

FINANCIAL REPORTING FOR PRIVATE COMPANIES: WHERE TO?

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During the last decades, the subject of accounting rules for public companies (entities listed on regulated capital markets) has made the front-page news of every important accounting publication and has been the priority task for all major standard-setters. All this time the majority of companies, the non-listed ones, called private companies, has been neglected. This situation started to change in 2003 when International Accounting Standards Board (IASB) initiated a project on accounting standards for small and medium-sized entities. This paper aims at assessing the evolution and the current state of the aforementioned IASB project, the reactions of the national standard-setters and the European Union authorities to the project and its opportunity as far as the Romanian private companies are concerned.

Key words: *financial reporting, small and medium-sized entities, private companies*

In the last decades, phenomena like market integration and international financing have become something regular even for the small companies. In this context, some specialists started to debate on the necessity of a single set of standard designed exclusively for the use of small and medium-sized entities (SMEs) that do not finance their business through a stock-exchange. They argued that applying IAS/IFRS was far too costly, complex and, sometimes, irrelevant for these entities. Moreover, the needs of the users of their financial statements are quite different from the ones of the investors in public companies. Various solutions were suggested. One of them was the issuance of an international standard, task which was assumed by IASB that started to work on the project called „IFRS for SMEs” in 2003. At the same time, the European authorities initiated their own projects on simplifying the financial reporting for these entities.

MATERIAL AND METHOD

In this paper we aimed at establishing the role and the importance of these companies in the current economic environment, at assessing the necessity of a global reporting standard for SMEs, at analyzing the main projects developed by IASB and the European Commission and at comparing those rules to the ones applied by the non-listed Romanian companies.

In order to achieve those goals we made a theoretical research based on the specific literature and the current legal regulation applied in the European Union and in

our country. We also critically analyzed and compared all these rules to provide the needed indication of the current state of accounting and reporting standards used by the most significant category of entities: the SMEs.

RESULTS AND DISCUSSIONS

The private companies are entities with no public accountability, meaning that they are not listed or about to be listed on a regulated public market or that they do not hold assets in the name of a broad group of peers, such as banks, insurance companies, mutual funds, pension funds, securities brokers/dealers or investment banking entities [3].

From a statistical point of view, in most countries all over the world more than 99% of all entities are not listed on any capital market, so they are private companies. Moreover, most of them have fewer than 250 employees, assets up to €43 million or a net turnover less than €50 million which makes them small and medium-sized entities. To separate the small companies from the medium ones or from the micro-entities, the thresholds taken into consideration are settled by the European Commission recommendation (*tab. 1*).

Table 1

Criteria for the SMEs classification

Type of entity	Average number of employees	Total balance-sheet assets	Net turnover
Micro-entity	<10	≤ € 2 mln.	≤ € 2 mln.
Small entity	<50	≤ € 10 mln.	≤ € 10 mln.
Medium entity	<250	≤ € 43 mln.	≤ € 50 mln.

In any national economy, the private companies are known to be very dynamic and active, offering a wide-range of services. All the specialists acknowledge their contribution to the economic growth and to the workforce market (more than 65% of all employees from the private non-financial industries work for SMEs). These entities help to improve the market competition (and therefore, the quality of the products/services and their prices), to penetrate different niche markets less attractive for big public companies, to innovate and develop new products and services or to put to good use some local resources. Nowadays, there are around 23 million non-listed companies (99.9% - in comparison, the listed ones are about 0.1% of all) and 99.8% of them are SMEs (including micro-entities).

For accounting purposes, the thresholds used to differentiate these entities (except the one concerning the average number of employees) are not the same with the criteria presented in table 1. They are stated in the 4th accounting Directive „Annual accounts of companies with limited liabilities”. The accounting criteria for small entities are: balance-sheet assets less than €4.4 million or net turnover less than €8.8 million. For medium-sized companies the criteria are: balance-sheet assets less than €17.5 million or net turnover less than €35 million.

As regards micro-entities, the accounting thresholds are also different: assets less than €0.5 million and net turnover less than €1 million.

As an EU member, Romania has adopted the European criteria that define SMEs. As a former communist country, Romania did not have a real SMEs sector till late '90s. Therefore, the performance of this relatively new category of entities in the Romanian economic landscape is situated well below the EU average (starting with the number of SMEs per 1000 inhabitants which is 23, considerably below the number reported by other member states – 70, and finishing with their value added which is around €16 billion). Other key numbers regarding Romanian SMEs are: in 2007, statistics reported a number of 487.628 SMEs representing 99.5% of all entities [6], the main industries in which the SMEs are the most active are: services (75%), manufacturing (12%), construction (9%) and agriculture (4%), the jobs provided by SMEs account for $\frac{3}{4}$ of all jobs (which is close to the EU average), the contribution to the GDP is 70%.

In Romania, the accounting thresholds defining the small entities have not been updated since 2003 (balance-sheet assets less than €3.65 million or net turnover less than €7.3 million), while the ones identifying the medium entities are situated around €17.52 million or € 35.04 million respectively. As far as the micro-entities are concerned, the average number of employees is between 1 and 9 and the annual revenues less than € 0.1 million.

Considering the significant number of non-listed companies existing in virtually every country and their important contribution to the national economies, it is rather understandable that the European Commission shows a lot of interest in simplifying their business environment and in easing the administrative burden off their shoulder. The European projects rely on the „think small first” motto [4] and acknowledge the central role played by these entities in today’s economies.

The task of reducing the administrative burden is to be achieved by simplifying the accounting and auditing rules. For these goals, the European Commission has initiated and finalized the following projects:

- the amendment of the accounting directives (the 4th and 7th Directives) to simplify the disclosure requirements for medium companies and to eliminate the obligation to draw up consolidated accounts;
- the exclusion of micro-entities from the scope of the 4th directive.

The amendment of the 4th directive in June 2009 (Directive 2009/49/EC of 18 June 2009) meant the increase of the number of exemptions allowed for medium-sized companies regarding disclosure for formation expenses or the break down of the net turnover by categories of activity and into geographical markets. These exemptions, whose appliance is optional for the memeber states, are expected to have a big impact upon medium entities helping them save €11 million up to €21 million [5].

The exclusion of micro-entities from the application of the 4th directive means the simplification of the business environment for the biggest group of European entities (75% of all). This project is not finalized yet but an amendment

is expected soon. The assessment of impact of this amendment conducted by the European authorities showed a potential annual saving of €1200 per micro-entity.

The IASB project for private companies came to an end in July 2009 through the publication of the IFRS for SMEs. The final form of the standard resulted after many modifications and deliberations. The IFRS is organized by topic and aims at reducing the options allowed for public companies, eliminating some irrelevant topics for SMEs, simplifying the recognition and measurement rules, improving the financial statements' comparability among users (creditors, business partners etc.).

The main controversy related to this standard has always been the fact that it relies heavily on the general framework used for the preparation and presentation of financial statements published by public companies (strongly oriented towards satisfying the investors). Many opponents argue that the IFRS for SMEs slightly modifies the rules and principles from the full IAS/IFRS version. These modifications are: the omission of some topics (such as interim reporting, equity-settled share-based payments, insurance contracts, earnings per share etc.); the choice of the simpler option (e.g. cost-depreciation model for investment property, indirect method for reporting operating cash flows, one method for all grants, cost-amortization-impairment model for property, plant and equipment and intangibles etc.); the simplification of recognition and measurement rules (for financial instruments, goodwill impairment, research and development costs etc.); the reduction of disclosures in the explanatory notes.

The reactions to the publication of the new IFRS are still expected, but there will be some difficulties in its application due to the cultural barriers, the fiscal consequences and the inevitable transformation of the accounting and auditing practices. All these changes are related to the extensive use of professional judgement strongly recommended in all IASB projects.

As an EU member, Romania applies the accounting rules provided by the European directives. They were transposed into the national legislation through the Order of the Minister of Public Finances (OMPF) no. 1752/2005. The regulation meant a transition from the accounting rules harmonized with the European directives and IAS, to the rules compliant with the European directives. The consequence is that the Romanian companies prepare their financial statements using the same legal framework (the 4th and 7th directives) as any other member state. But as many people know, the directives allow numerous options that may or may not be transposed into the national legislation. That is why there are many differences between the member states, even as far as the rules for private companies are concerned. For example, our country did not adopt many exemptions meant to simplify the financial reporting for SMEs (only 10% of all the exemptions). The only exemptions in force are:

- the abridged layout of balance sheet and the facultative draw up of cash flow statement and statement of changes in equity;
- the permission not to use principles such as substance over form and materiality;

- the consent to simplify the disclosures on financial instruments and their fair value in the consolidated accounts;
- the exemption to break down the net turnover by categories of activity and into geographical markets;
- the permission not to disclose the amount of emoluments granted to the members of the administrative, managerial and supervisory bodies and any retirement pensions for former members of those bodies;
- the authorization not to audit the annual financial statements.

These simplifications apply only for small entities (the ones with fewer than 50 employees, net turnover less than €7.3 million or total assets less than €3.65 million). None of the exemptions provided by the directives for the medium entities are transposed into the Romanian legislation...yet.

CONCLUSIONS

The financial reporting rules for private companies, which are mostly SMEs, are very diverse and often too complex and irrelevant. The explanation for this situation may be that, because of the extensive use of IAS/IFRS in many countries all over the world, the SMEs are often forced to apply the same rules as the public companies. But the differences between these two categories of entities are very important at least as far as the financial resources they can access or the needs of the users of the financial statements are concerned.

The main efforts made for the simplification of the financial reporting of private companies that are worth being mentioned are: the IFRS issued by IASB for SMEs and the projects initiated by the European Union (consisting of amending the directives). The two projects seem to be little compatible or no compatible at all, but the European Commission (known as an important IFRS supporter) already rejected the IASB project and started its own plans for SMEs. Due to the multiple cultural, fiscal or financial challenges that the new IFRS might bring with, there are small chances that the European Union would support this project. In our opinion, it is very possible that the standard should be well received in USA because it might smooth the path for the full replacement of US GAAP by IAS/IFRS. On the other side, the projects initiated by the European Commission in order to improve the business environment for SMEs, including the accounting requirements, are very interesting but time-consuming, especially if they lead to the replacement of the current directives with new, modern and improved versions. Moreover, till the complete elimination of the multiple choices allowed for the member states, the simplification of the accounting rules is hard to be achieved.

In our country, after the European Union integration, there are little efforts made to improve the SMEs activities. The current crisis has only made things worse and the fiscal and financial measures promoted by the government are very controversial. This situation is not specific only to Romania, because in many

countries all over the world the SMEs were left to fend alone in front of the crisis, the authorities being too busy to save the big companies from failure.

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