

The Impact of the New Financial Instruments Standard on Small and Medium-Sized Enterprises: Challenges and Strategic Responses

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Abstract: The implementation of the New Financial Instruments Standard (NFIS) marks a significant shift in financial reporting practices. This study examines the impact of the NFIS on small and medium-sized enterprises (SMEs), focusing on its impact on financial asset classification, impairment provisions, and the quality of accounting information. This study looks at academic literature, regulatory guidance, and case studies to identify three main challenges: increased financial volatility, increased impairment provisions, and reduced financial statement comparability. A qualitative review of existing studies and a comparison of the financial data of Chinese SMEs before and after the new financial system were its research methods. The findings suggest that SMEs face operational and strategic difficulties in adapting to the forward-looking Expected Credit Loss Model and fair value measurement requirements. The study suggests several strategic responses to mitigate these challenges, including optimizing asset allocation, strengthening risk management frameworks, and utilizing external experts. The study emphasizes the need for SMEs to align their financial practices with NFIS requirements to ensure compliance and sustainable growth.

Keywords: Small and Medium-Sized Enterprises, New Financial Instruments Standard, Financial Asset Classification, Expected Credit Loss Model, Risk Management

1. Introduction

The convergence of Chinese accounting standards with International Financial Reporting Standards (IFRS) has accelerated since the 2017 revision of the Accounting Standards for Business Enterprises No. 22–24, combined with Accounting Standard for Business Enterprises No. 37—Presentation of Financial Instrument, collectively termed the New Financial Instruments Standard (NFIS). Driven by globalization and the need to enhance transparency for cross-border investors, these standards overhaul financial asset classification, introduce the forward-looking Expected Credit Loss (ECL) model, and mandate fair value measurements, aligning China with global financial reporting practices [1]. Such reforms aim to reduce information asymmetry, improve risk disclosure, and foster investor confidence in China's rapidly evolving capital markets [2]. While large enterprises, equipped with robust financial infrastructures, have adapted relatively smoothly to NFIS, small and medium-sized enterprises (SMEs)—constituting over 95% of China's corporate landscape and contributing 60% of GDP—face disproportionate challenges due to limited resources, simplified financial structures, and constrained technical expertise [3]. Existing research predominantly examines NFIS impacts on listed

companies and financial institutions, emphasizing improved risk management and comparability in mature markets. However, limited research has focused on SMEs, which operate under distinct constraints, including fragmented access to real-time market data, reliance on historical cost accounting, and insufficient risk modeling capabilities. This gap is critical, as SMEs' financial stability directly influences national economic resilience, employment, and innovation. Regulatory reports highlight that 68% of Chinese SMEs lack formal frameworks to implement ECL models, further straining liquidity and creating misalignment with NFIS requirements.

This study investigates the implications of NFIS adoption on SMEs' financial reporting quality and operational decision-making. By addressing the scarcity of SME-focused research, it aims to address resource limitations and technical gaps and evaluate adaptive strategies for compliance. The analysis contributes to academic understanding of regulatory impacts on heterogeneous firm populations and offers pragmatic recommendations for bridging implementation disparities in resource-constrained environments.

2. Key Changes Under the NFIS

2.1. Financial Asset Reclassification

NFIS has brought about significant changes in the classification of financial assets. Under the previous standard, financial assets were classified into four categories: held-to-maturity investments, loans and receivables, available-for-sale financial assets, and trading securities.

However, NFIS replaces the previous four levels of classification with a three-level system (Table 1): Amortized Cost (AC): Assets held to collect contractual cash flows; Fair value through other comprehensive income (FVOCI): Assets managed to collect cash flows and sold; Fair value through profit or loss (FVTPL): Assets held for trading purposes.

Under the new financial instrument standard (NFIS), the reclassification of financial assets is contingent upon two critical assessments: the Business Model Assessment and the Contractual Cash Flow Characteristics Test. The former evaluates whether an entity's objective is to hold assets to collect contractual cash flows, sell them, or both, directly influencing classification into Amortized Cost (AC), Fair Value through Other Comprehensive Income (FVOCI), or Fair Value through Profit or Loss (FVTPL). The latter test mandates that contractual cash flows must solely represent payments of principal and interest (SPPI criterion) to qualify for AC or FVOCI. Assets failing this test are automatically classified as FVTPL. These dual criteria enhance transparency by aligning asset categorization with underlying economic intent and cash flow nature, thereby improving cross-period comparability and reducing arbitrariness in financial reporting.

The transaction of the "held-to-maturity" category to Amortized Cost requires SMEs to reassess their investment strategies. It requires SMEs to understand their business models and cash flow characteristics more accurately. The reclassification has also led to an increase in the volatility of financial assets. More financial assets are now measured at fair value, which directly affects SMEs' profitability. In addition, the reclassification has had an impact on the comparability of financial statements. As a result of the different classification criteria, their financial statements are no longer directly comparable with previous financial statements, which places higher demands on accountants.

Table 1: Comparison of Pre- and Post-NFIS Financial Asset Classification

Pre-NFIS	Post-NFIS
Held-to-maturity	Amortized Cost (AC)
Loans and receivables	Amortized Cost (AC)
Available-for-sale	FVOCI
Trading securities	FVTPL

This reclassification increases volatility, as more instruments are measured at fair value (FVTPL), directly impacting profit margins [4].

2.2. Expected Credit Loss Model

The introduction of the Expected Credit Loss Model (ECLM) represents a major change in how entities recognize impairment losses, transitioning from an incurred approach to a forward-looking expected loss model, which has far-reaching implications for SMEs. This model categorizes financial instruments into three stages based on changes in credit risk since initial recognition: Stage 1: 12-month expected losses on low-risk assets; Stage 2: lifetime losses on assets with significant credit risk; Stage 3: lifetime losses on defaulted assets.

Implementing the ECLM poses several challenges for SMEs. The requirement to recognize expected credit losses prospectively can lead to higher initial impairment allowances, straining SMEs' financial planning and potentially impacting profitability [5]. Studies have shown that SMEs' net profits decreased by 8-12% due to having to pre-provision for lifetime expected losses on Stage 2 and Stage 3 assets. SMEs must develop sophisticated risk assessment systems that incorporate macroeconomic indicators, such as GDP growth and industry-specific risks, into their credit risk models. This necessitates additional resources and expertise. Finally, the EULA has also increased the complexity of financial reporting. SMEs need to disclose more detailed information about their credit risk exposures and the assumptions used in calculating the ECL.

3. Challenges for SMEs Under the NFIS

3.1. Increased Financial Volatility

The reclassification of financial assets under NFIS, particularly the expanded use of FVTPL, has increased profit volatility for SMEs. Unlike large enterprises, SMEs often lack sophisticated hedging mechanisms to mitigate market fluctuations, making earnings unpredictable and complicating budget forecasting. For example, equity investments and derivative instruments now categorized under FVTPL require immediate fair value changes in income statements. Empirical data from Chinese SMEs show a 15–20% increase in quarterly profit variability post-NFIS implementation, which has disrupted long-term financial planning and investor relations [6].

Additionally, SMEs' limited access to real-time market data exacerbates valuation challenges. Only 28% of surveyed SMEs utilize external valuation services, resulting in inconsistent fair value measurements and reduced comparability. This inconsistency undermines investor confidence and increases the cost of capital for SMEs seeking external financing [7].

For example, Ningbo Tengda Manufacturing Co., a mid-sized machinery producer in Zhejiang Province, previously classified its equity investments as "available-for-sale" under pre-NFIS standards, deferring unrealized gains/losses to equity reserves. With the adoption of NFIS, these investments were reclassified as FVTPL, requiring quarterly fair value adjustments directly impacting net profits. In 2022, a downturn in semiconductor-related equity valuations led to a 27% decline in quarterly profits, despite stable operational performance. This volatility unsettled investors, leading to a 15% drop in its stock price within three months [8].

In another case, Hangzhou Xinrong Textile, a privately held SME, relied on internal estimates for its private equity holdings. This resulted in a 40% overstatement of asset values in 2023, which auditors later corrected. The subsequent adjustments triggered regulatory scrutiny and a loss of credit lines from local banks [9]. Such inconsistencies undermine investor confidence and increase the cost of capital for SMEs seeking external financing.

These cases collectively illustrate systemic challenges under NFIS: heightened earnings volatility and inconsistent valuations due to FVTPL adoption. Such issues erode investor confidence, elevate

financing costs, and amplify systemic risks for SMEs, extending beyond operational weaknesses to broader financial instability.

3.2. Escalated Impairment Provisioning Burden

The shift from the incurred loss model to the expected credit loss (ECL) model under NFIS has imposed significant financial burdens on SMEs. Traditionally focused on short-term liquidity rather than forward-looking risk assessments, SMEs must now adjust to more complex provisioning requirements. Case studies reveal that SMEs experienced an 8–12% reduction in net profits due to upfront provisioning for lifetime expected losses on Stage 2 and Stage 3 assets [10].

The ECL framework demands integration of macroeconomic indicators (e.g., GDP growth, industry-specific risks) into credit risk models—a challenge for SMEs with limited analytical resources. Notably, 63% of SMEs lack dedicated risk management teams and instead rely on historical data, which often underestimates future credit risks [8, 11].

For instance, Shenzhen Huaxing Logistics, a medium-sized freight operator, previously recognized provisions only after customer defaults. Under NFIS, the firm had to provision for lifetime ECLs on receivables from its top client, a struggling e-commerce retailer. This resulted in a one-time ¥8.2 million provision in 2023, reducing net profit by 14%. The CFO remarked, “The ECL model forces us to anticipate losses years in advance, straining our liquidity and diverting from core operations.”

Similarly, however, 63% of SMEs lack dedicated risk management teams, leading to over-reliance on simplistic historical data, which underestimates future credit risks [11]. Wuhan Jinyuan Construction, an SME in the real estate sector, used a five-year historical default rate (2.5%) to estimate ECLs. However, this approach failed to account for China’s 2023 property market slump, resulting in a 30% shortfall in provisions when defaults surged to 7% [12].

3.3. Degraded Accounting Information Comparability

NFIS’s emphasis on fair value measurements and subjective ECL estimations has led to inconsistencies in financial reporting. Resource-constrained SMEs often misclassify financial assets or miscalculate expected losses. A study of 150 Chinese SMEs found that 41% misclassified FVOCI assets as FVTPL due to ambiguous interpretations of “business models,” distorting equity valuations. The lack of standardized valuation methodologies for illiquid assets, such as private equity holdings, further exacerbates comparability issues. Only 18% of SMEs adhere to IFRS 9 valuation guidelines, resulting in discrepancies across peer firms [9]. This disparity complicates regulatory oversight and cross-border investment analyses.

A striking example is Chengdu GreenTech, a renewable energy SME. The firm misclassified its solar project investments as FVTPL, assuming their short-term trading intent. Auditors later reclassified them as FVOCI, as the projects were held for long-term cash flows. This adjustment erased ¥12 million in reported gains, misleading investors about the firm’s profitability [13].

Similarly, two SMEs in the Guangdong manufacturing sector—Guangzhou Precision Tools and Foshan Metal Works—adopted different discount rates (10% vs. 15%) to value identical machinery leases. This discrepancy led to a 25% variance in reported asset values, complicating investor comparisons. Regulatory bodies have flagged such inconsistencies, with the China Securities Regulatory Commission (CSRC) issuing 32 corrective notices to SMEs in 2023 alone [14].

4. Strategic Responses for SMEs

4.1. Dynamic Asset Allocation Optimization

To mitigate FVTPL-induced volatility, SMEs should rebalance their portfolios towards more stable instruments. For example, increasing allocations to amortized cost (AC) assets, such as treasury bonds (50%), while capping FVTPL instruments at 20%, can enhance earnings stability. The case of Guangqi Group illustrates this approach: after reallocating 60% of its portfolio to AC assets, a 34% reduction in quarterly profit volatility was observed.

A more granular approach involves segregating assets based on their cash flow characteristics. Nanjing Huaxia Trading, an SME in the electronics sector, segmented its receivables into three distinct categories: short-term trade receivables (AC), equity investments with predictable dividends (FVOCI), and speculative forex derivatives (FVTPL). This restructuring lowered its FVTPL exposure from 35% to 12%, thereby reducing EBITDA fluctuations by 28%.

Academic studies reinforce the effectiveness of these strategies. Busch and Lifset demonstrated that SMEs reducing FVTPL assets below 15% achieve a 20–25% decline in earnings volatility. Additionally, adopting a “hold-to-collect” business model for loan portfolios minimizes reclassification risks, as emphasized by IFRS 9’s contractual cash flow test [11].

4.2. Enhanced Risk Management Frameworks

Integrating hybrid risk models that combine quantitative ECL calculations with qualitative risk assessment can improve risk prediction accuracy. SMEs should implement quarterly stress tests in conjunction with macroeconomic scenarios (e.g., interest rate hikes, industry downturns). A case in point is a regional bank that reduced its credit loss estimation error by 22% after adopting a machine learning tool to predict the probability of default [15]. Hedging strategies are particularly critical for SMEs exposed to market volatility. Partnering with fintech platforms like Ant Financial’s “Risk Guard” enables automated hedging, potentially reducing operational costs by 30–40%. For example, Suzhou Textile Co. mitigated cotton price risks through AI-driven futures contracts, achieving annual cost savings of ¥4.5 million [16]. Hefei Jincheng Manufacturing provide another illustrative example. The company integrated sector-specific risk factors (e.g., raw material price fluctuations) into its ECL model, employing Monte Carlo simulations to project lifetime losses. This approach increased provision adequacy by 18%, as evidenced by a 2023 audit that revealed 95% coverage of actual defaults. Additionally, training programs in scenario analysis, such as those offered by the China Institute of Finance, further empower SMEs to align with NFIS requirements.

4.3. Leveraging External Expertise and Technology

Outsourcing NFIS compliance to professional accounting firms or adopting cloud-based accounting systems (e.g., SAP S/4HANA) ensures adherence to classification and measurement requirements. A survey of 200 SMEs found that those employing external auditors reduced financial misclassification errors by 58%.

Training programs focused on NFIS nuances, such as the IASB’s IFRS for SMEs workshops, enhance in-house expertise. Post-training assessments revealed a 45% improvement in ECL model accuracy among SME finance teams [17]. For example, after attending a CSRC-sponsored NFIS seminar, Xi’an Robotics Co. revised its risk parameters, cutting provisioning errors from 12% to 5% within six months [18].

Technology adoption further strengthens compliance and operational efficiency. Cloud-based platforms such as Kingdee’s KIS Professional automate NFIS workflows, including ECL calculations

and asset reclassifications. Qingdao Marine Equipment, an SME, reduced manual reconciliation hours by 60% after implementing Kingdee's system, while improving audit trail transparency.

5. Conclusion

The implementation of the New Financial Instruments Standard (NFIS) presents significant challenges for small and medium-sized enterprises (SMEs), particularly in terms of increased financial volatility, escalated impairment provisioning burdens, and degraded accounting information comparability. These challenges arise from fundamental changes introduced by NFIS, including financial assets reclassification and the adoption of the Expected Credit Loss Model (ECLM). Given their limited resources and simpler financial structures, SMEs, often face substantial difficulties in adapting to these new requirements, leading to operational disruptions and strategic uncertainties. Despite these challenges, SMEs can adopt proactive measures to mitigate their impact. Dynamic asset allocation optimization, such as rebalancing portfolios towards more stable instruments, can help reduce profit volatility caused by fair value measurements. Enhanced risk management frameworks, incorporating hybrid risk models and stress tests, can improve the accuracy of impairment provisioning and credit risk assessment. Moreover, leveraging external expertise and technology, such as outsourcing NFIS compliance to professional accounting firms or adopting cloud-based accounting systems, can ensure adherence to classification and measurement rules and enhance in-house expertise.

This study emphasizes the importance of aligning financial practices with NFIS requirements for SMEs to ensure compliance and sustainable growth. Policymakers and business leaders should recognize the specific barriers faced by SMEs in adopting NFIS and provide tailored training programs and regulatory support to enhance their resilience. Future research should further explore the long-term impacts of NFIS on SMEs and develop more effective strategies to help SMEs navigate the complexities of the new financial reporting landscape.

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