

## DIFFERENTIAL FINANCIAL REPORTING FOR MICRO-ENTITIES: ADVANTAGES AND LIMITS

Professor PhD. **Ramona NEAG**  
Universitatea "Petru Maior", Tg. Mures, Romania  
ramonaneag@yahoo.com

### **Abstract:**

*At European level, the European Commission supports the reduction of the information reporting requirements for the small and medium-sized companies and makes the first move towards the classification of the unlisted entities in SMEs and micro-entities. For the last category of entities, the European Commission acknowledged that the rules of extensive reporting applied to these are not proportional with their accounting specific needs; they create an additional cost and can be an obstacle for the efficient use of the capital in productive purposes. Positive effects of the review will include a reduction of burden mainly for small enterprises ("think small first") as well as qualitative improvements for all enterprises in the scope of the Directives.*

*We propose to present the need for simplification at our country level using some studies from the literature. We shall follow the implication of Romanian regulatory body in this process. The conclusion presented covers the analysed studies and the personal experience of the author.*

**Keywords:** - financial reporting, micro-entities, "think small first", simplifying, reduction of administrative burden

**JEL Classification:** M41

### **INTRODUCTION**

Small enterprises, where the owners are often also managers, consider that tax statements are a useful and sufficient source of information. But this state perception decreases with the growth of the enterprise and the evolution of the information system (Paoloni, M. et al., 1999; Dugdale, D. et al., 1998) [1]. Together with the development of the company, the disadvantage of high costs is gradually transformed into an advantage of the drawing up of financial statements in a language understood by most accounting information users who operate in a competitive market (Keasey, K. and Short, H., 1990). The subsequent development of a former small enterprise (business) and its evolution into a listed company already involves the use of IFRSs for the drawing up of financial statements.

Neag shows that the preserving of national elements specific to the practices in the financial accounting field constitutes an opportunity, and IASB's perspective of standardization of European accounting pays too little attention to the possibility that accounting practices in different communities could offer the alternatives required by the evolution of the market (Neag, R., 2003, p 20) [2]. Thus different accounting requirements arise, which gradually lead to ... specific accounting practices. Meantime the Commission for Judicial Affairs of the European Parliament has noticed the more and more theoretical character of IASB standards, which actually have become so complex and theoretical, that SMEs, particularly, cannot follow them; at the same time it is questionable whether IFRS for SMEs adequately reflects the needs of SMEs and the variety of modes and sizes in which they operate; it all regrets that the IFRS for SMEs doesn't take adequate account of the specifics of these enterprises where the accounts' addressees are not anonymous investors more interested in short term investments as it is the case of public limited companies (European Parliament, 2007) [3].

In the general context of better regulation, the European Commission has decided to simplify the regulatory environment for European businesses, in co-operation with the European Parliament and the Member States. The objective is to ensure that Community legislation in the fields of company law, accounting and auditing corresponds to today's business needs and allows European businesses to compete more effectively and to be more successful in a highly competitive global environment.

At European level the Directive 78/660CEE on annual accounts of certain types of companies contains provisions related to the presentation and content of annual accounts. Accordingly, three criteria (total assets, net turnover, average number of employees during the financial year) are used for classifying the entities in those which prepare five financial statements (balance sheet, profit and loss account, statement of changes in equity, statement of cash flow and explanatory notes) and entities that prepare three financial statements (balance sheet, profit and loss account and explanatory notes). By the Recommendation 2003/361/CEE, the Commission defined micro, small and medium-sized enterprises according to the same three criteria. In June 2007 the Commission published a report identifying the changes that could affect the accounting directives in order to reduce the administrative burdens for the micro-entities. These entities operate at local level and regional level; have low or inexistent cross-border activities and limited resources to meet the burdensome regulatory requirements.

In March 2009, the Commission of the European Communities issued a Proposal for a Directive of the European Parliament and of the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities. The mentioned proposal suggests that a category of micro-entities as the smallest enterprises could be introduced into the EU legislative framework. Furthermore the European Parliament encourages the Commission to continue its activities with regard to the simplification of company law, accounting and auditing, in particular the 4<sup>th</sup> and 7<sup>th</sup> Company Law Directives. The role of published financial statements as regards micro-entities is considered to be limited. However the information presented by these entities must meet the needs of enterprises, managers, lenders, business partners or other stakeholders such as state authorities. [4]

Commenting on the micro-entities proposal, Michael Izza, Chief Executive of the "Institute of Chartered Accountants from England and Wales" (ICAEW), said: "This proposed exemption for micro-entities represents a bold step to enhance the long-term competitiveness of European business. It provides much needed flexibility for Member States to have a comprehensive debate as to the most appropriate financial reporting regime tailored to the needs of the smallest businesses. It is right to have this debate at national level as the majority of very small companies generally do not conduct their operations across borders – they rely on local clients, suppliers and banks – so the benefits of comparability across European borders are less compelling" [5]. The Committee on Economic and Monetary Affairs calls on the Committee on Legal Affairs, as the committee responsible, to propose rejection of the Commission proposal and to ask for a general revision of the 4<sup>th</sup> and 7<sup>th</sup> Company Law Directives in 2010, which focused, in particular, on reducing the administrative burden and simplifying the financial reporting requirements of micro-entities.

## METHODOLOGY

The objective of this article is to present some ideas related to the simplification process at the European level as a result of reducing the administrative burden for the smallest entities and micro-entities. The main objectives of our study are:

- 1) To identify potential arguments that led to the simplification of financial reporting as a result of European initiatives;
- 2) To present some conclusions related to accounting simplification for the Romanian economic environment.

The documents used by the author were: the European proposal related to the mentioned subject, the specialized literature, others documents published at the European level and not in the last some practical elements from some studies realized at national and regional level.

In order to realize this material the author gathered and analyzed various information related to the subject, interweaving the conclusions from the mentioned documents with those from personal experience in the field.

## PROBLEM FORMULATION

In February 2010 the European Parliament discussed (first reading), the Draft Legislative Resolution on the proposal for a directive of the European Parliament and of the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies regarding micro-entities, presented by the Committee of Legal Affairs. The fact that the micro-entities are often subject to the same reporting rules as larger companies was highlighted. So, those rules put a burden on them which is not in proportion to their size. The annual accounts provide also an important input for statistical information. However, the obligation to keep records showing the company's business transactions and financial situation must be kept. It was presented the possibility for the Member States to decide the different impact of the threshold values when implementing these modifications. [6]

The transparency of financial data offered by these micro-entities could also be a delicate subject. The possibility to provide financial information to those who are commercial partners could not be ignored. When these matters are discussed and analysed we suppose to look forward to those who are really involved in this process, the preparers and users of micro-entities financial reports and their information needs. The preparers group represent accountants providing accounting services to small and micro-entities. Those offering accounting services dealt with mostly small and micro-entities, limited companies, sole traders and partnerships.

The users and their information needs vary depending on the nature of the entity. In the case of small and micro-entities the main users are the owners, the lenders and commercial partners. A micro-entity engaged in cross border trading could be deprived of access to its trading partner annual accounts and therefore it would be deprived of a means to check the solvability of its trading partner. This could affect cross-border trade.

Exempting micro-entities to prepare and publish annual accounts (financial statements) will not exempt them from preparing tax-accounts. Nor will it prevent stakeholders and lenders from asking a micro-entity to have annual accounts prepared before doing business with them or before lending them money or extent credits. For the smallest entities the financial statements are only one component of the decision-making process for lenders, perhaps of greater importance are other non-financial indicators, such as the relationship that the bank has with the client and the client's account history, lists of debtors and creditors, preparation of business plan for the client, site visits.

We should aware that for the smallest entities, lenders deal, many times, with owners themselves, rather than speaking to preparers/accountants. In many cases business owners are not financially literate and rely upon their accountant to represent them and their business in relation to the lenders. Presenting the financial reporting from the smallest entities in a standardized format is another issue. Such standardization makes it easier for the lenders to make decisions quickly and allow access to credit quickly whilst the business opportunity still exists.

It is clear – as the Commission rightly indicates in its impact assessment - that the statistical information now drawn from the annual accounts of micro-entities will have to be collected through other means, thereby significantly reducing and possibly even undo the advantages of the Commission proposal. [7]

Accounting is a source for financial security for the smallest entities that is why those issues presented above could not be ignored.

In March 2011 "Autorité des Normes Comptables (ANC)", the French authority for accounting regulation, presented a proposal related to the simplification for SMEs for the entire obligation to draw up annual accounts in order to have access to finance for their own development. For accomplish theses objective they involved in the process the accounting profession, the national bank from France, the department for fiscal legislation. For their point of view the financial information presented through annual accounts must be useful for the owners, for fiscal matters, for commercial partners and represent a guarantee for the security of the transactions made. "For millions entrepreneurs in France, those financial statements represent the only important

information in order to lead there business, and they are, before other users, an economic guidance, with minimum information that must be know, ones a year". [8]

The ANC made a proposal which will follow up three objectives:

- a) Reduction of the content for financial statements (annual accounts) and more precisely the notes to financial statements;
- b) In order to elaborate accounting standards to take into account the needs of the entities and their environment;
- c) Be aware of the volume and nature of the others information required from these entities.

The ANC is speaking about "micro-entities" (in French "micros sociétés"), the unlisted SMEs, listed SMEs and big companies. The ANC will focus on diminishing the contents of notes and the result will be a minimal content for this notes.

Why is important to mention the French ANC proposal? Because the way used by this normalization authority can be followed by other European countries. The modification of 4<sup>th</sup> European Directive is inevitable, that is way all European countries will improve the accounting regulation accordingly.

## **RESULTS AND FINDINGS FOR ROMANIAN ACCOUNTING REGULATION**

In Romania, in November 10, 2009, the Ministry of Finance issued the Order 3055 for the approval of the accounting regulation complying with the Fourth Directive of the European Economic Communities, in use from January 1, 2010. So at the present the SMEs and big companies fall under the scope of the accounting regulations in line with the European Directives. Considering the new accounting orientation at European level we expected to find within this accounting regulation the new orientation. We expected to see how the proposal of the EU affects the Romania accounting regulation. We will find out the Romanian accounting regulator position regarding the European proposal for amending the European directives? Despite our expectation the accounting regulation are more complex compared to the previous one.

This regulation includes several aspects of differential reporting in terms of accounting. The companies which do not comply with two of three size criteria (total assets 3.650.000 Euros, turnover 7.300.000 Euros and number of employees 50) will prepare a set of financial statements that includes: a simplified balance sheet, profit and loss account and notes to financial statements. Those which exceed the mentioned criteria will fulfill a set of financial statements that includes: balance sheet, profit and loss account, and notes to financial statements, statement of cash flow and statement of change in equity.

The new accounting regulation didn't mention anything about "micro-entities".

Because we understood the necessity for simplification we made a research in county Mures, Romania, in order to see if it is a need for simplification in accounting. We address our questionnaire to the professionals, by fax or by e-mail, especially those who are working as CPA in entities which could meet the threshold criteria mentioned in European proposal. What is important to mention here is the fact that the professionals are in favor of differential accounting regulation for entities classified according to their size. In the same idea we tried to find out if the professional consider that "micro-entities", as classified according to European proposal, must be exempt from the obligation to prepare financial statements. The answers were in favor of the obligation to prepare financial statements for smallest entities too. Also they were in favor of standardization for balance sheet and profit and loss account. According to other opinions, to submit a limited number of financial information rather than a balance sheet and a profit and loss account with standard form will not prevent banks and others creditors to require more complex financial reports from all entities, regardless their size. The state (80%), the banks (68.24%) and suppliers and customers (41.18%) represent, for the tested area, the real users of financial information. We wanted also to see the opinion related to cash accounting versus accrual accounting for "micro-entities". The results can be surprising because the idea of simplification is not connected with cash accounting for "micro-entities". Accrual accounting is the option for 44.71% of the respondents. It is also

interesting that 32.94% consider that the entities should have the possibility to choose between cash accounting and accrual accounting. (Neag and al., 2010) [9]

We could not extend our research among the owners of the smallest entities. We must be aware that almost all of them are not financially literate and they rely upon their accountant to represent them and their business in relation with others users of financial information. That is why we consider a limitation of the study research realised. We must notice that the area was limited to county Mures, Romania.

In 2011, another study was realised, but this one tried to cover a bigger area. The team wanted to identify the attitude of professional accountants from Romania regarding a simplified reporting system for small and medium – sized enterprises. The conclusion of this study revealed that 52,6% of the respondents consider that the current regulation do not provide for a reasonable level of simplification for the small and medium-sized enterprises and, consequently, a more simplified reporting is needed for the SMEs. Regarding the users of financial information the study revealed that the main user is the tax authority (42.6%) and the lenders represent also an important user (22.1%). The limitation of this study was also related to the fact that just the professional accountants were questioned. (Bunea and al., 2011). [10]

The debates regarding the necessity for simplification of accounting regulation related to micro-entities represent an issue of great interest for Romania too, not only because Romania is a Member State, but also due to the importance of the problems identified. There are voices that strongly affirm the opportunity of this process.

At present the accounting regulator in Romania presented an exposure draft related to accounting reporting simplification. [11] The criteria used for classifying the entities do not have anything to do with the threshold criteria within European proposal. For our point of view the mentioned exposure draft is meant to point out that the Romanian government is taking into consideration the accounting issues related to simplification but nothing else. Compare with the French ANC release our proposal cannot be judged as serious.

Generally speaking when this simplification process is started you suppose to include in it all interested parties. Also you should notice the fact that the modification for accounting regulation must be in some limits, which are very clearly, specified when we are speaking about accounting Directives.

For each accounting regulator improving the accounting statement for SMEs and smallest entities in each European country suppose to be an important objective in his strategy. The accounting treatment for smallest entities must be simple and to cover the maximum of possible situation. The Ministry of Finance from Romania, the Department of accounting legislation, must propose new accounting texts or modification of existing ones just when this are responding to a general interest required by entities or to a new obligation or constrain.

## CONCLUSION

In June 28, 2011, the President of FEE wrote that an overwhelming majority in the SME's and accountancy profession communities expressed major concerns with both the initial Commission's Proposal and the outcome of the first reading regarding the proposal for Directive on annual accounts of certain types of companies i.e. micro-entities. FEE outlined the importance of accrual accounting which they believe is essential and contributes to sound business management and to transparency and reliability of all financial information. The FEE supports the reduction of excessive and unnecessary administrative burdens and the simplification of the financial reporting requirements for micro and small companies within the scope of 4<sup>th</sup> Directive.

A professional organization, with his size and his importance worldwide cannot be ignored.

For Romania, we general support for attesting the statements of micro-entities. This should ideally take the form of a short report by an accountant rather than a statement established by the owner because many small business owners are not financially literate. We have general support

for standardization and fixed format for financial statements at the micro-entity level. A good set of financial statements are seen to be a good indicator of the control that the owner has managed his business.

We re-enforce the role of accrual accounting and the importance of preserving minimal transparency related to financial information presented by micro-entities for Romanian economic field. We believe the publications of financial information are a benefit to businesses and stakeholders in our country.

We are not defenders of eliminating the accounting obligations included in directives for micro-entities, not at all for SME, in Romania we only encourage a classification of the entities in small and medium-sized entities and micro-entities and we condition the accounting regulation for these categories of entities, by a public debate, as we have seen that other regulatory bodies have done.

In order to validate the conclusion presented for the Romanian entities we know that we suppose to have the entities opinions related to all the presented matters. But can we rely on them? Can we make them be interested in these debates? We think that all that we are doing is in the best interest of the entities. Are we wrong?

We know that in Romania and elsewhere are also others users of accounting information prepared by this "micro-entities", like creditors, commercial partners and financial institutions. Who tested their opinions?

These questions could be a subject for further research realized in Romania, research that must cover all the interested parties.

## REFERENCES:

1. Paoloni, M. et al. (1999), *Financial reporting by SMEs in Italy and Spain*, paper presented at the annual congress of the European accounting association, Bordeaux, France
2. Neag, R., "Contabilitatea financiara intre national si international", Editura Universitatii Petru Maior, Tirgu Mures, 2003, p. 20.
3. European Commission (2007) "Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing", available on-line at [http://ec.europa.eu/internal\\_market/company/docs/simplification/com2007\\_394\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/simplification/com2007_394_en.pdf)
4. European Commission (2009) "Simplifying the business environment for companies" available on-line at [http://ec.europa.eu/internal\\_market/company/simplification/index\\_en.htm](http://ec.europa.eu/internal_market/company/simplification/index_en.htm)
5. ICAEW 2009
6. Klaus-Heiner Lehne, 2010, *REPORT on the proposal for a directive of the European Parliament and of the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities*, European Parliament, Committee on Legal Affairs, February 2010
7. Impact Assessment: *Accompanying document to the Proposal for a directive of the European Parliament and the Council amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities*, SEC(2009)206, 26.02.2009, p. 30
8. Autorité des Normes Comptables, Mars 2011, *Livre blanc Warsmann.pdf*, [www.gouv.fr](http://www.gouv.fr)
9. Neag R, Masca E., Pascan I., 2010, "Research on the field tests in Mures county Romania regarding the opportunity for different accounting requirements for "small entities" or "micro-entities", AMIS 2010, Proceedings of the 5<sup>th</sup> International Accounting and Management Information Systems, Bucarest, Romania, [www.isiknowledge.com](http://www.isiknowledge.com)
10. Bunea S., Sacarin M., Minu M., 2011, *Romanian professional accountants' perception on the differential financial reporting for small and medium-sized enterprises*, AMIS 2011,

Proceedings of the 6<sup>th</sup> International Accounting and Management Information Systems, Bucarest, Romania

11. Ministry of Finance, Romania, *Order for approval of simplified accounting regulation*, June 2011, project, <http://discutii.mfinante.ro>