INTERNATIONAL FINANCIAL REPORTING STANDARD FOR SMALL AND MEDIUM-SIZED ENTITIES- A NEW CHALLENGE FOR THE EUROPEAN UNION

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Abstract: *In the context of the global economic crisis, small and medium enterprises are most affected. That is why the problem that arises more frequently is the harmonization of national legislation with the European legislation. The necessity to implement specific standards for SMEs appeared in order to provide them a beneficial framework for better economic and financial market positioning. In this respect, the International Accounting Standards Board issued in 2009 IFRS for SMEs, a referential aiming to the simplification of accounting procedures, reconciliation and increase of confidence of potential investors (stakeholders). The question of compatibility of these standards with the European Accounting Directives appears in situations where they may choose to use IFRS for SMEs. The aim of this paper is to evaluate the incompatibilities between IFRS for SMEs and the European Accounting Directives and to analyze the results concerning the implementation of the IFRS for SMEs in Europe. Through this article we want to contribute to the SME accounting area of knowledge.*

Keywords: IFRS for SMEs, compatibility, European Accounting Directives, harmonization, reconciliation, implementation.

JEL classification: F15, F23, F36, K20, M41.

1. INTRODUCTION

Paul Holt and Cheryl Hein defined harmonization as a process of reducing differences in accounting, to encourage standardization (Holt and Hein, 2001). The effect of the harmonization is the increasing comparability of financial statements presented by companies from different

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countries. According to Nobes and Parker, the harmonization process should be viewed as increasing the comparability of practices in different countries by establishing limits of variation (Nobes and Parker, 2004). Also, harmonization of accounting can be defined as a negotiation between the specialized international bodies, in order to reach an agreement regarding the international comparability (Zeff , 1981). Nicolae Feleaga sees harmonization as a process through which national regulations that differ from one country to another are made comparable (Feleaga, 1999, p.36).

Accounting harmonization process implemented within the European Union began in the 1970s. It is a part of the harmonization of company law for European Union countries and aims to harmonize the accounting systems of the member states, developing in this respect, European Accounting Directives that will be incorporated into the laws of each state (Ristea and Dumitru, 2005, p.33).

Special roles, in terms of accounting harmonization at the European Union level, have the Fourth and Seventh Directive.

The Fourth Directive concerning the financial statements of public and private companies other than banks and insurance companies has a dual mission: to meet the information needs of European enterprises and to ensure comparability of information published by these companies (Belkaoui, 2000, p.19). The Seventh Directive, published in 1983, concerns consolidated financial statements.

After the early 1970s, EU made great progress in terms of international accounting harmonization through Economic Directives, the IV and VII, as well as through International Accounting Standards. The process culminated with the obligation for all traded companies to use IFRS from 2005. The author Bernard Raffournier says that the obligation to apply IFRS does not apply unless traded companies. Listed companies from the United States of America are required to apply Financial Accounting Standards (FASs). Harmonization of international accounting has been a process with two speeds: fast for large publicly traded companies, but much slower for others (Raffournier, 2009).

Why IFRS in Europe? On the one hand, accounting and financial information belonging to a European plan for action has to become global, and on the other hand, IFRS must arise as the choice of European Union economic and political decision, in a general plan of action.

Why IFRS for SMEs in Europe? These standards were created because there was a special request for them, considering SMEs large number and their economic potential. 'Micro, small and medium-sized enterprises (SMEs) are the engine of the European economy. They are an essential source of jobs, create entrepreneurial spirit and innovation in the EU and thus, all this objectives are crucial for fostering competitiveness and employment. The new SME definition, which entered into force on 1 January 2005, represents a major step towards an improved business environment for SMEs and aims to promoting entrepreneurship, investments and growth. This definition has been elaborated after broad consultations with the involved stakeholders, which proves that listening to SMEs is a key towards the successful implementation of the Lisbon goals' (European Commission, 2009). In the 27-member EU, there are about 23 million SMEs, representing 99% of all EU companies, employing around 75 million people.

The IFRS for SMEs should be applied by small and medium-sized entities. There are several ways to define such companies in each state according to specific legislation. As an objective, to be no difference in understanding the concept in Section 1 of the standards, small and medium-sized entities are defined as not having public accountability and by publishing general purpose financial statements for external users (IASB, 2009a).

The objective of IFRS for SMEs is to provide a framework, to generate relevant information, reliable and useful, characteristics of a set of high-quality standards, easily understood to be applied at SMEs level (Grosu and Bostan, 2010, p.2).

The purpose of this article is to provide a framework of history of IFRS for SMEs, the differences between IFRS for SMEs and European Accounting Directives, to realize an analysis of benefit/cost report and to see what is the general European reaction regarding standards' implementation.

2. THE HISTORY OF IFRS FOR SMEs

International Accounting Standards Board (IASB) initiated in 2001 a project to develop accounting standards appropriate for small and medium entities (SMEs) due to special need to develop this niche. Because of these, the Board set up a working group of experts to provide information, case studies and feed-backs on the issues, and although potential solutions.

First document referring to standards for small and medium entities was published in June 2004, by the IASB in the discussion paper "Preliminary Views on Accounting Standards for SMEs".

The major issues set out in the discussion paper were (IASB, 2009b, p.6):

- Should the IASB develop special financial reporting standards for SMEs?
- What should be the objectives of a set of financial reporting standards for SMEs?
- For which entities would IASB standards for SMEs be intended?

- If IASB standards for SMEs do not address a particular accounting recognition or measurement issue confronting an entity, how should that entity resolve the issue?
- May an entity using IASB standards for SMEs elect to follow a treatment permitted in an IFRS that differs from the treatment in the related IASB standard for SMEs?
- How should the Board approach the development of IASB standards for SMEs?
- To what extent should the foundation of SME standards be the concepts and principles and related mandatory guidance in IFRSs?
- If IASB standards for SMEs are built on the concepts and principles and related mandatory guidance in full IFRSs, what should be the basis for modifying those concepts and principles for SMEs?
- In what format should IASB standards for SMEs be published?

In 2004 and 2005, the Council reviewed the issues raised by those who answered to the clarifications proposed by the discussion document and concluded that an International Financial Reporting Standard for SMEs (IFRS for SMEs) is absolutely necessary. In the same time, many countries wanted to adopt IFRS for SMEs rather than standards developed locally or regionally. Therefore, Council decided, as a next step, to publish an exposure draft of IFRS for SMEs. For this purpose, the Council decided to hold meetings with the participants in economic life. Those who prepare financial statements for SMEs and those who base their decisions on them (stakeholders) discussed changes in the recognition and measurement principles presented in IFRS, in order to use them in IFRS for SMEs.

In February 2007 the IASB published an exposure draft of a proposed IFRS for SMEs. The aim of the proposed standard was to provide a simplified, self-contained set of accounting principles that are appropriate for smaller, non-listed entities and are based on full IFRSs, which are developed to meet the needs of entities whose securities are traded in public capital markets. The proposed standards were based on full IFRSs with modifications to reflect the needs of users of SMEs' financial statements and to consider cost-benefit reports. The exposure draft proposed five types of simplifications of full IFRSs, which were referring to (IASB, 2009b, p. 8):

- Some topics in IFRSs were not included because they are not relevant to typical SMEs. However, for some of those omitted topics, the exposure draft proposed that if SMEs encountered circumstances or a transaction that are addressed in full IFRSs but not in the IFRS for SMEs, then they would be required to follow the relevant full IFRS;

- Where an IFRS allows an accounting policy choice, the exposure draft included only the simpler option but proposed that SMEs should be permitted to choose the more complex option by reverting to the relevant full IFRS;
- Simplification of many of the principles for recognizing and measuring assets, liabilities, income, and expenses that are in full IFRSs;
- Substantially fewer disclosures;
- Simplified redrafting.

Testing program as proposed by the IASB exposure draft of the IFRS for SMEs was applied to the 116 small entities (each of them with a total of up to 50 employees) in 20 countries.

The three main problems identified in the tests were: the need to use fair value as the main method of evaluating the closing of each financial year due to market fluctuations; the need to simplify the information presented and the need to use full IFRSs to address certain situations much less developed in IFRS for SMEs.

Following the responses received and the deliberations of the Council, the final form of the IFRS for SMEs has undergone several changes, including: the final document should be independent by IRFS, but eliminates the cross-referencing to full IFRS, to national regulations and any changes therein; the use of multiple accounting policies on investments, of impairment of equity instruments; options are not allowed; assessment of costs and expenses for tangible and intangible assets, which should be recognized as research and development costs and borrowing costs.

After five years of consultations and debate, in July 2009 the IASB issued International Accounting Standards for Small and Medium Enterprises.

At the European Union level, the body responsible for adopting International Financial Reporting Standards and International Accounting Standards (EFRAG) proposed the application of the International Financial Reporting Standards for SMEs on a representative group of States, starting with August, 2009. The mission of the SME Implementation Group is to support the international adoption of the IFRS for SMEs and monitor its implementation. This representative group of 21 members was selected based on their knowledge and experience on SMEs reporting. The selection pursued the criteria of fairness, related to geographical location.

After the implementation, representatives of the European Commission and the European Financial Reporting Advisory Group will be those who will supervise the mode of action of the countries involved in this project. Considering that, the implementation questions raised by users of the IFRS for SMEs will to be answered and, as a result, it will be decided which ones need to be published in the implementation guidance. In this context, it becomes necessary to reach a consensus on what that guidance should be, to develop proposed guidance in the form of questions and answers that would be made publicly available to interested parties and to request IASB to approve them to be issued. The questions and answers are intended to be non-mandatory guidance that will help those who use the IFRS for SMEs to think about specific accounting questions. The recommendations are for implementation issues that cannot be addressed by questions and answers, and also for new and amended IFRSs that have been adopted since the IFRS for SMEs were issued or last amended.

3. THE MAIN INCOMPATIBILITIES BETWEEN EUROPEAN ACCOUNTING DIRECTIVES AND IFRS FOR SMEs.

The differences between European Accounting Directives (78/660/EC and 83/349/EEC) and International Financial Reporting Standard (IFRS) for Small and Medium-sized Entities (SME) are an important topic discussed around European Union's economic institutions. In November 2009, European Commission asked for EFRAG's help concerning these differences. This Institution's role was to find out exactly which points of the IFRS for SMEs are incompatible with the EU Accounting Directives.

The incompatibility has the following meaning, according to European Commission: 'An accounting treatment required by the IFRS for SMEs is not permitted under the EU Accounting Directives' (EFRAG, 2010B).

After the study of those two referentials, EFRAG found the next sixth important differences or incompatibilities (EFRAG, 2010c):

Extraordinary items: income or charges. According to IFRS for SMEs, in the statement of comprehensive income it is not allowed to present or describe any item of income or expense as being extraordinary (IASB, 2009a, art 5.10). E.U. Directives classified the activities of a company as being ordinary or not. If during a fiscal period there are incomes or expenses that can't be classified as being ordinary, than it is necessary to define them as being extraordinary income or extraordinary charges. (EC, 1978, Fourth EU Accounting Directive, art. 29.1).

Financial instruments at fair value. According to IFRS for SMEs, at the end of the reporting period, all the financial instruments mentioned in section 12 should be evaluated using fair value (IASB, 2009a, art.12.2) and all their modifications should be recognized in the statement of comprehensive income. There are some exceptions regarding equity instruments and some contracts related to such instruments. E.U. Directives choose the purchase price to value an item at the end on the reporting period (EC, 1978, Fourth EU Accounting Directive, art. 32). Although we find the fair value concept in the text of the directives, European legislation gives permission and does not impose to each member state to request the valuation of financial instruments using fair value method for all the companies or for a group of them (EC, 1978, Fourth EU Accounting Directive, art. 42a). This is not an option when we speak about consolidated accounts. In this conditions we refer to liabilities held as a part of a trading portfolio, derivate financial instruments and not at the elements mentioned in art 42.a.4 (EC, 1978, Fourth EU Accounting Directive, art. 42a). The difference is that the IFRS for SMEs require more elements than those listed in the Fourth Council Directives, in particular for financial liabilities to be measured applying fair value method (EFRAG, 2010a, p. 86).

Useful life of goodwill. According to IFRS for SMEs, goodwill should be recognized and measured at the cost level less accumulated amortization and accumulated impairment losses. According to IFRS for SMEs, if the company doesn't have a rational method for establishing the useful life of goodwill, this has to be presumed to be 10 years (IASB, 2009a, art. 19.23). European Union Accounting Directives, referring to the goodwill as a positive consolidated difference, mentions that it should be subtracted immediately from reserves (EC, 1983, Seventh EU Accounting Directive, art. 30). The article no.34 of the Seventh Directive also specifies a 5 years useful life of goodwill (EC, 1983, Seventh EU Accounting Directive, art. 34). Regarding goodwill, IFRS for SMEs are not compatible with the E.U. Directives, which do not allowed a period of more than 5 years for goodwill amortization (EFRAG, 2010a, p. 152).

Immediate recognition of negative goodwill. According to IFRS for SMEs, negative goodwill should be recognized immediately in the income statement (IASB, 2009a, art. 19.24). Council Directives do not allow the immediate recognition of the negative goodwill in financial statements if it is possible that goodwill to be related to a future negative result (EC, 1983, Seventh EU Accounting Directive, art. 31). Concluding, the recognition of a negative goodwill is treated differently in the two referentials.

Presenting unpaid capital as an offset to equity. According to IFRS for SMEs, 'the requirement to present the amount receivable from equity instruments, issued before the entity receives the cash or other resources, as an offset to equity and not as an asset' (IASB, 2009a, art.. 22.7(a)). According to CEE Directives, unpaid subscribed capital appears as asset (EC, 1978, Fourth EU Accounting Directive, art. 9).

Reversal of impairment loss recognized for goodwill. According to IFRS for SMEs, 'an impairment loss recognized for goodwill shall not be reversed in a subsequent period' (IASB, 2009a, art. 27.28). According to Fourth Council Directive it is necessary to reverse goodwill impairment losses if the reasons for which they have been recognized are not applying anymore (EC, 1978, Fourth EU Accounting Directive, art. 35).

4. THE HARMONIZATION OF THE EUROPEAN UNION ACCOUNTING SYSTEMS BY USING IFRS FOR SMEs

The objective of introducing IFRS for SMEs ‘is to provide a framework, to generate relevant information, reliable and useful, characteristic of a set of high-quality, easily understood to be applied at SMEs level’(Grosu and Bostan , 2010, p.2).

After the publication of IFRS for SMEs in 2009, many opinions appeared concerning the need for their implementation at the European Union level. European Commission decided to centralize all those opinions. With the objective of gathering the view of EU stakeholders, between November 2009 and March 2010 there was a public consultation on the IFRS for SMEs by using ‘Questionnaire on the public consultation of the IFRS for SMEs, promoted by the European Commission. The consultation document had 12 questions regarding possible application in the EU, the impact on the role of Accounting Directives and some initial reactions to them. European Commission received 210 responses from 26 Member States and four non-EU states, from public authorities and accounting standard setters (14%), preparers (42%), users (12%), accountants and auditors (32%) (European Commission, 2010a).

At the European Union level there are various opinions on widespread use of IFRS for SMEs within Europe. The general opinion is that IFRS for SMEs should be used all around Europe. Most of those who expressed an opinion on it believe that the Standard are best suitable for Large and Medium- sized companies, for international groups, for subsidiaries and for companies active internationally. They also believe that by using them, harmonization and comparability will be improved and foreign investors will be more interested on European affairs.

On the other hand all of them agreed on the necessity of a cost/benefit analysis of implementing the standards, before any decision is taken. They also mentioned the comparability between full EU IFRS and IFRS for SMEs.

Using IFRS for SMEs as the regulatory legal framework for financial reporting has its own benefits:

- First of all these standards allow international comparability between financial reports of a large number of entities;
- They facilitate the mobility of accounting and audit services within the EU;

- The standards provide more harmonized information from which stakeholders should benefit. We are referring here to investors, business partners and creditors. Also, the process of decision making based on harmonized information could and can result in lower costs of capital;
- By implementing the standards, the same accounting language is used for the transmission of information;
- These standards give an important support to the prepares about consolidated accounts;
- Companies that have subsidiaries in different member states can use these standards; this way, they will avoid problems reflecting different accounting methods used by one or another;
- Facilitate cross border trade;
- Facilitate foreign mergers and acquisitions;
- Facilitate international growth of companies (European Commission, 2010a);
- Using the same standards will increase confidence in global financial reporting and will increase satisfaction of the needs of users of financial statements (Grosu and Bostan , 2010, p.3);
- Increased comparability will make the financial statements analysis easier.

According to Grosu and Bostan, I. (2010, p.2) the application of IFRS for SMEs 'will lead to a high degree of comparability of financial statements, increasing the confidence of users of SMEs in financial reporting and will cause a significant reduction in costs for national reporting standards'.

In the same time we have some important costs of implementing the IFRS for SMEs:

- The standards are too complex and applying them means new methodology, redesign the internal processes, training staff on new accounting system;
- Stakeholders are used to current accounting rules so it will be difficult and costly to implement new rules;
- The need to prepare a second set of accounts for tax purpose can be pricy, if the government ask for it and if there are several important differences between the IFRS for SMEs and national regulations. The main differences are those regarding tax, profit distribution, accounting regimes;
- Companies which are active only locally and have a limited number of shareholders have no benefits. For national entities, harmonization under the current framework is sufficient;
- The development of a common educational framework for accountants (European Commission, 2010a).

It is known that IFRS for SMEs are characterized by greater flexibility on the implementation of the professional reasoning, so it is possible that, applying the same standard, the same transaction to be recognized and reported differently in financial statements (Grosu and Bostan , 2010, p.3).

Most of the EU public authorities, standard setters believe that the adoption of the IFRS for SMEs should be provided for within the EU accounting legal framework. Those who agree with it believe that in this way ‘will increase harmonization of the single market’ (European Commission, 2010a). In the same time, most European countries believe that it is necessary to reach compatibility between the standards and the directives and that it is not logical to have a Member State option regarding IFRS and not to allow the adoption of IFRS for SMEs (European Commission, 2010a). On the other hand, there are voices who say that the most appropriate approach would be to make amendments to Accounting Directives to ensure the compatibility with the international regulations. In this way, complexity, administrative burden and uncertainty will be avoided (European Commission, 2010a).

Regarding the possibility and not the obligation of adopting IFRS for SMEs by member states, the general opinion is that they should be applied. In this way, each member state will have the opportunity to compare the standards with the national regulations, to decide the criteria and the area for adoption and to analyze if the standard is compatible with the tax and capital maintenance laws. There are also voices which say that ‘in order to benefit from the adoption […] a uniform and world-wide application would be necessary’ (European Commission, 2010a, p. 11). Everyone agreed that there could be a better solution for the adoption of the standard. Most of the respondents pointed out that the better solution is to revise the Accounting Directives.

Between the IFRS for SMEs and the European Accounting Directives are a lot of differences as we showed in the previous section. European Union must find a solution to eliminate them. The European Union members pointed out some possible solutions. A radical point of view is to amend the Directives and ‘to preserve international comparability and allow full application of the IFRS for SMEs’. Some suggest the opposite solution: to amend the IFRS for SMEs so that they will be in accordance with the directives. Another point of view suggested asking the member states to resolve the problem. Most of the respondents believe that the companies should make a choice between the standards and the directives (European Commission, 2010a, p.13)

The most important question is about the future role of the Accounting Directives in the Europe Union. Some believe that Directives must act as a ‘transparency benchmark’ between national and international standards. Most of the respondents believe that ‘the Directives must be kept as the basis of European harmonization’ (European Commission, 2010a, p.14).

It is very important for us to see which was the Romanian position regarding the importance and the adoption of IFRS for SMEs.

Romanian Ministry of Public Finance believes that IFRS for SMEs are not suitable for widespread use within Europe choosing the Directives instead. But according to it, European Accounting Directives must be reviewed and modernized to achieve more stability and comparability for the accounting information. In the opinion of Romanian legislators, small companies, those which have securities traded on a regular market and those that are part of a group would benefit from the adopting the standards. The users of the financial statements would not benefit from the international comparability assured by the IFRS for SMEs especially because small companies have only local activities. The Romanian Ministry of Public Finance believe that there must be an 'unitarian' European accounting legal framework, including the IFRS for SMEs and the Directives. That is why the IFRS for SMEs must be mandatory only for consolidated annual financial statements. In any other situation, it is the member state or company choice to use it. Regarding the incompatibilities between the IFRS for SMEs and the Accounting Directives, Romanian's position is that the Directives should be revised in order to avoid differences in the following areas: cash flow evaluation, financial statements, extraordinary items, valuation rules. (European Commission, 2010b)

The Body of Expert and Licensed Accountants of Romania (CECCAR), contrarily to the Romanian Ministry of Public Finance, believes that IFRS for SMEs is suitable for widespread use within Europe for medium companies. CECCAR considers that increased comparability of financial statement and of accounting information will be beneficial to the users of financial information. In the same time, the Body mentions that the IFRS for SMEs should be adopted within the EU accounting legal framework only if better criteria of defining SMEs will be provided. The IFRS for SMEs must be mandatory for all the entities taken into consideration at the European Union level and the enforcement of the IFRS, without local approval, must not be an option. CECCAR's position is that there must be only an accounting evaluation criteria and we should apply the Directives or the IFRS for SMEs.

As we can see there is a different opinion in EU, also in Romania, concerning the IFRS for SMEs and their importance. In this situation we can put into question if there is a harmonized accounting in Europe or not.

5. CONCLUSIONS

The necessity of having accounting standards for small and medium sized companies is an important debate in European Union especially because European directives do not ensure harmonization of accounting regulation for SMEs in Europe. Nowadays, European Union legal framework does not provide differential reporting standards or regulations for SMEs. The accounting rules applied by the European Union countries are presented in The Fourth and The Seventh Directives, but according to the majority, it is not enough. In 2009, after analyzing for several years the necessity of developing a set of standards that should be applied by the SMEs, IASB developed new IFRS for SMEs. They are important because of some simplification on recognition and measurement, on disclosure and on documentation requirements. The Standard should be used by any SMEs. There are some countries that have already endorsed the Standard but EU is still examining it.

The most difficult issue is the fact that, between the Directives and the IFRS for SMEs, there are a lot of differences regarding the recognition of extraordinary items, the use of fair value method, the useful life of goodwill, the immediate recognition of negative goodwill, the recognition of unpaid capital as offset or to equity or asset and the reversal of impairment loss recognized for goodwill.

Starting from the differences between those two, there is an European debate regarding the adoption of the Standard in European Union and on the cost and the benefit of adopting it, especially on the most appropriate method of adopting it - provided within the EU accounting framework or not. In the same time it is put into question the future role and modification of the Directives. As we have seen there are strong and significant differences between the EU countries concerning these issues.

Small and medium entreprises are very important for the EU economic environment and financial understanding and communication is crucial, that is way, we believe that SMEs accounting should be subject of the European regulation and not of a national one. IFRS for SMEs must be taken into consideration by European Commission in defining a common accounting framework for SMEs. All the SMEs from EU should apply the same accounting rules. If they should apply the Directives or the IFRS for SMEs it’s hard to say. In our opinion IFRS for SMEs represents the best choice. Taking into consideration this, we believe that there must be some transformation in EU regarding accounting framework and fiscal policy. European Commission and the member states of the EU, should never forget that the main objective is the harmonization.

There, will not be any harmonization process if each member states has some national accounting regulations and the choice of adopting or not the international standards.

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