Is Harmonization of SMEs Reporting Really Necessary? A Case of Central and Eastern European Countries.

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Abstract

The Small and Medium Enterprises (SMEs) can play an important role in the international business environment provided these enterprises display flexibility in improving their accounting practices and are willing to adopt the International financial accounting standards. Business enterprises that have already adopted the International Financial Reporting Standards (IFRS) have witnessed improvement in the comparison of financial information and also in the flow of communication with their external stakeholders. In other words adoption of IFRS has helped in reducing investor's uncertainty, cost of capital and risk mitigation. This paper highlights the challenges of applying IFRS in emerging Central and Eastern European countries (CEE countries), i.e. Czech Republic, Slovakia, Poland and Ukraine. It also discusses the impact of IFRS adoption on the tax burden and administrative costs of SMEs.

Key words: Accounting harmonization, small and medium sized enterprises, IFRS, CEE countries

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1. Introduction

The SMEs sector plays a crucial role in national economies; as they form the basis of business growth and innovation. Apart from that SMEs are an important source of employment creation and thereby social stability and economic growth in an economy. Despite its importance SMEs have often difficulties in obtaining capital or credit due to the continued unwillingness of financial markets to take risk with the insufficient guarantees offered by SMEs to the financial institutions. The constraint of limited access to credit also limits access to information about cost effective methods of production and the existence of potential future market opportunities. More importantly, the cross-border activities of SMEs are limited by many obstacles and difficulties. In particular, the biggest obstacle to the expansion of cross border participation of SMEs is the existence of 27 different accounting systems within the European Union (EU) which needs to be somehow harmonized. One way of doing so is the adoption of IFRS by the concerned SMEs so as to harmonize accounting practices. Thus the international accounting standards offer a window of opportunity to the SMEs whose reporting methods are comparable with their international counterparts, provided their local regulations permit them to do so. Thus all those SMEs that qualify the definition of an SME, given in the IFRS, would be able to have a common reporting system that facilitates the exchange of financial information.

One difficulty in the use of IFRS in the Czech, Slovak, Polish and Ukrainian Republics is that their tax legislations do not accept accounting profit calculated according to IFRS as a basis for income tax calculation. It means reporting according to IFRS entails some complexities in the preparation of financial statements in the Czech Republic, Slovakia, Poland and Ukraine (Accounting Acts and Income Tax Acts of the concerned countries, 2010).

SMEs form as much as 99 percent of business entities around the world (Bastic 2009). In the Czech Republic, the participation of SMEs in total employment is around 61.52 percent, their share in GDP value addition is 54.57 percent and are 99.83 percent of the total number of business enterprises. In the Slovak Republic the share of SMEs in total employment is around 69.90 percent (including self-employed people), their share in value addition is 54.70 percent and represent 91.10 percent of the existing businesses. Similarly, SMEs compromise of a big share in the economic development of Poland. They comprise approximately 99.8 percent of all companies, create about 67 percent of employment and generate 48.6 percent of GDP. In Ukraine small and medium businesses make up 91 percent of the total number of enterprises and employ 56.8 percent of the employed work force (Eurostat, 2009 and Ukrainian Statistical Office, 2009).

Apart from highlighting the challenges of introducing the IFRS in the four Central and Eastern European countries this study also puts together questionnaire based responses of 295 selected SMEs regarding the adoption of IFRS in the respective CEE countries.

Plan of the paper is to give a brief review of literature in section 2. The EU definition of SMEs and the current state of financial reporting is given in section 3. In section 4 of the paper we discuss the challenges of introducing IFRS. Section 5 discusses the main responses of selected SMEs regarding the adoption of IFRS and finally section 6 provides the main conclusion.

2. Literature Review

It is a well known fact that SMEs lack financial resources to adopt the international financial standards and the financial institutions also happen to be insensitive to their financial needs. This problem has made it even more difficult for the SMEs to meet the high standards of accounting required by the international accounting standards. Although it is commonly agreed that adoption of IFRS by SMEs is useful, there seem to be no consensus regarding the recommended solutions. The question of whether or not accounting practices and standards of small and large business entities should be similar has led to open debate among most accounting agencies across several countries (Maingot & Zeghal, 2006 and Collis et al., 2001).

Although size of a business entity is a crucial factor in determining its accounting practices, yet empirically research studies seem to be silent about the impact of size of a business entity on the attitudes of its owners towards the financial reporting set up. Review of literature indicates that a few studies have focused on the aims and objectives of the financial statements of SMEs. (Abdel-Khalik, 1983; Page, 1984; Carsberg et al., 1985; Barker & Noonan, 1996; Pratten, 1998; and Collis & Jarvis, 2000). Other studies have examined the attitudes and behaviour of SMEs towards their financial record, and its auditing (Collis et al., 2004)

Currently the argument of a harmonious reporting system is gaining strength, but a more important question is how the accounting standards differ between large entities and the SMEs (Eierle, 2005). It needs to be clarified as to what criteria may be used to distinguish between the large and small size classes of reporting entities. Such a criteria must also take into account the costs and benefits of adopting those accounting standards (Eierle, 2005). However, it may be difficult to formulate specific accounting standards for a certain size class of enterprises and may also not be easy to interpret, regulate and maintain those accounting standards (Evants et al., 2005)

One of the main arguments forwarded in favour of the extension of IFRS to the financial accounts of small enterprises is that international financial reporting standards may facilitate international comparison and flow of financial information of these small business entities. Pacter(2004). It may also lead to more transparent financial statements of the SMEs. Evans et al.(2005). Apart from these advantages of the IFRS some other suggested benefits for SMEs include improved management and marketing efficiency of SMEs. Marten et al.(2002)

3. Definition of SMEs and the Current State of Reporting in EU

3.1 Definition of SMEs in EU

Given some benefits of IFRS to the SMEs, the European Union has given a more recent concept and definition of SMEs valid from 1 January 2005. It involves three major criteria i.e the number of employees, annual turnover and total assets in terms of Euro.

Table 1 EU Definition of SMEs

Size	Number of Workers	Turnover in Euro(millions)	Balance in Euro (millions)
Medium enterprise	50 -249	upto 50 million.	upto 43 million.
Small enterprise	10 -49	2 – 10 million.	2 – 10 million.
Micro-enterprise	10 or less	2 million or less.	2 million or less.

Source: http://www.czechinvest.org/definice-msp

Besides the above mentioned three indicators of SMEs given in Table (1), SMEs are also required to fulfill the criteria of independence i.e, the share of other business partners in capital must not exceed twenty five percent of the total capital.

Although, the term "Small and Medium-Sized Entities" has a different meaning and interpretation in different countries, the definition of SMEs according to the IFRS include all those business activities that do not have public accountability or publish general purpose financial statements for external users. This definition of SMEs is different from the meaning of SMEs mentioned in the business codes of different countries. Even if an entity is not liable to public accountability every entity has some form of accountability to its owners and the local tax authorities. For example, according to the Business Code of Ukraine small businesses are legal entities whose average number of employees during the reporting period are not more than 50 employees and their total turnover for that period does not exceed 70, 000, 000 hryvnas (€ 7 000 000). Thus according to the IFRS definition of SMEs, size is not the only determining factor as to which entity can use the IFRS for SMEs – its applicability is entirely based on the condition whether the entity has public accountability or not. Thus SMEs that may want to adopt the international standards may differ in size ranging from large enterprises to very small sized business entities. In other words the international accounting standard may have a large audience and according to a rough estimate 95 percent of all companies meet this criteria.

3.2 Current State of Financial Reporting in EU:

SMEs operating in EU member countries maintain and report their accounts according to the accounting regulations of their respective countries. The accounting regulations of each member country are based on their traditional accounting practices and are in accordance with their economic & legal environment. However, business entities listed on the European capital markets are bound to comply with the IFRS framework while preparing their financial statements as per the EU decree No. 1606/2002. A unique element of the EU business environment is that despite the integration of European markets into a single market, the economic integration of SMEs in the European market is low. This may be so due to the prevailing differences in their legal environment, accounting standards, taxation systems and limited access to the capital markets. A part from these factors cultural and language barriers may have also limited the participation of SMEs in the European single market.

To integrate SMEs into the single EU market it is important to develop unified legal standards for SMEs and standardize their financial reporting systems. Keeping in view the limited role of SMEs in the European market, some initiatives were taken in this regard in the year 2000. The purpose of these initiatives was to provide the required know how and skills essential for participation in the EU market as well as outside EU to facilitate the possible export of goods and services.

Moreover, apart from several other benefits financial statements prepared in compliance with the international standards can provide a high level of transparency and comparability. Use of international standards will reduce investor's uncertainty and can thus reduce the cost of capital. It can also significantly improve communication between the business entities and users of all their financial statements. Adoption of the IFRS, also imply that higher quality output resulting from the said accounting system may enable the management to take timely and effective decision making. Thus the cost of changing over to reporting, according to international standards may be outweighed by the benefits in terms of the simplification and user-friendliness of IFRS for SMEs.

4. Challenges of Applying IFRS in CEE Countries

A few important problems of accounting based on IFRS are highlighted as below:

First, the main issue of financial accounting based on IFRS is the tax calculation, which in the case of some countries like the Czech Republic is based on the accounting profit. This means the accounting practices of SMEs that report according to IFRS by law, will have to translate their business profits, in such a way as they would have reported if they were reporting according to the Czech regulations.

Second, in case it was compulsory for SMEs to adopt the IFRS, it would mean changes in the accounting legislation of their countries. It also implies that the SMEs will have to provide the necessary training to their accountants and develop their expertise in the new accounting practices. In other words adoption of the new accounting practices involve increase in the administrative and financial burden of the SMEs.

Third, difficulties in the transition process to IFRS in Slovakia are very similar to those in the Czech Republic. One of the most serious challenges is the education and qualification requirements for the accountants which have always been high.

Fourth, the Polish companies may need approximately one year for the adoption of IFRS (this is the time required to properly prepare all documents in order to prepare the report at the end of period according to the new rules). The conversion is complicated, time consuming and costly, especially in case of huge production companies possessing a large amount of assets. Another difficulty with conversion appears with regard to the companies that were so far not required to report within international accounting standards, and were benefiting from many simplifications allowed by the Act of Accounting but are not admitted by the International Accounting Regulations.

Fifth, majority of the SMEs are less interested in “true and fair view” of accounting practices. Most of the SMEs maintain financial records for tax deduction on their profit earned and they rarely rely on accounting data from the managerial point of view.

Finally, according to Ukrainian national accounting legislature, companies shall measure all assets at historical costs upon balance sheet date. The only exemption is measurement of finished goods and work in process that are not revalued upon the balance sheet date. However, it shall be stated that majority of the balance sheet items are reported in a consolidated manner and investors do not have information about the value of each of the assets or liabilities items in a disaggregated way.

5. Adoption of IFRS by the Four CEE Countries:

This research project include 295 enterprises with 115 enterprises taken from the Czech Republic, 54 enterprises selected from Slovakia, 26 enterprises taken from Poland and 50 enterprises were included from Ukraine. All these enterprises had employed less than 250 workers. The structure of the responding companies by type of activity is summarized in Table 2.

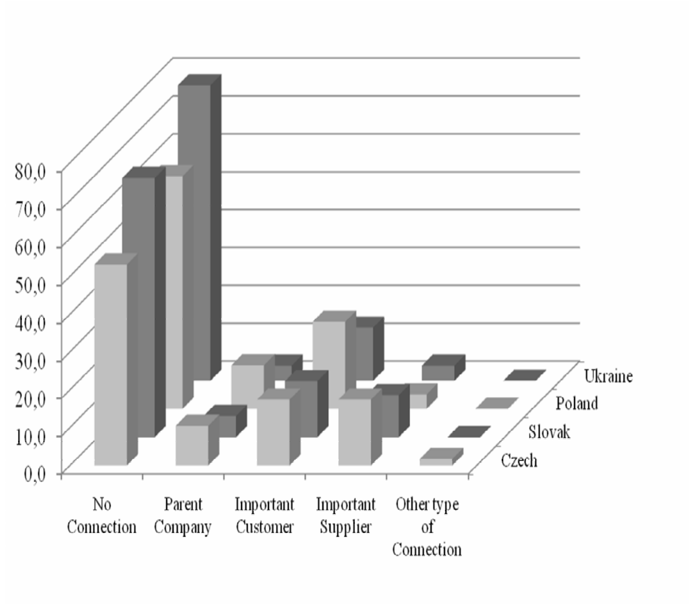
Table 2 Structure of Companies by Type of Activity in Percent

Type of Activity	Country			
	Czech Republic	Slovak Republic	Poland	Ukraine
Production	26.1	37.0	26.9	38.0
Trade	25.2	31.5	38.5	30.0
Services	48.7	31.5	38.5	32.0

Source: Our Analysis

A questionnaire was designed to collect information about the responses of the 295 SMEs regarding the five main aspects of adoption of IFRS in the four CEE countries.

Fig 1 Connection of Companies With Foreign Entities



Source:Our Analysis

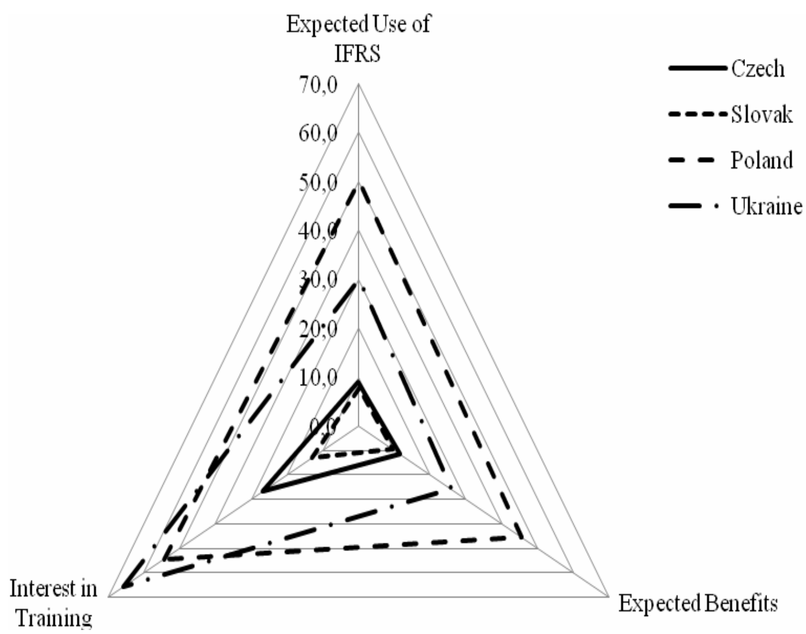
First, it was enquired whether besides the national accounting system, the company concerned also reported according to any other accounting system. It was found that out of a total sample of 295 companies, three Czech and five Polish companies reported according to the IFRS. While, only one Czech companies reported their accounts according to the French reporting system. As far as the Ukrainian or Slovak companies are concerned none reported their accounts under a non-national framework.

Second, it was of interest to know whether these companies were somehow connected to some foreign entity. Figure 1 shows that in all the four countries, the number of enterprises that are not connected with foreign entities makes about 50 percent. Whereas, interaction with the foreign entities make about 50 percent.

Third question was related to the main areas of accounts that have been modified and changed from the previous individual country based accounting system, to another accounting system if any. The Czech enterprises were found to be reporting according to another system besides their Czech based accounting system. The Czech companies that reported according to another accounting system, had altered the assessment of assets and financial leases; these companies also altered other including provisions, exchange rates, corrections, depreciation, measurement of inventories, financial assets and accruals. Only one Slovak company reported in other than the national system but it did not specify the alternative accounting system of its accounts. Polish companies reporting under the IFRS seem to have the greatest number of problems in reporting of inventories, accruals, expenses and equity. None of the Ukrainian companies reported in other than a national system of accounting.

Fourth, companies were asked whether they planned to adopt the IFRS in the near future and in doing so were they willing to train their accountants on IFRS. The relative frequency of the positive responses is provided in Figure 2.

Fig. 2 Percent of Positive Answers Regarding the Future Use of IFRS



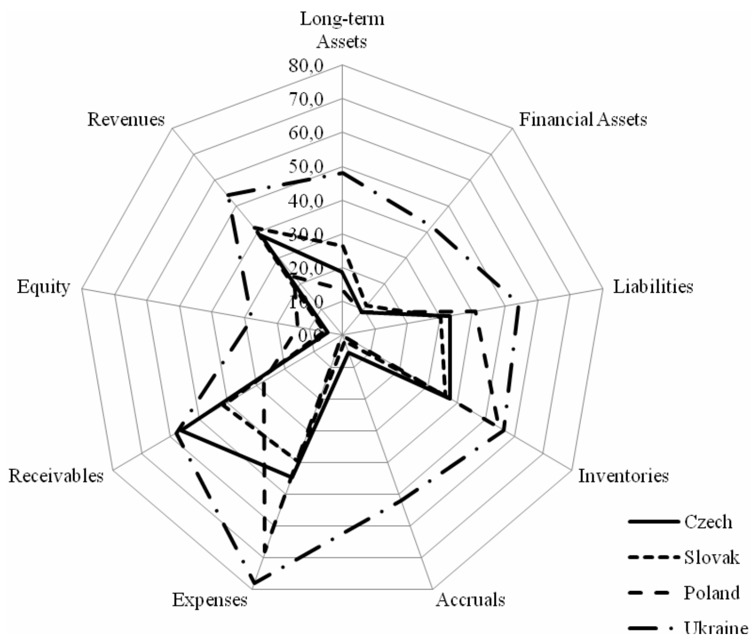
Source: Our analysis

The response of most of the companies reveals that interest in training and courses on IFRS prevails among all countries. Interest among the four countries in reporting according to IFRS, can be arranged in the following sequence: Slovakia, the Czech Republic, Ukraine and Poland.

Fifth, the SME enterprise owners were asked to identify the major areas of accounting which they considered as difficult. A list of financial reporting items included in the questionnaire were, financial assets and liabilities, long-term assets, inventories, accruals, expenses, receivables, equity capital and revenues. The relative frequencies of accounting items reported, are mentioned in Figure 3 and 4. Again the answers were evaluated comprehensively and independently for companies with different type of activities.

Fig. 3 Frequency of Accounting Items Considered as Important (in percent**)**

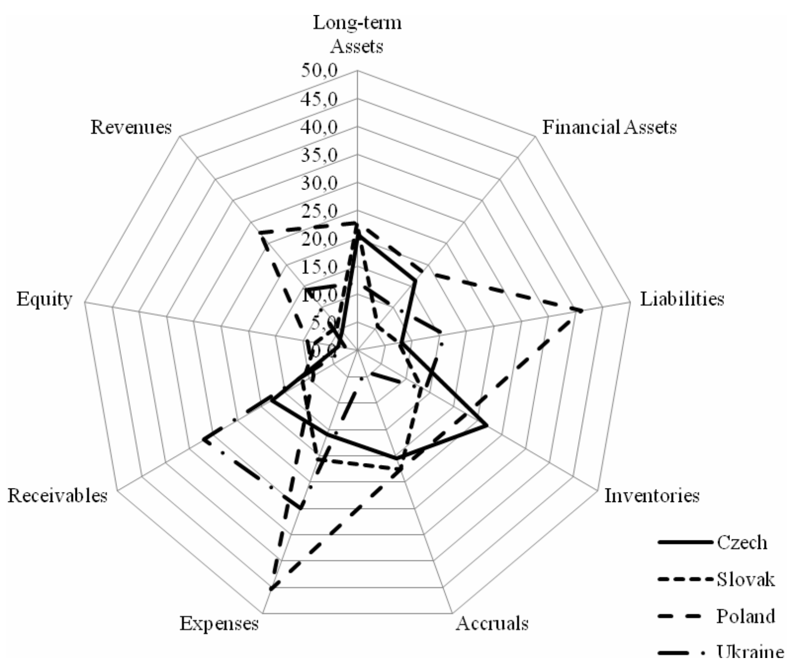
Source: Our analysis



It is shown that Czech as well as Slovak companies considered receivables, expenses, revenues, liabilities and inventories as important items. Polish companies identified expenses as dominant areas followed by inventories and liabilities. With the exception of equity, Ukrainian companies indicated all the items as important. Generally, equity is considered as an accounting item of lower importance. An interesting fact is that Ukrainian companies in general appraise accounting items more, compared to companies in other countries.

The Czech and Slovak companies evaluated the problems of accounting items nearly identically. For them, the problematic items included one-term assets, receivables, expenses, accruals and inventories. The Polish companies evaluated expenses as the most problematic area, unlike companies in other countries, followed by liabilities, revenues, and long-term assets. For Ukrainian companies the most problematic items are receivables and expenses. Ukrainian companies also rated the problem items lowermost.

Fig. 4 Frequency of Accounting Items Considered as Difficult (in percent)



Source: Oour analysis

6. Conclusion

According to the results of this research it can be concluded that all those SMEs that are not required to prepare their accounts as per the IFRS, have no interest in adopting the IFRS. This may be so because most of these SMEs prefer to focus on their current business situation rather than the future business development. Perhaps adoption of IFRS may put them in a difficult situation due to the cost involved relative to the benefits that they may receive.

The Czech companies reporting under IFRS framework face the biggest problems when they are reporting their long-term assets, leases, provisions and exchange rate differences. Long-term assets are also problematic in the Slovak Republic. Besides that, SMEs have difficulties in reporting their inventories, expenses and revenues. Polish companies reporting under IFRS have the greatest problems in reporting of inventories, accruals, expenses and equity.

The IFRS can in particular benefit the SMEs that exchange the sale and purchase of goods and services beyond their national boundaries. In this way they could possibly develop relations with their clients and expand their businesses. As part of the selection and evaluation criteria large foreign companies in their business dealings with SMEs, select SMEs on the basis of their financial statements and the adoption of IFRS which help in creating a positive image of those SMEs.

Adoption of international standards could possibly change the attitude of SMEs towards internationally accepted accounting practices, where emphasis is laid on the preparation of financial statements including cash flow statementand statement of changes in equity (these are neither mandatory nor reported by most of the SMEs in the Czech Republic). All this would expose them to different measurement practices and a whole range of supplementary information in the Notes. It will also enable them to link and understand the relationship among different transactions and their implication. However, to be able to appreciate the use and benefits of IFRS

SMEs would require qualified and professional accountants to ensure smooth transition from their existing accounting practices to the IFRS.

At present if some SMEs are preparing their financial statements as per the accounting regulations other than that of the Czech Republic, it is simply because their foreign owners require financial statements that are comparable , and could be easily used for consolidation of accounts. Such SMEs adapt and modify information according to the specified set of rules.

Although the strength of SMEs lie in their ability to adopt change and create innovation, given the present slow economic and business environment in the Czech Republic, adoption of IFRS will put extra tax burden and administrative costs on the SMEs.

In case of SMEs in Slovakia, the financial statements are completed according to the national accounting legislation and subsequently they are transformed into the IFRS. Although the implementation of IFRS is somewhat complicated, it would make financial reporting more simple and integrated, if applied.

The main stimulus for transition into IFRS by Polish SMEs is related to the possibility of development and cooperation with foreign entities, for investment opportunities from foreign investors and for obtaining a wider scale of clients and contractors. This is similar to the SMEs of Czech Republic as their foreign owners require comprehensive, data that is easy to understand and compare for consolidation of accounts.

Financial information that is widely understood and compared may help in improving relations with customers, suppliers, investors and bankers. Internationally accepted financial statements can enhance and build the confidence of business partners. This can act as a key factor in securing finance, reducing the cost of borrowing, and developing business partnerships.

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