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Convergence of National Regulations with IFRS for SMEs: Empirical Evidences in the Case of Romania

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Abstract**—**The IFRS for Small and Medium-sized Entities (SMEs) was issued in July 2009 and currently regulators are considering various implementation strategies of this standard. Romania is a member of the European Union since 2007, thus accounting regulations were issued in order to ensure compliance with the European Accounting Directives. As the European Commission rejected recently the mandatory use of IFRS for SMEs, regulatory bodies from the Member States have to decide if the standard will affect or not the accounting practices of SMEs from their countries. Recently IASB invited stakeholders to discuss the revision of IFRS for SMEs. Empirical studies on the differences and similarities between national standards and IFRS for SMEs could inform decision makers on the actual level of convergence in different countries**.** The purpose of this paper is to provide empirical evidences on the convergence of the Romanian regulations with IFRS for SMEs analyzing the results in the context of the last revisions proposed to the EU Accounting Directives.

Keywords**—**EU Accounting Directives, IFRS for SMEs, national regulations

I. Introduction

THE implementation of IFRS for SMEs is expected to contribute to increasing the international comparability and the quality of SMEs accounting information. National standard setters may choose to require or recommend the application of the standard as it is or to issue national standards or regulations convergent, as much as possible, with IFRS for SMEs. At the European Union level, the European Directives were issued to achieve harmonization. However, prior research ([15], [28], [22], [12], [21]) reported a low level of harmonization. After the last decision of the European Commission, IFRS for SMEs could affect the accounting of the European SMEs if regulators or standard setters from Member States would revise their national standards or regulations in order to increase their convergence with the standard respecting also the limitations imposed by the European Directives.

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Formal convergence measures could bring empirical evidence on the magnitude of the changes involved. The accounting harmonization assumes both formal harmonization and material harmonization. Formal harmonization refers to harmonization between regulations, and is called also *de jure* harmonization.

Material or *de facto* harmonization refers to harmonization between practices applied by companies. As formal harmonization represents the basis of achieving material harmonization we will focus in this paper on measuring formal harmonization of Romanian regulations with IFRS for SMEs. The rest of the paper is organized as follows. We begin by reviewing the studies related to IFRS for SMEs application within EU and non EU countries and studies conducted in Romania, we present the research methodology and the results and finalize with the conclusions of the study.

II. Literature Review

In order to be applied within EU countries IFRS for SMEs has to be compatible with the EU Accounting Directives and to be adopted by member states as national standard. This is the reason why the European Commission asked EFRAG to provide advice on the requirements of IFRS for SMEs which are incompatible with the EU Accounting Directives.

EFRAG conducted a study [14] and concluded that few requirements of IFRS for SMEs are incompatible with the EU Directives (the prohibition to present items of income and expenses as extraordinary, financial instruments measurement at fair value, the presumptive useful life of 10 years for goodwill, the prohibition to reverse an impairment loss recognized for goodwill, the immediate recognition in profit or loss of any negative goodwill and the requirement to present the amount receivable from equity instruments issued before the entity receives the cash or other resources as an offset to equity and not as an asset).

However, this analysis has certain limitations: it does not take into consideration how the EU Directives were implemented in different countries and it was based on the concept of 'incompatibility', understood as the situation where a requirement of IFRS for SMEs is prohibited by the EU Directives ([1],[14]). A public consultation on the use of IFRS for SMEs within EU took place between 17 November 2009 and 12 May 2010([17]).

The Commission Services received 210 responses from 26 EU Countries and 4 non-EU countries ([17]). Divergent opinions were expressed by stakeholders regarding the potential application of the IFRS for SMEs in Europe.

The increased comparability and harmonization within EU, the facilitation of cross border trade, foreign mergers and acquisitions and of the international growth of companies, the attraction of foreign investors and the reduction of the costs involved by the preparation of consolidated accounts in multi-national groups were the main arguments in favor of IFRS for SMEs adoption ([17]. Supporters of the use of IFRS for SMEs considered that the Standard is suitable for large and medium-sized companies, for international groups and subsidiaries of companies reporting under full IFRS as well as for companies developing an international activity, listed on non-regulated markets, seeking foreign financing or "non publicly accountable" (as defined in the IFRS for SMEs)([17]). The opponents highlighted the standard's complexity (especially for smaller entities) and questioned the benefits that the standard could bring to companies operating only locally and having a limited number of shareholders ([17]). The linkage between taxation and accounting and capital maintenance were cited as problems of IFRS for SMEs application in certain countries ([17]). Also, the necessity of another accounting framework in the EU (besides national regulations and full EU endorsed IFRS) was generally questioned ([17]). The need of modernization and simplification of the EU accounting Directives was widely supported ([17]).

The Centre for Strategy and Evaluation Services ([6]) conducted a study on IFRS for SMEs which included surveys and interviews with stakeholders regarding the application of the standard. The study reported that the banks interviewed did not consider that IFRS for SMEs would be helpful and that regulators appreciated that very few companies would chose to apply the standard ([6]). The opinions of the professional bodies were divided. Some of them were supportive, but others pointed out that the standard will lead to increased costs ([6]).

Certain accounting firms considered that IFRS for SMEs could be implemented relatively quickly, but most others appreciated that the process would be challenging because of the costs involved by the training and the preparation required ([6]). It was expressed the view that IFRS for SMES is useful for SMEs with cross border activity (which represent only 10% of the total number of SMEs). It resulted also that IFRS for SMEs is more appreciated by current users of IFRSs ([6]). Few studies were developed in certain Member States. Ikäheimo et al. ([23]) conducted interviews with auditors in Finland. The auditors interviewed considered that IFRS for SMEs is justified to be applied by SMEs developing international activities and would be appreciated by the international banks which would have the possibility to harmonize their processes in case of similar SME reporting across countries([23]). They identified various benefits that the standard would bring to financial institutions, such as more straight forward financial statement analysis, better comparability of firms and more timeliness reporting [23]). All interviewees considered accounting firms to benefit from the potential adoption of SME, but provided mixed opinions on the net benefits for the reporting firms ([23]). Litjens et al. ([24]) observed that preparers consider costs and benefits of IFRS for SMEs separately, not concurrently, and evaluate them in relative terms.

The results indicate that a voluntary adoption decision depends on the preparers' context for the cost-benefit analysis, which appears to be a non-linear process ([24]). Simpson ([27]) examined the views of the stakeholders who have direct or indirect association with the financial reporting of SMEs in Ghana, and assessed the suitability of current reporting standards for SMEs in this country. Results indicated lack of uniformity in the application of regulations by SMEs and a low level of compliance, citing problems such as the lack of skilled accounting personnel, high compliance costs and low levels of awareness of the existing standards ([27]).

The topic of the IFRS for SMEs has also been in the focus of Romanian researchers ([7]; [8]; [9]; [19]; [18]; [10]; [11]). Deaconu ([7]) reviewed the standard setting actions for IFRS for SMEs up to that time.

The author concluded that the original purpose of IASB of simplification of IFRSs has not been achieved, since the complex reporting requirements such as consolidation and fair value have been preserved in the 2006 version of the standard. As the impact of IFRS for SMEs on Romania is concerned, the authors generally agree that implementing such a referential would lead to significant improvement the financial reporting of Romanian entities: higher quality of the accounting information, homogeneous accounting rules, better understandability and comparability but also underline the current deficiencies/difficulties, such as lack of trainers, teachers and practical specialists ([18]); cost of their adaptation to local SMEs ([19]); insufficient simplifications in the Romanian approach ([10]). Albu et al ([1]) developed an exploratory study on the possible implementation of IFRS for SMEs in Romania and identified other difficulties: the emphasis on conformity with tax regulations, the rule-based orientation and the preference of accountants for prescriptive regulations.

III. Research Methodology

The objective of this paper is to measure the differences and similarities between the IFRS for SMEs and the Romanian regulations. A comparative study between national regulations and IFRS for SMEs was realized by the professional body ([5]). Other general analyses were conducted by Albu et al. ([2];[3]). An in-depth convergence analysis between Romanian regulations and IFRS for SMEs was conducted by Albu, Gîrbină and Cuzdriorean-Vladu ([4]) for inventories.

There is a rich body of literature on accounting harmonization using different methods: Mahalanobis distance ([25]), Euclidean distance ([20]), average distance ([29]), Jaccard's similarity coefficient and Spearman's correlation coefficient ([20]), absence and divergence indexes ([13]), fuzzy clustering analysis ([26]). However empirical evidence on IFRS for SMEs is scarce.

Following Yu and Qu ([30]) we classified the accounting requirements for each comparison item in the Romanian regulations and IFRS for SMEs using the following framework:

TABLE I
ACCOUNTING PRACTICES CLASSIFICATION FRAMEWORK

	Type	Description
I.	Required	An accounting practice is required by an accounting regulation.
II.	Allowed	More than one accounting alternative exist.
III.	Not regulated	An accounting practice is not regulated.
IV.	Forbidden	An accounting practice is not permitted by the accounting regulation

We calculated four indexes to measure the convergence level of Romanian regulations and IFRS for SMEs: modified Jaccard's Coefficient, Absence Index, Divergence Index and Average Distance.

The modified Jaccard's Coefficient JACC was determined as follows:

$$JACC = \frac{a + d}{a + b + c + d}$$

where ***a*** is the number of provisions which are permitted (classified as "Required" or "Allowed") in both regulations, ***d*** is the number of provisions which are not permitted (classified as "Forbidden") in both regulations; ***b*** is the number of provisions which are permitted in IFRS for SMEs but not regulated or forbidden in Romanian regulations; ***c*** is the number of items which are permitted in Romanian regulations but not regulated or forbidden in IFRS for SMEs. JACC reflects the similarity between the two sets of accounting regulations: the larger the value of JACC, the higher the level of convergence.

The Absence Index is calculated as follows:

$$ABSE = \frac{e}{a + b + c + d}$$

where *e* is the number of provisions which are not regulated in either Romanian regulations or IFRS for SMEs, ABSE expresses the degree of dissimilarity between Romanian regulations and IFRS for SMEs resulting from the absence of regulation on this issue in either of the two sets of standards. There is an inverse correlation between ABSE and the level of convergence.

The Divergence Index is determined as follows:

$$DIV = \frac{f}{a + b + c + d}$$

where ***f*** is the number of provisions which are permitted in one set of standards but forbidden in the other. DIV measures the degree of dissimilarity between Romanian regulations and IFRS for SMEs resulting from different treatments required by the two sets of standards on the same accounting issue, and the larger the value of DIV, the lower the level of convergence.

The Average Distance is determined as follows:

$$AD = \frac{\sum g}{a + b + c + d}$$

Variable g is coded as 0 when the requirements under Romanian regulations and IFRS for SMEs are classified into the same strength type (I,II,III or IV); as 1 when the discrepancy of strength types between the two sets of standards for the comparison item is one, for example, when an accounting treatment is required by IFRS for SMEs and allowed by Romanian regulations as 2 when the discrepancy is two, for example, when an accounting treatment is required by IFRS and not regulated by Romanian regulations, as 3 when the discrepancy is three. AD ranges from 0 to 3. The value of AD is inversely correlated with the level of convergence.

A list of 180 items required or permitted under IFRS for SMEs or under the Romanian regulations was used as benchmark. Table I and Table II below present the allocation of the items according to the framework presented above.

TABLE II
CLASSIFICATION OF ACCOUNTING PRACTICES ACCORDING TO ROMANIAN REGULATIONS

Number of items			
Required	Allowed	Not regulated	Forbidden
70	18	31	61

TABLE III
CLASSIFICATION OF ACCOUNTING PRACTICES ACCORDING TO IFRS FOR SMES

Number of items			
Required	Allowed	Not regulated	Forbidden
119	41	14	6

IV. RESULTS

Table IV illustrates the value of indexes for all the items analyzed.

TABLE IV
CONVERGENCE INDEXES

Index	**Value**
Jaccard's Coefficient JACC	0.377778
Absence Index ABSE	0.25
Divergence Index DIV	0.372222
Average Distance AD	1.533333

A medium level of convergence of Romanian regulations to IFRS for SMEs was observed. This is determined more by the difference in the treatments required by national regulations and IFRS for SMEs than by absence of related regulation in either set of standards (DIV is higher than ABSE).

Further, the items were grouped in three categories: conceptual requirements, recognition and valuation requirements and disclosure and presentation requirements.

We present below the levels of the indexes for the last two types of requirements (Table V).

TABLE V
CONVERGENCE INDEXES FOR CATEGORIES OF REQUIREMENTS

Index	Values for presentation and disclosure items	Values for recognition and measurement items
Jaccard's Coefficient JACC	0.459016	0.275229
Absence Index ABSE	0.344262	0.220183
Divergence Index DIV	0.196721	0.504587
Average Distance AD	0.196721	1.825688

We observe a higher level of convergence for presentation and disclosure requirements than for recognition and measurement items. The differences are caused more by the absence in case of disclosure requirements and by divergence in the case of recognition and measurement items.

Main divergences in disclosure area are related to the presentation of comprehensive income (as a single or second statement), the presentation of the statement of retained earnings in certain circumstances, disclosure on the face of the balance sheet of biological assets measured at cost or fair value, presentation of deferred income tax in the balance sheet, presentation of the income statement by function as primary statement, separate disclosure of gains and losses from discontinued operations and the separate disclosure of extraordinary items.

We observe also that main divergences are caused by items which are prohibited by Romanian regulations. This is explained by the fact that Romanian regulations state the layout of the financial statements which is standardized. Certain items are not disclosed according to Romanian regulations because they are not recognized as separate assets or liabilities (as it is the case of biological assets or investment properties).

The main divergent accounting treatments are related to: the use of IFRS to develop an accounting policy, the retrospective application of a change in accounting policies, the deduction of cash discounts from the cost of inventories, PPEs and from revenue, the use of fair value option for PPEs, the use of LIFO for inventories, the use of the most recent price method for inventories, the initial valuation of the agricultural produce at fair value less costs to sell, the initial and subsequent valuation of biological assets at fair value less selling costs, recognition of gains and losses from biological assets, the reversal of the impairment loss for goodwill, the deduction of the residual value to determine the depreciable amount for tangible and intangible assets, the recognition of the investment properties received in operating leases in certain circumstances, valuation of the investment properties at fair value, discounting of long term receivables, fair value for derivatives, hedge accounting, classification of financial assets in four categories (if IAS 39 is used), separation and valuation of the embedded derivatives, the use of the percentage of completion method for construction contracts, the recognition of deferred tax assets, separation of compound instruments, discounting the value of revenue, grouping and interpreting together transactions for revenue recognition purposes, valuation of the investments in joint ventures using the cost model, fair value and the equity model and valuation of investments in associates at cost or fair value in consolidated accounts, valuation and recognition criteria in business combinations, recognition of contingencies in business combinations, and subsequent adjustment of the cost for contingencies, amortization of goodwill in 5 years, immediate recognition of badwill in P&L, valuation at fair value of the investments in subsidiaries, associates and joint ventures in the separate financial statements.

Certain items which are regulated in Romanian are not regulated under IFRS for SMEs such as certain constrains related to profit or reserves distribution, monthly actualization of foreign currency items, the use of chart of accounts and separate evidence requirements. However we consider that they do not impair convergence with IFRS for SMEs.

Having the last decision of the European Commission, IFRS for SMEs cannot be applied as it is in EU countries ([16]). The last EU Proposal for a Directive on the annual financial statements ([16]) introduced few changes that may affect the level of convergence of national regulations with IFRS for SMEs.

Certain differences between the proposed Directive and the IFRS for SMEs related to the presentation of unpaid subscribed share capital and the amortization periods for goodwill whose expected useful life cannot be reliably estimated will limit the maximum level of convergence with IFRS for SMEs achievable at EU level. However some changes may increase the level of convergence of Romanian regulations with IFRS for SMEs, if implemented. We include here the introduction of general principles of "materiality" and "substance over form", the prohibition to capitalize formation expenses, the elimination of LIFO, the prohibition to present separately the extraordinary items in the income statement and the principles-based treatment for the recognition of negative goodwill in the consolidated profit and loss account. Other changes allow member states to use methods different of those prescribed by IFRS for SMEs (such as revaluation accounting for fixed assets). The reduction of the number of layouts will not affect Romanian regulations because the formats eliminated were not used. Also, post balance sheet events were already required by Romanian regulations.

V. CONCLUSION

As IFRS for SMEs cannot be applied as it is in EU member states, international harmonization of accounting for SMEs can only be achieved by eliminating the differences between national regulations and the standard.

Using methodology form previous harmonization studies we assessed the level of convergence of Romanian regulations with IFRS for SMEs. The differences identified provide a general overview of the divergences between the two sets of regulations and on the magnitude of changes to be done to increase the level of convergence. The limitations imposed by the compliance with the European directives were also considered. The limits of the research are related to the subjectivity in selecting the items used as benchmark for comparisons and the relevance of the indexes determined to measure the level of formal convergence.

Future studies on material convergence could provide a more complete view on the convergence of the accounting practices of Romanian SMEs to IFRS for SMEs.

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