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THE FUTURE OF SME FINANCIAL REPORTING

The introduction of the IAS or IFRS in the financial reporting of European listed companies in 2005 was a revolutionary milestone especially for those EU member countries where the linkage between taxation and financial reporting has traditionally been very close. Finland is a typical example of these member countries. The gap between the IFRS based group accounts of listed companies and the separate accounts of individual companies has grown quite wide. The linkages between taxation and financial accounting are still there, and in practice it is difficult to draw up separate accounts according to IFRS, even though Finland has used the national option allowed under the EU IAS Regulation.

Now, four years after the introduction of IFRS for listed companies in their consolidated accounts, the focus has turned to the unlisted companies, especially to the small and medium sized companies. From the public policy point of view, two tracks can be observed: the simplified IFRS for SME's (or Non-publicly accountable entities, as they are sometimes also called) and the European efforts to simplify the company law, among others the accounting directives for small and medium sized companies.

According the latest information, the final IFRS for SME's or "Nappies" will be published in late second quarter of this year. The IASB staff plans to submit to the Board a ballot draft before the end of this month.

In Finland, there is not too much enthusiasm for the simplified IFRS package for "Nappies". For small and medium sized unlisted companies, the close relationship between taxation and financial accounting is traditionally seen as a realistic starting point of reporting. By contrast, the independence of tax accounting and financial accounting is the basic default in the IFRS. From this point of view, IFRS based financial accounting for the SME is seen as an extra administrative burden compared to the situation today.

In the Finnish tax system, there are explicit linkages with the accounting system, in the same way as for instance has been the case in Germany for a long time (the so-called *Prinzip der umgekehrten Massgeblichkeit*). For instance, a company is not allowed to deduct as depreciation an amount larger than which has been deducted in the tax year in its financial accounting. The fact that the depreciation accounting in taxation is reflected in the financial accounts as adjustment items (so called depreciation difference) both in the profit and loss accounts and in the balance sheet is seen as an acceptable fact from the cost-benefit point of view for SME's. This means simply that no deferred tax liability is calculated as would be the case according to IFRS.

In a thorough article published last year in "Accounting in Europe" a group of academics commented on the IASB's exposure draft "IFRS for SME". Among other comments, it was said that SME financial statement user groups and their needs differ from the users and user needs of large, public-interest enterprises. Arguments for differential reporting frequently refer to undue burdens and disproportionate costs as well as a perceived lack of relevance of statutory accounts to the main user groups. On the other hand, the main arguments against differential reporting are a demand for universality, the need for comparability, reliability and the perception that statutory financial statements satisfy some information needs and provide some protection to stakeholders without access to inside information.

In Finland, the arguments against the introduction of IFRS for SME are the following:

- starting with the Framework, IFRS has been developed for the listed companies; consequently the focus is on the investor as a stakeholder; for a small or medium sized company other stakeholders, for instance lenders or the tax man are normally most relevant as users of the financial information
- making a distinction between tax accounting and financial accounting increases the reporting costs without leading to benefits
- rather than showing fair values of assets, the cash flow information should be required from SME

It is also often pointed out that politically the future role of IFRS for Finnish SME is principally dependent on the decisions made by the European Commission. Right now it seems that it is not at all probable that the simplified IFRS for SME or "Nappies" would be adopted for a certain group of European unlisted companies in the same way as the full IFRS has been introduced for the listed companies.

The European Commission has recently taken steps to simplify the accounting rules for SME. As a fast track measure a first series of amendments to simplify some disclosure requirements for medium-sized companies were adopted in 2008. As a second step, and as a far more revolutionary measure, the Commission wants to introduce a Member State option to create a new micro entity category that will be exempted from the accounting requirements under the Fourth Directive. The definition used by the Commission for a micro company is based on turnover under 1 million euro, balance sheet under half a million euro and personnel under 10. This proposal was given at the end of February.

As a third measure, the Commission launched in February also a consultation with the heading "Cutting Accounting Burden for Small Business". This consultation is a part of the “think small first” programme of the European Commission. Legislative proposals concerning the accounting directives based on this consultation would be presented before the end of this year.

The idea of leaving micro companies outside the scope of the Accounting Directive has encountered rather mixed reactions in Finland. As such, the idea of relieving the administrative burden for this group of companies is naturally very welcome. Finland is a typical small business state, and many small companies also have cross the border activities. Introducing the micro company limits as such would mean that 94 percent of Finnish companies could be left outside the scope of European accounting rules if the new member state option would be used.

Finland joined the EU in 1995 and harmonizing our accounting rules to European directives meant remarkable legislative work and remarkable administrative changes for all Finnish companies. It also meant a need to start rethinking about the basics of accounting since our accounting rules had been based on a national accounting theory for more than 20 years.

Introducing now the micro company option would mean a huge step backwards as a measure of disharmonization. The objectives of European accounting harmonization would not be achieved and in fact new hurdles for business in the European region would be built up.

Comparability of the financial statements is one of the building blocks of the European internal market. If the majority of companies could be left outside the common European rules would certainly not be in line with the idea that the European internal market is at the same time the home market for all companies. Leaving accounting information for most companies to national rules only could be detrimental for the business itself, as disharmonized rules increase the risks related to cross-border transactions between companies.

To sum up, from the Finnish point of view, some other measures to modernize and improve the European accounting rules should be looked for than to enact a micro company member state option. The present framework of the directives is a good starting point, and from this platform it should be deliberated what kinds of simplifications are needed for the smaller companies. The need to diminish the administrative burden is in the forefront, and consequently the cost-benefit analyses are crucial in this context.