

INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) WILL SUPPORT MANAGEMENT ACCOUNTING SYSTEM FOR SMALL AND MEDIUM ENTREPRISE (SME)?"

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ABSTRACT: The problem of reporting financial data useful for readers in most of the countries and languages is receiving considerable attention with the implementation of the new financial reporting standards in the United States, European Union Canada, Australia, and Japan. The theoretical model of the new standard forms that would be produced in a particular country and especially for public and world companies will expedite the search and analyses of usefulness of this reporting. The characteristic formulation of accounting and financial information is to obtain a common language in reporting financial data, capable to be used by readers in the same meaning and to be useful for all participants. In other words the needs for harmonization of financial and accounting information to all participants. There are a lot of interferences, convergences and divergences between accounting and financial reporting that still should be resolved for SMEs. Using a comparative method between needs for accounting and financial information for management in one side and bank on other side in two countries, Canada and Romania, it will be able to show how accounting and financial information can be harmonized for SMEs and to be implemented in IFRS.

Key words: IFRS, Management Accounting, SWOT

JEL codes: M 40, M 41)

Introduction

The current financial crisis has underscored the fragility and interconnectedness of our global economic system. The credit bubble has emphasized that not only the economy should be encouraged, but also, our accounting and financial reporting systems have to be resilient and modernised as well. "Governments and regulators need to step up initiatives to promote convergence to global accountancy and auditing standards" according to IFAC G20 Accountancy Summit on July 23 and 24 in London (CMA Management, October 2009, page 6).

In the last twenty years a rapid expanding global economy with multinational companies has created broader business opportunities and a larger consumer marketplace, but it is placing a dangerous strain on the way in which accounting and financial reporting should be viewed. In this system the SMEs are viewed as the engine of the economy. Which are the information requirements for management accounting purpose in order to sustain external accounting? Do we have to redefine the IFRS system in a new manner for SMEs? Can reporting of accounting and financial information, be harmonized and used on the same way by all users? To get answer to those questions we used a comparative method between accounting and financial reporting in two countries: Canada and Romania, and between management needs for accounting and financial

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information in one side and bank on other side. Finally, we will explain how new reporting and requirement of IASB (International Accounting Standards Board) for SMEs can be harmonized for some major accounting reporting.

Literature review

A recent overview of two specialists of the literature for accounting and financial reporting for SME is research mentioned: "The findings of this paper indicate that very little research has been previously conducted looking specifically at micro-entities as these tend to be subsumed in the term SME. This gap in the literature indicates that this is an area that is ripe for further in-depth examination and research." (Clare Roberts and Dr. Suki Sian - MICRO-ENTITY FINANCIAL REPORTING: PERSPECTIVES OF PREPARERS AND USERS -Small and Medium Practices Committee International Federation of Accountants – Information Paper, December 2006. The accountings for SME vary a lot from country to country, "The accounting systems in place for small enterprises in Member States vary a lot. We personally agree to this point of view, moreover there are cases when there are no accounting requirements at all and cases where the accounting requirements are relatively strict for small enterprises." (The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and Industry Directorate – General Promotion of SMEs' competitiveness – November 2008, Page 24). There are a lot of difficulties in applying IFRS to SMEs "Consequently, it has often been difficult to apply them to SMEs, particularly those in developing countries and countries with economies in transition."(UNCTAD-ISAR Accounting by Small and Medium - sized Enterprises).

Researchers agree over the needs of accounting and financial records:"all small enterprises will need to keep some kind of financial records in order to keep financial control over their businesses" (The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and Industry Directorate – General Promotion of SMEs' competitiveness – November 2008, Page 24).

For the present study , the following area of research are particularly relevant: definition of Small and Medium sized Enterprises, users and user needs of financial reports, accounting and financial reporting standard for Small and Medium – sized Enterprises.

Trying to define Small and Medium sized Enterprises.

Some authors consider the enterprise as an "entity engaged in an economic activity" (*The Recommendation of the European Commission 2003/361/EC of 6 May 2003*), other authors linked definition of enterprises to legal form: "any business imply a legal form of constituency". (Constantin Groza, *Sa facem afaceri??* ISBN: 978-973-53-0040-1).

The European Commission considers that SME should be treated quiet different by public company: "A small enterprises is not simply a smaller version of a large enterprise."(The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and Industry Directorate – General Promotion of SMEs' competitiveness – November 2008, Page 22)

Many researchers consider the lack of universal definition to be an obstacle for business studies and market research. (Stanworth, J. and C. Gray (1991), *Bolton 20 years on the Small Firm in the 1990's*, Paul Chapman). There is not a unanimous view about definition of SME. The differences are related to the sizes and components to be considered relevant for SME. There are advocate for quantitative criteria (Curran, J. and R. A. Blackburn (2001), *Researching the Small Enterprise*, Sage, London.), or for qualitative criteria (Paoloni, M., P. Demartini, J. M. Moneva and B. Cuellar (2000), *Financial reporting by SMEs in Italy and Spain. Quaderni di Economia Aziendale (Working Papers), Urbino University,Italy.*) or for both quantitative and qualitative criteria in defining the SME. There are suggestions for alternative definitions focusing on

ownership or organizational structure (Chittenden, F., J. McConnel and C. Risner (1990). *The role of the accounting profession in the growth and development of small business*, Research Report 18, ACCA.).

According to *the Recommendation of the European Commission 2003/361/EC of 6 May 2003 (OJ L 124, 20.5.2003, p.36)*. "Small and Medium-sized Enterprises are defined as enterprises which:

- Employ fewer than 250 persons and
- Have an annual turnover not exceeding EUR 50 million or
- An annual balance sheet total not exceeding EUR 43 million."

This definition is quite different by SME definition listed by III Working Group on IFRS impact and CBSO Database where are added to the definition companies with no shares or debts listed on an exchange market and no banks, no insurances, no other financial intermediaries no investment funds or similar. (SME ACCOUNTING STANDARDS – Answers to questions submitted by IASB on Staff Questionnaire on R&M modifications 30 June 2005 page 4)

States traditionally have their own definition of what constitutes an SME, for example the traditional definition in Germany had a limit of 250 employees, while, in Belgium it could have been 100. But now the EU has started to standardize the concept. Its current definition categorizes companies with fewer than 10 employees as "micro", those with fewer than 50 employees as "small", and those with fewer than 250 as "medium". By contrast, in the United States, when small business is defined by the number of employees, it often refers to those with fewer than 100 employees, while medium-sized business often refers to those with fewer than 500 employees (Wikipedia- the free online dictionary). The definition of Small and Medium sized business varies according to different sources:

- According to Canadian Industry Profiles, a small business is defined as one with revenue between \$30,000 and \$5 million. A medium business has revenues between \$5 million and \$25 million.
- Statistics Canada defines small businesses as firms with less than 500 employees and less than \$50 million in annual revenues.
- The Canadian Council of Ministers of the Environment defines business size according to the number of employees. Small Business has less than 50 employees. Medium Business has 51 to 500 employees.

ISAR (International Standard of Accounting and Reporting) do not state a definition of enterprise but use the term of SME. However IASB in his exposure draft for SME define those enterprises as entities that:

- (a) Do not have **public accountability**; and
- (b) Publish **general purpose financial statements** for external users.

Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies (Exposure draft of a proposed IFRS for Small and Medium-sized Entities, February 2007).

Formal important points of financial reports

All the accounting regulators body recognize the importance of differences between SME and listed companies, and the implication of introducing the new accounting standard for such enterprises (IFAC, European Commission, IASB).

Introducing **the same reporting and standard for SME** can potentially inhibit innovation and growth in this important sector (Speech on July 13, 2006 by Graham Ward, IFAC President, <http://www.ifac.org/MediaCenter>). "Therefore, each enterprise needs to decide who the main users are and what their needs are." (The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and

Industry Directorate – General Promotion of SMEs’ competitiveness – November 2008). All above consideration are based on the benefit and the cost associated with compliance (Paoloni, M. and P. Demartini (1999). Harmonizing small business financial reporting in Europe: A missed opportunity. *Quaderni di Economia Aziendale (Working Papers)*, Urbino University, Italy).

Other researchers are **against differential reporting** due to: the universality argument (i.e., companies should not be subject to different rules giving rise to different “true and fair views”), second of all the need for comparability and reliability derives from the universal application of accounting regulations; also published accounts are “the price to pay for limited liability” of ownership and management; and reduction in regulations for smaller entities may portray small companies as second class citizens and may even risk bifurcation within the profession (Collis, J., D. Dugdale and R. Jarvis (2001). Deregulation of small company financial reporting in the UK. Contemporary issues in accounting regulation. S. McLeay and A. Riccaboni, Kluwer Academic Publishers).

There are other researchers that consider the differential reporting is a ***fiction of academics and practitioners rather than SME owners and users***. They argue that 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 (See page 11, Clare Roberts and Dr. Suki Sian - MICRO-ENTITY FINANCIAL REPORTING: PERSPECTIVES OF PREPARERS AND USERS - Small and Medium Practices Committee International Federation of Accountants –Information Paper, December 2006).

There are not divergences related to users of financial reporting. Therefore the financial statements should be designed to reflect users’ needs. Researchers agree that the users need for accounting and financial information are expressed under the form of reporting requirement. (SME ACCOUNTING STANDARDS – Answers to questions submitted by IASB on Staff Questionnaire on R&M modifications 30 June 2005 page 5).

There are two issues related to information contained in reporting format. One is when there is an insufficient detailed format. User will need to go fishing for the information or can take a wrong decision for lack of format. A second issue is when there are too many information detailed in format. Users will need to work hard to find the needed information or to understand those.

The solution of those issues is again in users need. The most important user need, we consider, should be found in the management need of accounting and financial information. All other user needs should be around management

For Romania the users of financial statements could be the owners, the tax authorities, the management of the enterprise for the distribution of the profit resulted from economic activity and also other categories of users (Annex 2 The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and Industry Directorate – General Promotion of SMEs’ competitiveness – November 2008).

For Canada some researchers classify the users after their need in private entity and private entity with external users. For private entity the users are Business owners/investors and management. For entity with external users the users are:

- Business owners/investors
- Management
- Governments and its agencies
- Banks and other creditors
- Customers/suppliers
- Employees

(The AC Group of Independent Accounting Firms Limited <http://www.acsbcanda.org/strategic-planning/private-enterprises/item18891.pdf>)

“At its 17th session in July 2000, ISAR identified a number of obstacles that small and medium-sized enterprises (SMEs) were facing in applying accounting standards that had been issued by various standard-setting bodies, both national and international. These existing standards have been created primarily with the financial reporting needs of larger companies in mind. Consequently, it has often been difficult to apply them to SMEs, particularly those in developing countries and countries with economies in transition. ISAR therefore agreed to work on identifying possible approaches that would meet the accounting and financial reporting needs of SMEs”(http://www.unctad.org/en/docs/c2isard50_en.pdf page2).

Some researchers “believe that the SME rules should be sufficiently comprehensive and that only should be excluded those recognition and measurement rules, which are absolutely inapplicable for the SMEs (SME ACCOUNTING STANDARDS – Answers to questions submitted by IASB on Staff Questionnaire on R&M modifications 30 June 2005 page 5). That because SMEs do not have in-house that large company have to distinguish and disclose the very detailed information required by the standard.

Is there a need for accounting and financial reporting standard for Small and Medium – sized Enterprises?

High quality of accounting data comparable among different companies, to support decisions of a varieties of users including management teams, through creation of a large data base, are restricted to a small number of companies because it is very costly and time consuming (SME ACCOUNTING STANDARDS – Answers to questions submitted by IASB on Staff Questionnaire on R&M modifications 30 June 2005 page 5).

For that reason the standardization of accounting and financial information get an important support from researchers.

There are some arguments in favor of and against an international standard for SMEs (See page 22, 23 Clare Roberts and Dr. Suki Sian - MICRO-ENTITY FINANCIAL REPORTING: PERSPECTIVES OF PREPARERS AND USERS -Small and Medium Practices Committee International Federation of Accountants –Information Paper, December 2006).

At the level of international bodies that regulate accounting where identified some possible approaches to meet accounting and financial reporting needs of all enterprises. ISAR has developed a three-tiered level structure to meet the financial reporting needs of all enterprise.

Level 1 - For all listed enterprises or in which there is significant public interest.

Level 2 – For all enterprises that do not have public securities and there is not significant public interest.

Level3 – For all enterprises, which are often owner-managed and have no or few employees.

(http://www.unctad.org/en/docs/c2isard50_en.pdf page2)

The European Commission has categorized the accounting legislation at EU level in force using a three layer model as well which determines the accounting requirements for different kind of companies/enterprises. First layer - the listed companies in the EU, second layer the limited liability companies and third layer the residual of enterprises which are not covered by the EU accounting legislation in the first and second layer. (The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and Industry Directorate – General Promotion of SMEs’ competitiveness – November 2008, page 11-12). Both ISAR and The European Commission recommend that each state should determine how these levels are determined.

In our research we used second and third layer to define the accounting and financial reports. The first level is already implementing IFRS. The objective of Level 2 and Level 3 financial statements are to provide information about the reporting Enterprise’s financial performance and financial position while the objective of accounting system is to provide the owners/managers with appropriate financial information.

There are some issues related to financial accounting and management accounting. At the level of economic entity especially for small enterprise the accounting system is classified as external, internal and tax accounting. Internal accounting also called management accounting is intended for management and is based on the enterprise's internal accounting procedures and recorded accounting information. External accounting, called the financial accounting, makes use of the accounting information from the internal accounting system.

The issue is that while for internal accounting there are not express rules stated by accounting bodies or state, for external accounting the small enterprises can be governed by local GAAP (in Canada) or by state (Romania). In other words, some states have introduced external accounting rules for small enterprises, while others have no accounting rules in place. However, in some Members state internal accounting is compulsory even for small enterprises (The Final Report of the Expert Group Accounting systems for small enterprises - Recommendations and good practices issued by European Commission Enterprise and Industry Directorate – General Promotion of SMEs' competitiveness – November 2008, page 14).

For this study we do not consider relevant Tax accounting which normally is based on external accounting system. However, we will identify the information requirements for management accounting purpose in order to sustain external accounting.

Research methodology

Our research took the approach that the **users of internal and external accounting are most likely to have well-developed opinions on the use of SME** accounting and financial information. IASB argued that the general purpose of financial statements are only for external users and not for owner managers (See page 16, Clare Roberts and Dr. Suki Sian - MICRO-ENTITY FINANCIAL REPORTING: PERSPECTIVES OF PREPARERS AND USERS -Small and Medium Practices Committee International Federation of Accountants –Information Paper, December 2006). We consider, the internal accounting is the foundation of external accounting and external accounting can be distortional if the owners/managers have no interest in financial information. In the same time internal accounting can offer more accuracy to external accounting information if both internal and external accounting information are used properly by owners/managers.

We were influenced in this approach by the finding that the majority of small enterprises are with limited resources to support high developed financial information and the owners/investors of those enterprises have limited knowledge about financial information.

For **comparative method between accounting and financial reporting** in two countries: Canada and Romania, we found that in countries classified as Continental European accounting tradition (among which Romania), majority of concepts required by the users (banks, investors, and tax authorities) are extracted directly from the national GAAPs or from state regulatory. Specifically they are detailed items of compulsory disclosure from the models of tables that which companies must to publish in their financial statements (see models of balance sheet and income statements where there are detailed elements).

On the other side in the countries where the accounting information are extracted under the GAAP (Canada) identified as Anglo-Saxon, "firms tend to publish relatively simplified balance sheet and income statements" (DING, Y.; STOLOWY, H. TENENHAUS, M(2001) "The Internationalization of Financial Statements Presentation: an Empirical Study of French Groups" Paper presented at the 24th Annual Congress of the European Accounting Association, Athens, Greece). For such financial statements, the comparable accounting information are often unavailable.

The issue is: which accounting information systems provide better decisional help for SMEs users? Continental European or Anglo Saxon accounting

To get answer we selected two variables of SME namely management need or usefulness of financial information for management of SME's and designed features of accounting information. We used questionnaire-based research for both variables as benefits in conjunction with cost of preparing or using financial information for SME .

Several reasons were found in literature related to those questionnaires (AICPA (2005), Private Company Financial Reporting Task Force Report, American Institute of Certified Public Accountants, New York, page 6 – 13).

First of all, we asked to 10 owners and managers of SME with similar profile of business to answer which are management needs or usefulness of financial information in Canada and Romania.

The value of this questionnaire is show in Table no.1 in percentage basis.

Table no.1

Management need for financial information

		Canada	Romania
No.	Characteristics	Value (%)	Value (%)
1	For use as a decision tool	10	10
2	Useful information to asses income/expenses	10	10
3	Allow comparability between reporting periods and with other companies as a standardized language	10	-
4	Owners/managers to asses cash	10	-
5	Owners/managers prefer to have financial information made by an accountant like auditor/advisor	-	10
6	Owners/managers prefer to have financial information for internal use	40	20
7	For tax support purpose	20	50
	TOTAL	100	100

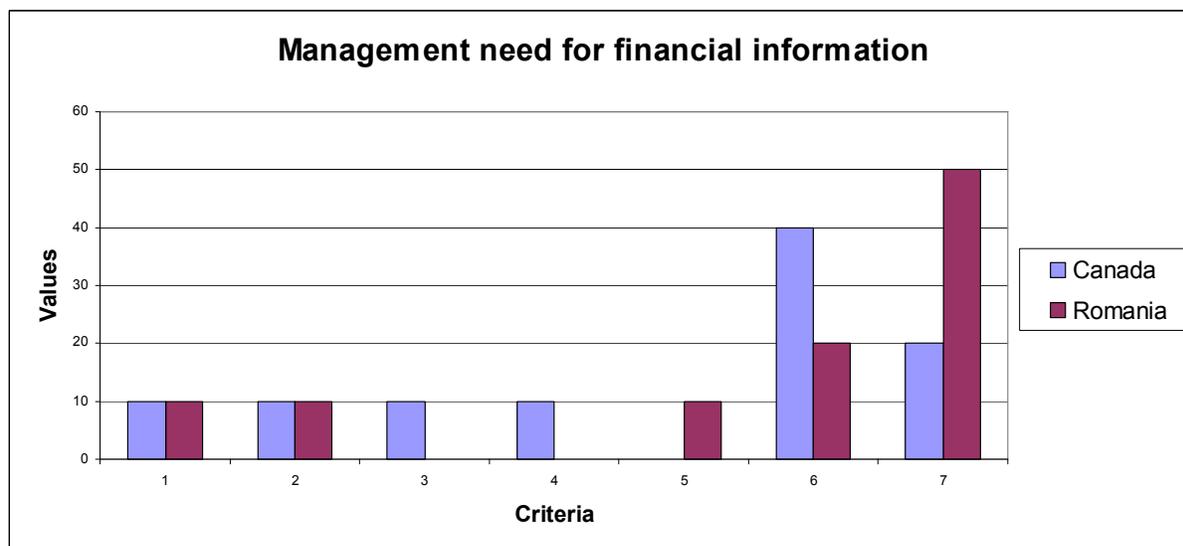


Fig. no.1 Management need for financial information

We found that 40 percent of the respondents say they prefer to have financial information for internal use in Canada and 20 percent respondents in Romania. If we take in consideration that 10 percent from the respondents declared that they use financial information as a decision tool and 10 percent to assess income/expenses that means that 60 % in Canada and 40 percent in Romania prefer to use financial information in internal purpose (marketing, payroll, income/expenses). That information is not far by what others researchers found related to this issue (for a review see: Page19, Clare Roberts and Dr. Suki Sian - MICRO-ENTITY FINANCIAL REPORTING: PERSPECTIVES OF PREPARERS AND USERS -Small and Medium Practices Committee International Federation of Accountants –Information Paper, December 2006).

We should note that an important role of income statement is viewed by respondents to be used to **support tax assessment** (20 percent in Canada and 50 percent in Romania). The difference between two countries is because tax education and regulation for SME as well as cultural influence that looks quite different.

The second variable that we used in our research was designed features of accounting information. We used a questionnaire as well as an assessment of the interest of owners/managers in this particular issue. We asked the same respondents. The result is showed in Table 2 in absolute value.

Table no.2

Design features of accounting information

No.	Characteristics	Canada Value	Romania Value
1	User are involved in recording accounting transaction	3	1
2	Users have the capacity to produce financial statements	1	1
3	Users have knowledge and skills to analyze financial statements	3	1
4	Users have ongoing access to training to overcome lack of financial statements	1	-

	understanding.		
5	Users are able to manage financial statements reporting because of statements understanding.	3	1
6	Users receive adequate training before financial statements are produced.	3	2
7	Users need an simplified financial statements	10	10

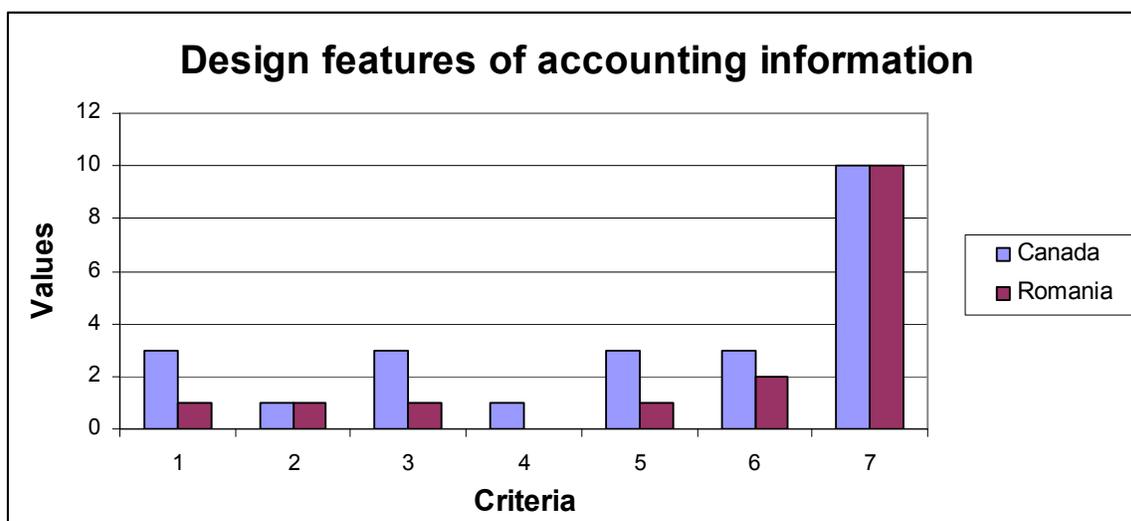


Fig. no.2 – Design features of accounting information

All the participants from both countries argue that they need simplified financial statements in order to easy understand and use of those information (Row 7). There are some differences between two countries related users involvement in recording accounting transaction, knowledge and skills and training received (Rows 1,3,5,6) due to more experience, simplified income statements and accounting requirements in Canada on comparison to those in Romania.

To analyze management needs for accounting and financial information in one side and bank on the other side in both countries Romania and Canada we used a questionnaire as well.

Conclusions

There are a lot of interferences, convergences and some different views between accounting and financial reporting in Canada and Romania. In the some time there are few features of that still should be simplified in order to be synchronize the internal accounting with external accounting for SMEs.

We found that standards for preparing financial statements must meet user needs. There are a need for simplified financial statements to SMEs in comparison with financial statements for larges companies.

In this way internal accounting can help external accounting and financial statements to be useful for all users.

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