IFRS for European Small and Medium-Sized Entities?

A Theoretical and Empirical Analysis

- Management Summary -

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After years of development and debate, the International Accounting Standards Board (IASB) has recently published an International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs, IASB 2009). This standard provides an adoption of the “full” International Financial Reporting Standards (IFRS), which were designed with publicly traded entities in mind, to the environment of private firms. If the EU or its member states introduced the IFRS for SMEs, it would impose a major change of financial accounting regulation on millions of European firms.

This research report evaluates on a priori basis whether such a regulatory move would benefit European SME firms. We analyze the character and role of financial accounting in the SME setting theoretically and empirically in order to give an ex ante opinion on whether an adoption of a homogenous financial accounting regime across European SMEs can be expected to be beneficiary. We find that one of the central advantages of the IASB as a financial accounting standard setter is that, as a privately organized standard setting body, it is able to build on the high level of institutional expertise of its members. Currently, the IASB and other bodies of the International Accounting Standards Committee Foundation (IASC, from March 1, 2010: IFRS Foundation) lack members which have an SME background. Also, the financing of the IASB and IASC is heavily biased towards global corporations, Big Four auditing firms and capital market institutions. While this seems comprehensible from the perspective that the focus of the IASB used to be on publicly listed firms, it is doubtful whether the IASB is or will be able to develop and maintain high quality financial accounting and reporting standards for the private sector.

Doubt on applicability for SMEs

Although legal issues are not the focus of this economic research report, it appears questionable whether the legislative authority of the European Union extends to delegating the standard setting authority for the financial accounting regulation of private firms to a private standard setter. The endorsement mechanism, which currently is in place for transforming IFRS for public firms into EU law, does not mitigate this concern, as this is an issue especially of the subsidiarity principle. Also legal issues at the member state level might conflict with a voluntary or mandatory adoption of the IFRS for SMEs.

Financial accounting of SME firms plays a crucial role for a myriad of contractual relations of these firms. These relations include but are not limited to such diverse topics as taxation, income distribution, credit contracts and negotiations, (other) regulatory issues and management compensation. Contractual usage varies across countries throughout Europe, depending on different regulatory settings and other national differences such as cultural diversity. Also, within each country, they vary by the type and environment of each firm.

Different conditions and objectives

Public firms (the major target group of IASB standard setting so far) are working in a vastly different environment from private firms. As regulatory action and cross-country competition has increased the globalization of European capital markets over the last decades, European public firms are facing a different and arguably more harmonized setting than private European firms. Also, for publicly listed firms and their investors, financial accounting fulfills a valuation role which aims at providing information which is helpful for asset pricing at (supposedly) efficient capital markets. The contracting role of financial accounting becomes less important – in contrast to private firms, who have no access to organized capital markets.

The objective of the IASB is to develop a single set of ‘general purpose’ high quality accounting standards. This focus on ‘one size fits all’ standards seems reasonable: If the IASB wants to succeed in developing a coherent set of standards, it has to identify a single objective. Multiple objectives are likely to require multiple sets of customized standards. Insofar, the IASB caters to the demand of publicly listed firms, globalized capital markets and their participants. As SME firms operate in other environments than internationally-oriented publicly-listed firms, research has clearly identified that the objectives for SME financial accounting differ from the objectives of public firms. In contrast, the IASB seems to believe that concepts and pervasive principles shall not differ between IFRS for SMEs and full IFRS.

However, it is a matter of open scientific debate whether these different accounting objec-
atives really give rise to different financial accounting outcomes. If this were not the case, then imposing the same set of coherent high-quality standards on a diverse group of firms would probably not do material harm. This is why we conduct an empirical study to test whether the regulatory infrastructure and the incentives of private firms across Europe can be linked to substantially different accounting outcomes.

**Sample of 1.1 million firms supports heterogeneity**

Using a sample that includes over 1.1 million European firms (and more than 7.7 million firm-year observations) – a sample more or less unparalleled in the scientific arena of empirical accounting research – we provide clear empirical evidence that as of now, the financial accounting outcome of private firms differs predictably across Europe and that this difference is driven by the accounting objectives of the respective firms.

Looking at the time-series smoothness of earnings in comparison with cash flows from operations (a scientifically accepted measure of accounting outcome), we document that private firms cater to creditor as well as to owner incentives when preparing their financial accounts. Also, and this might be even more important, they take the country-level infrastructure into account: Private firms in countries which have a strong link between tax and financial accounting report significantly smoother earnings streams. In addition, firms seem to take the general governance infrastructure of their home-country into account when making financial accounting decisions.

**Requirements for harmonization not met**

We conclude from our empirical analyses that different accounting objectives across Europe, which are shaped by the different incentives of the major contractual partners of the firms and by the country-level governance infrastructure, have a significant impact on financial accounting outcomes.

Taken together, our results suggest that the essential preconditions for successful SME financial accounting harmonization across Europe are - at least currently - not met.

The EU governance infrastructure (including taxation and dividend distribution) is not harmonized to such an extent that its impact on the financial accounting objectives of private firms across Europe can be expected to be immaterial. An EU-wide adoption of IFRS for SMEs would especially require the harmonization of direct taxation – a challenge which has been on the EU agenda for more than five decades without substantial achievements so far.

The IASB and its organizational infrastructure appear not to be qualified for SME accounting standard setting. SME financial accounting harmonization across Europe would require a standard setting process which has sufficient institutional expertise in developing high quality standards for SMEs. This implies that SME firms would need to have a significant say and influence in this process.

**Harmonization and subsidiarity principle**

The EU wide adoption of IFRS for SMEs provokes legal questions which remain unsolved. SME financial accounting harmonization across Europe has to obey the principle of subsidiarity and democratic requirements at the EU and member-state level.

Even if all the above mentioned preconditions were met, this would not necessarily imply that SME financial accounting harmonization across Europe would be successful in economic terms. Apart from the inability to remove cultural and other cross-country differences that will continue to influence business practice across Europe in the foreseeable future and therefore most likely induce additional indirect costs of harmonization, SME accounting harmonization also causes direct costs by forcing millions of European firms to, e.g., adjust their accounting information systems and to train their accounting staff. An SME financial accounting harmonization can only be successful if the benefits of harmonization exceed the direct and indirect costs of harmonization.

**In short: “Financial accounting harmonization is the end of the harmonization process, not the beginning!”**

As long as the regulatory infrastructure of private firms across Europe differs significantly, imposing harmonized financial reporting on them has the effect of a legal implant interfering with existing (legally regulated) contractual regulations that have been established (and proven successful) over centuries. The process of material international accounting harmonization across European public firms more
or less originated from the firms themselves in the early 1990s. It can be expected that private firms will take the same action as soon as they feel that the benefits of harmonizing their accounting regimes will outweigh their costs.

Disclaimer
This research report is based on existing literature, theoretical analyses and empirical data. It comprises a scientific assessment of certain theoretical and empirical aspects of SME accounting in general and of the adoption of IFRS for SMEs in particular. This assessment reflects the specific and long-lasting research experience of the authors on the field of international accounting. A dissenting opinion from third parties such as regulators, government agencies, courts of justice, lobby and professional groups or other scientists is not per se impossible. The authors assume no liability, especially no liability for any damage caused directly or indirectly by this research report.

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