feeling of resentment towards auditors, with many auditor interactions characterised by conflict:

> 'No, it's a pain … I mean I say to my wife: "Okay cool, they are nearly finished their fieldwork, I will re-introduce myself to you and the kids in about 3 weeks" time.' (P3)

This adversarial relationship may in part be attributed to resource limitations. The strained relationship with auditors impedes the financial statement process as noted in Section 4.2.2.

Preparers were visibly distressed when discussing the audit process and did not see any value in a financial statement audit. P7 emphasised that 'there is no value-add. Not at all. Seriously, not at all' (emphasis in original). This lack of value-add may be due to the hesitancy of the client to bear weight to auditor recommendations but may also be due to auditors allocating fewer resources to smaller audits due to their perceived lower importance by the market. A1 and A2 both noted that whether intentional or not, they do prioritise the audits of larger listed clients over small- and mid-cap listed clients.

Like the small firms that are audited, the auditors themselves face resource constraints. Big-4 firms prioritise larger fee-producing clients while smaller audit firms predominantly service smaller firms where the use of fewer resources is more appropriate (Dezoort et al., 2000; Ettredge et al., 2011; Solomon et al., 1999). Auditors' limited resources are spent on ensuring compliant financial statements rather than adding value, further perpetuating the strained relationship between auditor and client:

> 'By the time that you get something from a large-listed client, it is 90% ready, whereas the smaller company, there are all these version control issues, things get done over and over again.' (A1)

A1 and A2 noted that the audits conducted on larger listed companies were more efficient with less time spent explaining the requirements of IFRS and correcting inaccuracies. This is consistent with previous findings, where it was noted that finance teams of smaller cap companies are smaller, less qualified and less technically competent (Appelbaum & Shapiro, 1991; Delfgaauw & Dur, 2010).

Conclusion

Small- and mid-cap listed companies are often overlooked by academics and the financial press. In a South African context, the top 40 JSE-listed companies by market capitalisation account for 80% of the JSE's entire market capitalisation. This often leads academics to assume that analysing the top 40 companies provides a representative sample of the JSE. However, small-capitalisation companies have a net asset value of as little as R700 000.00 while the largest company's net asset value exceeds R1 billion. Accordingly, this article adopts a different stance. It does not assume that small- and mid-cap companies face similar challenges as their top 40 counterparts. It takes an exploratory approach to investigating the challenges small- and mid-capitalisation JSE-listed entities face. In doing so, challenges can begin to be addressed by both the accountants preparing financial statements as well as the respective regulators and standard setters. For example, a key finding is that small- and mid-capitalisation entities perceive their financial statements to be a tick-box exercise, in part due to the lack of interest from shareholders and the financial press. This can lead to a negative reinforcing feedback loop where a perceived lack of user interest in their financial statements leads to lower report quality which, in turn, enhances users' lack of interest in financial statements.

In achieving the objective of the study, the major challenge identified by small- and mid-cap companies in preparing financial statements related to resource constraints, specifically in relation to staffing. Decreased staff qualification and experience affect the staff's confidence and ability to apply and explain IFRS. Smaller finance teams and limited resources result in less time allocated to the preparation of financial statements. The challenges experienced are exacerbated by preparers' views that auditors provide limited value-adding services. Auditors, on the other hand, cited the additional time required to ensure IFRS-compliance as the reason for a lack of value-adding services. Challenges related to staff skill and experience extend to the audit committees of smaller listed companies, with interviewees expressing limited improvement in financial statement quality through interactions with the audit committee.

Less complex operations requiring less complex IFRS application and often-closer involvement of shareholders in the daily operations of entities reducing the reliance on financial statements assist in mitigating the challenges experienced by small- and mid-cap companies. Lower staff turnover and smaller finance teams with a more detailed and integrated understanding of many aspects of the business counteract the negative effects of resource constraints on financial statement quality. With a more in-depth understanding of the business and limited changes to operations year-on-year, judgements and estimates required by IFRS are easier to determine reliably.

The findings of this article provide the foundation for future reporting reform projects by regulators and standard setters by providing areas of focus and improvement for regulatory and reporting amendments. The findings also practically contribute to small- and mid-cap companies understanding of their financial statement shortcomings and areas for development. This may improve financial reporting quality resulting in increased access to capital. Many members of the accounting field have a role to pay in addressing challenges in this important financial sector. Companies could reach out to their auditors and academic institutions for technical assistance on the application of IFRS principles. This not only provides preparers with the skills they require, but also provides an opportunity for academics to engage in business practically and offers audit firms the opportunity to foster positive and constructive relationships with their clients. Throughout the financial reporting process, preparers, regulators and standard setters should keep in mind that simple operations should result in simple, understandable financial statements.

The findings of this article are limited to the challenges faced by small- and mid-cap companies listed on the JSE and do not investigate the differences that may exist between industries and jurisdictions. An area for future research could include conducting a survey of small- and mid-cap companies in Africa to determine how common the challenges identified in this article are in other jurisdictions. The research focused on small- and mid-cap companies and did not involve any interviews related to large-cap listed companies. Results and insights could be improved by contrasting the experiences of smaller and larger listed companies.

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Authors' contributions

L.B. developed the first draft of this article as part of her studies to obtain an MCom in the field of accountancy. K.B. and W.v.Z. contributed to the writing and reviewing the article. W.M. contributed to the review and editing process and added key insights into the article.

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Data availability

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Disclaimer

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