The Possible Ways to IFRS (International Financial Reporting Standards) for Micro-Entities Development (an Investigation of its Usefulness)

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Abstract

There are many ways how to develop accounting standards compatible for SMEs, but most significant activity in this field is the research project of IASB (International Accounting Standards Board). IASB has developed IFRS. Even though IFRS are suitable for all the entities, their application in case of SMEs would be very expensive and could increase compliance costs of taxation significantly. The development has not finished yet and there has arisen some problems which need to be solved before financial reporting standards introduction to the public. The Exposure Draft IFRS for SMEs was published for public comment.
The research of IASB has shown that IFRS for SMEs should be used mainly by the entities which do not have public accountability – i.e. that its equities are not publicly traded and do not hold assets in a fiduciary capacity for a broad group of outsiders. The typical size of SME for which should be IFRS for SMEs developed is about 50 employees. Those standards may not be suited to the smallest entities within the SME spectrum – for micro entities. Micro entities are the smallest entities within the spectrum of small and medium entities.
The paper presents findings of an investigation into the users of micro entity financial reports and their information needs. The analysis of the legal status of micro entities across national jurisdictions and the nature and format of existing financial reports that these entities produce and needs of possible harmonization of their financial reporting is the key objective.
First, the micro entities and their significance are defined. Then the users of financial statements and their information needs are examined. In conclusion is the IASB Exposure Draft for SMEs evaluated and modified (reduced) for micro entities.

Key words: Small and Medium-sized enterprises (SMEs), micro entity, IFRS, harmonization, corporate income tax base

Introduction

Basing on the newest statistics, there are about 23 millions SMEs(Small and Medium Enterprises) operating in 25 EU member states. These companies are providing 66% of jobs in the EU (source Eurostat; Table 1). SMEs are considered to be the key factor of economic growth and employment in the EU. They are socially and economically important and represent 99% of all enterprises in the EU. In the last ten years, they have received a great attention in the EU. A new Recommendation 2003/361/EC regarding the SME definition was adopted in May 2003. This document categorized SMEs into three groups:

- Medium-sized enterprises with less than 250 employees and the turnover below € 50 million and/or balance below € 43 million;
- Small enterprises with more than 50 people and the turnover below € 10 million and/or balance below € 10 million;
- Micro enterprises with less than 10 employees and the turnover below € 2 million and/or balance below € 2 million.

Table 1: Structure of EU 25 business entities by number of persons employed

The share of enterprises on total EU employment	
Type of enterprise	**Share on total employment**
Large	34.20%
Medium	17.00%
Small	20.70%
Micro	28.40%

Source: Eurostat

The increase in the importance of SMEs in EU economy has forced the Commission to work on studies COM(2001)582 final and COM(2005)532 final in that area. These studies have dealt with the position of SMEs in the Internal Market and have identified the obstacles, which these types of enterprises are facing while operating in the Internal Market. As compared with large enterprises whose accounting system is harmonized by IAS/IFRS, the existence of obstacles (mainly in the form of 27 different accounting and tax systems which generate disproportional high compliance cost for SMEs) is the main reason why SMEs are less involved in the cross-border activities and that they less operate in the Internal Market (European Commission, 2003). The studies have revealed that SMEs operate mainly in the domestic market. It seems to be obvious that the higher involvement of SMEs in cross-border activities and their increased operation in the Internal Market could improve their competitiveness and performance. This could remarkably influence the economic growth as a whole. Benefits of global accounting standards for listed companies are obvious above all in the globalized financial market.

Small or medium-sized enterprises (SME) have a legal obligation to prepare financial statements in accordance with a set of accounting principles accepted in their country. Those statements are available to creditors, suppliers, government in their country, but they could be badly understandable to creditors, suppliers and others in other countries.

Is it necessary to develop special global financial reporting standards for SMEs? The benefit of global financial reporting standards is not limited to enterprises whose securities are traded in public capital markets. Small and medium-sized enterprises – and those who use their financial statements – can benefit from a common set of accounting standards different from full IFRS:

- Users may have less interest in some information in general purpose financial statements prepared in accordance with full IFRS than users of financial statements of publicly traded entities (users of financial statements of SMEs may have greater interest in short term cash flows, liquidity, balance sheet strength and interest coverage or they may need some information that is not ordinarily presented in the financial statement of publicly traded companies.
- Differences between full IFRS and IFRS for SMEs must be determined on the basis of users´ needs and cost-benefit analyses (the benefit of applying should exceed the cost)

Financial statements of SMEs that are comparable from one country to the next are needed for following reasons:

- Financial institution make loans across borders and operate multinationally,
- Vendors want to evaluate the financial health of buzzers in other countries before they sell goods or services on credit,
- Credit rating agencies try to develop rating uniformly across borders,
- Many SMEs have overseas suppliers and use a supplier’s financial statements to assess the prospects of a viable long-term business relationship,
- Venture capital firms providing funding to SMEs across borders,
- Many SMEs have outside investors who are not involved in the day-to-day management of the entity. Global accounting standards for general purpose financial statements and the resulting comparability are especially important when those outside investors are located in a different jurisdiction from the entity and when they have interests in other SMEs
- Global standards also improve consistency in audit quality and facilitate education and training

On the other hand:

- Good accounting and more disclosure add to SME burdens, rather than reduce them
- SMEs are often concerned about the competitive harmfulness of greater transparency

The aim of the paper is concerned with the possibilities of harmonization of 27 different accounting systems used by SMEs in the EU, because the existence of 27 different accounting systems is one of the most significant obstacles in cross-border activities for SMEs. The paper is concerned with possible ways of accounting harmonization in the EU and all over the world. The great deal of attention is paid to the most probably ways of the SME accounting harmonization – the IAS/IFRS modification for SMEs and the special modification for micro entities.
There are used IFRS as a starting point for their possible modification (simplification of standards or omitting standards) in the case of SMEs in this paper. And the Exposure Draft IFRS for SMEs is a starting point for modification for micro entities, because all proposed IFRS for SMEs may not be suited to the smallest entities in the SME spectrum.

Methodology

This paper is concerned with the identification of the legal status of micro-entities across national jurisdictions, the nature and format of financial reports prepared by these entities and the analyses of their users and information needs. The analyses of users and their needs is a starting point for harmonization need evaluation.

The approach to harmonization of financial reporting for micro-entities is divided in following steps:

1. the relevant criteria for a micro-entity are defined
2. position of micro entities in economy across the EU and the world
3. users of financial reports of micro-entities are identified
4. information needs of users are defined
5. needs for harmonization and possible ways of harmonization micro-entities financial reporting
6. possible ways to mirco-entities financial reporting harmonization

Theoretical background

The great deal of attention was paid to the question of defining relevant criteria for small entities in the past century. The small entity was defined as an enterprise which has a "relatively" small share of the market, are managed by owners and are independent in the sense that are not a part of a large entity[1]. The quantitative criteria for small entities definition were criticized in the beginning of 21st. century. The use of more qualitative criteria or mix of both was preferred[2]. The alternative approach focused on ownership or organizational structure[3] .
IASB (International Accounting Standards Board) refrained from adopting common quantitative size criteria for SME definition and focused on public accountability[4]. It would be left on individual countries to develop quantitative criteria or other measures of economic significance.
Research made by Barker and Noonan (1995) and Demartini (2005) demonstrated, that SMEs are not a homogenous group and these entities should be differentiated to groups:

- medium sized entities
- small entities
- micro- entities

Each group of SMEs category differs in many ways. There is the most significant difference in the field of regulation of financial reporting in many countries. For example many countries exempt smaller enterprises from statutory audit and subject them to differential reporting requirements. As a result of EU Code of accounting legislation, small and medium companies have to option of filling abbreviated reports with reduced levels of disclosure.[5] There are arguments supporting the need for differential reporting and relaxing requirements for smaller entities. Much of the disclosure information required by full financial statements intended for listed companies are not relevant to smaller businesses. Larger companies use their financial statements for a wider range of decisions and that they undertake more complex transactions than smaller enterprises, providing aggregated information that requires more sophisticated analysis.[6] The compliance cost of preparation full financial statements for smaller entities would not be appropriate (very high). Despite the fact that differential reporting is useful, owners of small entities have mixed views on the cost/benefit balance of regulation and producing such information. Recent research in the USA suggests that the benefits of preparing or using prescribed financial statements should be compared with the cost of preparing or using these statements. [7] Usefulness varies across different types of SMEs. Owners of growing small entities are much more likely to accept regulation as a means of generating interest, and therefore potential outside investment, in the company.[8]

[1] definition of Bolton Report (1971)
[2] Paoloni (1999).
[3] Chittenden (1990)
[4] An entity has public accountability if: it has filed or, is in the process of filing, its financial statements with a security commission or other regulatory organization for the purpose of issuing any class of financial instruments in a public market, or it holds assets in a fiduciary capacity for broad group of outsiders , such as bank, an insurance company securities broker, pension fund, mutual fund or investment banking entity (IASB,2006)
[5] IFAC report
[6] Collis (2002)
[7] AICPA (2005)
[8] Research made by Barker and Noonan in Ireland in 1995

The literature presents some cases against differential reporting for larger and smaller entities:

- the need for comparability and reliability derives from the universal application of accounting rules
- reduction in regulations for smaller entities may portray small companies as second class citizens and may even risk bifurcation within the profession[9]
- more than one set of rules may undermine the credibility of accounts in the minds of users since different rules may result in different results and, in particular, profit figures.

The arguments for differential reporting seem to be stronger. The main argument for differential reporting of smaller enterprises is based on the results of the IASB research[10].

The IASB definition of SMEs does not include quantified size criteria for SMEs determination, because those standards could be used in over 100 countries. It is not feasible to develop quantified tests that would be applicable and long-lasting in all these countries. In deciding which entities should be required or permitted to use the IFRS for SMEs, jurisdiction may prescribe quantified size criteria in each particular country. Despite this fact, the IASB approach focuses on "the typical SME" with about 50 employees. It is a quantified size test for defining SME but, rather, to help it decide kind of transactions, events and conditions that should be explicitly addressed in the IFRS for SMEs. There could be any problem, because IFRS for SMEs could not be suitable for very small entities (micro entities). This kind of entities prepares financial statements especially for taxation purposes. The organization of IFRS for SME should make easy for micro SMEs to identify those aspects of standards that are relevant to them. This approach might result in relatively low costs to SMEs in preparing financial statements in accordance with IFRS for SMEs.

The effort of IASB was completed by preparation of the Exposure Draft of IFRS for SMEs for public comments in February 2007.

The objective of the IFRS for SMEs

The aim of the proposed standard is to provide a simplified, self-contained set of standards, based on full IFRS, which were developed primarily for listed companies.

There is designed to apply to the general purpose financial statements and other financial reporting for all profit-oriented entities. General purpose financial statements are directed towards the common information needs of a wide range of users (shareholders, creditors, employees and the public) and provide information about an entity's financial position, performance and cash flows. Determining taxable income requires special purpose financial statement designed to comply with the tax laws and regulations in a particular jurisdiction. An entity taxable income is defined by the laws and regulations of the country or other jurisdiction in which it is domiciled. Tax authorities are also important external users of the financial statements of SMEs. General purpose financial statements prepared in an accord with IFRS for SMEs could be a starting point for determining taxable income in the future, but usually have some policies to minimize the adjustments to accounting profit or loss for the purpose of determining taxable income.[11] Designed global accounting standards for SMEs do not deal

[9] Barker and Noonan (1995)

[10] Comment letters to Preliminary Views on IFRS for SME (2004)

[11] For details see Nobes (2003)

with tax reporting in individual jurisdiction, but profit or loss determined in conformity with the proposed IFRS for SMEs could serve as a starting point for determining taxable income in a given jurisdiction by means of reconciliation that is easily developed at a national level.
It is not the primal purpose of the IFRS for SMEs to provide information to owner-managers to help then make management decisions, the more significant information source for managers is the system of management accounting, which is constructed in accord with the organizational structure of an entity. Nonetheless, general purpose financial statements will often serve managers as a source of information on business financial position, performance and cash flows.
The second possible approach to SMEs Financial reporting harmonization is the approach of UNCTAD/ISAR. It is similar to the approach of IABS. There is only one difference. The ISAR approach identifies three levels of financial reporting regulation:

- level 1: Listed entities whose securities are publicly traded and those with significant public interest should follow IFRSs
- level 2: Significant commercial, industrial and business entities that issues neither public securities nor financial report to the general public may follow IFRS for SMEs
- level 3: Is aimed to the smallest entities, the detailed definition of the smallest entities is not provided (it can vary internationally, depending on the size stage of development of countries[12]), these entities could follow a simple accrual-based accounting system, which should be consistent with the requirement of IFRSs but more simple, or cash based accounting.

Discussion and Results

Definition of micro-entities

Harmonization of financial reporting for large, medium-sized and small companies is already solved. There are IFRS for large publicly traded companies, IFRS for SMEs are on display for public comment. The typical entity for which were IFRS for SMEs developed is an entity with 50 employees. There is a question. Are IFRS for SMEs the best way for micro-entities financial reporting? In conformity with the Recommendation 2003/361/EC are micro-entities defined as entities with less than 10 employees and the turnover below € 2 million and/or balance below € 2 million. The importance of micro-entities varies across sectors of any economy. In EU countries in 2001, micro entities accounted for only 1.9% of all employment in the electricity, gas and water supply industry and 4.6% in mining and quarrying. In contrast, they accounted for 45.7% of employment in hotels and restaurants and 39.6% in distributive trades (Eurostat, 2005).

Table 2: Size criteria used in national legislation in various EU and non EU countries for micro-entities definition (in USD)

	Employees	Turnover	Balance Sheet Total
Belgium	*)	*)	*)
Czech	10	2.6	2.6
Estonia	10	0.8	0.4
Germany	10	2.6	2.6
Hungary	10	2.6	2.6
Italy	*)	*)	*)
Poland	10	2.6	2.6
Romania	10	*)	*)

[12] UNCTAD (2000)
*) there is not used special quantitative criterion for micro-entitiy

UK	*)	*)	*)
Brazil	*)	0.1	*)
China	*)	*)	*)
Russia	*)	*)	*)
Switzerland	*)	*)	*)

Source: own research

Most accounting regulatory regimes recognize difference between larger and smaller enterprises. There are the burdens placed upon smaller enterprises by financial reporting, many countries exempt smaller entities from statutory audit and subject them to differential reporting requirements.

Financial information and their suitability for micro-entities, users of financial information

Usefulness of financial information varies across different types of SMEs. Based on findings of Baker and Noonan (1995), the owners of growing small entities are much more likely to accept regulation as a means of generating interest, and therefore potential outside investment, in the company. Other micro-entities in a start-up situation prefer more relaxed regulatory regime. There are many micro-entities (especially in the transition economies) which do not actually keep proper financial records or accounts. The main reason is that they are not convinced of usefulness of financial information for decision making and control. For example, the smallest entities in the Czech Republic should use only the income tax act for financial recording. They keep records based on cash flows for taxation purposes and for decision making. The accrual principle is not allowed, while Cyprus and Malta require all companies to follow full IFRS. There are accounting requirements for purposes of taxation differentiated according to the size of the entity size in Poland.

Owners-managers of micro-entities could use financial information for a variety of purposes:

- to ascertain remuneration awards made to directors
- to compare entity performance with previous periods
- for purposes associated with loans and financing
- it is a useful tool for planning and decision-making
- to compare income and costs with past periods
- taxation

One of main aims of micro-entities run by owners and their families is to minimize tax liability. They do not use the financial information as a tool to communicate with external users or for management needs (Paoloni, 2000). This contrasts with Barker and Noonan (1995) study. They comment that the major uses include: to determine gross profit, asses directors fee, tax liability and ensure that the expenses are reasonable. The tax authority seems to be a major user of financial information of micro-entities. Tax authorities have their own rules to determine taxable income across countries. That means that one set of harmonized accounting standards will not satisfy every tax authority. Taxation is not the reason to harmonize financial reporting of micro-entities yet.

Finance providers are very important users of financial information of micro-entities. Banks are the most important source of finance for micro-entities in most countries. Financial information plays significant role in their lending decisions. Micro-entities should inform banks annually for the purpose of monitoring existing loans or for the purpose of applying for new loans. Micro-entities also gain finance from other sources. It may be government agencies, regional development agencies or EU agencies. Getting finance could be very important reason for financial reporting harmonization of micro-entities. Financial information should be understandable not only in the home country, but to creditors in other countries, because these entities can get finance (from bank or grants) in the home country or in other countries.

Possible ways to micro-entities financial reporting harmonization

There are three ways to micro-entities financial reporting harmonization:

1. financial reporting based on the cash-flow bases
2. financial reporting based on the accrual concept
3. financial reporting based on IFRS for SMEs

Financial reporting based on the cash-flow bases

This is a very simple and not demanding extra costs way to record economic activity of an entity. The main objective of a micro-entity´s activity is its capacity to generate positive cash flow. The positive cash flow is a starting point for taxable income generating and repaying loans ability estimating.
This approach is limited in its function to serve information for management, planning, decision making.

Financial reporting based on the accrual concept

The most convenient approach to micro-entities financial reporting is to simplify the IFRS for SMEs for micro-entities. IFRS designed for large publicly traded companies were simplified for SMEs (see Table 3). IFRS for SMEs were designed for typical SME with 50 employees. Many articles of IFRS for SMEs could be omitted for micro-entities, many articles could be simplified for micro-entities. In a micro-entity´s activity is many regularly recurrent operations and only a few irregular operations, financial statements tent to be prepared by owner-managers themselves or externally by a hired accountant. This is the main reason for simplification of IFRS for SMEs for micro-entities.

The simplification could be based:

- On omitting some accounting principles arising from the Conceptual Framework, it is especially prudence principle (micro-entities should not record provisions and adjustments
- Reduction of financial statements amount and simplification of theirs content (only a balance sheet and an income statement)
- The most significant valuation base should be historical cost (for inventories, property, plants and equipments)
- All kind of lease could be recorded as an operating lease
- Construction contracts could be recorded on the invoice bases (IAS 11 omitting)
- Only the current income tax recording.

Table 3: Survey of possible modification of each IFRS for SME

Standard	Name	Simplification	Omitting
IAS 1	Presentation of Financial Statements	+	
IAS 2	Inventories		
IAS 7	Cash Flow Statement	+	

IAS 8	Accounting Policie, Estimates and Errors	+	
IAS 10	Events after the End of the Reporting Period		
IAS 11	Construction Contracts	+	
IAS 12	Income Taxes	+	
IAS 14	Segment Reporting		+
IAS 16	Property, Plant and Equipment	+	
IAS 17	Leases	+	
IAS 18	Revenue		
IAS 19	Employee Benefits	+	
IAS 20	Government Grants	+	
IAS 21	The Effect of Changing Foreign Exchange Rates	+	
IAS 23	Borrowing Costs	+	
IAS 24	Related Party Dislosures	+	
IAS 26	Accounting and Reporting for Retirement Benefit Plans	+	
IAS 27	Consolidated Financial Statements	+	
IAS 28	Investment in Associates	+	
IAS 29	Hyperinflation		+
IAS 30	Disclosure in Financial Statement of Banks in Similar Financial Instituitions		+
IAS 31	Investment in Joint Ventures	+	
IAS 32	Financial Instruments: Presentation	+	
IAS 33	Earnings per Share		+
IAS 34	Interim Reporting		+
IAS 37	Provisions and Contingecies	+	
IAS 38	Intangible Assets	+	
IAS 39	Financial Instruments: Recognition and Measurement	+	
IAS 40	Investmet Property	+	
IAS 41	Agriculture		+
IFRS 1	First-time Adoption of IFRS	+	
IFRS 2	Equity-settled share based payment		+
IFRS 3	Business Combinations	+	
IFRS 4	Insurance Contracts	+	
IFRS 5	Non-current Assets Held for Sale and Discountinued Operations	+	
IFRS 6	Exploration for and Evaluation of Mineral Resources		+
IFRS 7	Financial Instruments: Disclosures	+	

Source: Exposure Draft of a Proposed IFRS for Small and Medium-sized Entities”

The simplification of IFRS for SME for micro-entities could be summed up in the following table:

Table 4: Survey of possible modification IFRS for SME for micro entities

Standard	Name	Simplification	Omitting
IAS 1	Presentation of Financial Statements	+	
IAS 2	Inventories	+	
IAS 7	Cash Flow Statement		+
IAS 8	Accounting Policie, Estimates and Errors	+	
IAS 10	Events after the End of the Reporting Period		
IAS 11	Construction Contracts		+
IAS 12	Income Taxes	+	
IAS 16	Property, Plant and Equipment	+	

IAS 17	Leases	+	
IAS 18	Revenue	+	
IAS 19	Employee Benefits		+
IAS 20	Government Grants	+	
IAS 21	The Effect of Changing Foreign Exchange Rates	+	
IAS 23	Borrowing Costs		+
IAS 24	Related Party Dislosures		+
IAS 26	Accounting and Reporting for Retirement Benefit Plans		+
IAS 27	Consolidated Financial Statements		+
IAS 28	Investment in Associates		+
IAS 31	Investment in Joint Ventures		+
IAS 32	Financial Instruments: Presentation		+
IAS 37	Provisions and Contingecies		+
IAS 38	Intangible Assets	+	
IAS 39	Financial Instruments: Recognition and Measurement		+
IAS 40	Investmet Properties	+	
IFRS 1	First-time Adoption of IFRS	+	
IFRS 3	Business Combinations		+
IFRS 4	Insurance Contracts	+	
IFRS 5	Non-current Assets Held for Sale and Discountinued Operations		+
IFRS 7	Financial Instruments: Disclosures		+

Source: Own research

Financial reporting based on IFRS for SME

This approach demands the highest costs of producing financial statements (compliance costs) and high level of skills of prepares of financial statements. There is the only tool of micro-entities financial reporting harmonization in the recent days.

Conclusion

Micro-entities use financial reports for a variety of purposes, such as obtaining credits from suppliers and banks, budgeting, monitoring profit for tax purposes, planning. Taxation purpose is the most significant purpose of financial reporting of micro-entities. In this case is still difficult to argue in favor of financial reporting of micro-enties harmonization. Micro-entities must follow income tax legislation in home country for taxation purpose. If financial information served by financial statement prepared in an accord with IFRS is a source of information for taxation purposes, international standards could replace national standards or current practice.

Harmonization of financial reporting of micro-entities is still the most significant for getting external credits and grants from other countries or EU funds.

There is an important fact, that harmonized financial reporting could be significant source of information for all purposes of micro-enities (including taxation) in the future.

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