IMPLICATIONS OF THE APPLICATION OF IFRS FOR SMES IN ROMANIA ON TAXABLE AND DISTRIBUTABLE PROFIT [20]

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On 9 July 2009, the International Accounting Standards Board (IASB) issued the International Financial Reporting Standard for Small and Medium Sized Entities („IFRS for SMEs") which aims to provide a financial reporting framework for SMEs falling within its scope. It is a matter for authorities in each jurisdiction to decide which entities are permitted or required to apply IFRS for SMEs. Because of the connection between accounting and taxation certain european countries had a reluctant position related to the application of IFRS for SMEs. Opponents focused on the incompatibility between IFRS for SMEs framework and the principles commonly accepted for tax purposes.

As the individual financial statements drown up in compliance with IFRS for SMEs will serve for profit distribution under the 2nd European Directive the question arises weather the profits determined under these accounting rules can be considered as realized for distribution purposes. In order to mitigate the mismatch between accounting and distributable profits, Member States will need to reconsider the circumstances in which gains and losses arising from re-measurement at fair value through profit and loss should be considered as realized.

In this scenario, two important questions arise: What are the potential tax effects of the application of IFRS for SMEs? Is the profit determined under IFRS for SMEs available for distribution or some adjustments are necessary? The paper addresses these issues in the context of the Romanian accounting and taxation systems. Romania represents a relevant case study, as it is one of the European countries with a close linkage between financial and tax, where the fiscal profit is dependent on the accounting profit (currently determined under domestic regulations).

The methodology consists in a comparative analysis of the recognition and measurement rules between national accounting regulations and IFRS for SMEs in order to identify the differences with possible consequences on taxable and distributable profit.

The comparative analysis identified tensions between accounting and taxation that should be solved and new accounting policies with impact on taxable and distributable profit. Under these circumstances regulators should analyse if new policies proposed by IFRS for SMEs are acceptable considering the purpose of specific regulations and modify the legal framework.

Keywords: IFRS for SMEs, taxable profit, distributable profit
JEL classification: M 40, M 41, M 48

1.INTRODUCTION

According to IASB, IFRS for SMEs is intended to apply to the general purpose financial statements of entities that do not have public accountability and present general purpose financial statements for external users. EU countries use quantitative trasholds for reporting requirements of companies. It is a metter of each jurisdiction to identify which entities wil be placed within the scope of IFRS for SMEs.

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In Romania it is the Order of the Minister of Public Finance no. 3.055/2009 (further referred as OMFP 3055), which currently foresees accounting principles and rules to be applied in recognizing, measuring, derecognizing and presenting the elements of annual financial statements. OMFP 3055 contains accounting regulations in conformity with the Fourth and Seventh Accounting Directives. The IFRS are mandatory only for listed companies in their consolidated accounts starting January 1st 2007 (OMFP no. 1221/2006) (while the national regulation needs to be applied for their individual accounts), as well as for all financial institutions. An option to choose between the 7th ED and IFRS is available for public interest entities in their consolidated accounts. Starting 2012 IFRS will become mandatory for the individual financial statements of financial institutions.

A number of papers on the Romanian case advocate for a difficult *de facto* and *de jure* harmonization between the regulatory and practical aspects of Romanian accounting and IAS/IFRS. For example, concerning the initial phase of implementation of IASs in Romania, Țogoe (2003, cited in Ionaşcu, 2007: 118) noted that there is “a local method, rather brief, of understanding and application of IASs”. On the other hand, Petre and Lazăr (2006:5-6) consider that the regulation of accounting is not connected to taxation. In practice entities might use fiscal instead of accounting rules, but this pertains to practice and not regulation, “there is no subordination of accounting to taxation and accounting rules are not harmonized with fiscal rules” (Petre and Lazăr 2006: 6). They consider that “such an opinion that accounting serves fiscal interests represents at least not knowing the current Romanian reality” (Petre and Lazăr 2006: 6). Bunea (2006: 143) shows that 80% of the sample he studied upon felt the need of detailed regulations, and only 20% agreed with the principle-based regulations. 59% consider that OMFP 1752 is not sufficiently detailed, and this might be an explanation for the use of the same (previous) accounting practices (Bunea, 2006: 144). Also, 97% noted that in the absence of a detailed rule in OMFP 1752, they choose the fiscal solution.

From the perspective of the implementation of IFRS for SMEs, Romanian authors generally agree that implementing such a referential would lead to significant improvement of financial communication by Romanian entities: higher quality of the reported accounting information, homogeneous accounting rules (there would be no requirement to follow Directives vs. IFRS), better understandability and comparability.

As literature reveals that tax accounting relationship rises problems even under current accounting framework it is reasonable to conclude that these tensions will be encoutered if IFRS for SMEs is to be applied.

The main arguments advanced in the literature against IFRS relates to the investor focus and information orientation, along with its tendency towards fair value accounting. Critics are concerned that these aspects of IFRS will lead to the distribution of “unrealized” profits, making IFRS inadequate as a basis for calculating distributable income. The introduction of IFRS as a potential basis for profit distribution poses a definite challenge for the European Union as a legislator and it can be questioned weather the 2nd Directive in its current format is sufficiently prepared for this challenge. Even if fair value is used less in IFRS for SMEs national regulator will have to analyze if the new accounting profit is available for distributions.

2. Literature review

Literature agrees on three aspects of IFRS that make controversial their concrete application in the modern tax systems: the balance sheet approach, the use of fair value accounting and the substance over form principle (Shön 2004: 426-440; Jacobs et al. 2005; Eberhartinger and Klostermann 2007:141-168). Although their influence is smaller under IFRS for SMEs they are still issued to be solved. In most European countries, including Romania the accounting income is the base for the calculation of corporate taxation with limited adjustments required by tax law.

This form of the relationship between accounting and taxation is referred to as "quasi-dependent approach". Under the quasi-dependent approach the shift to new accounting standard is expected to have effects on the tax regulations.
The European Commission, having indicated in its recent Communication that it had no plans to change the 2nd Directive. Besides the political decision, further research is needed to investigate whether there is a need for an alternative capital maintenance regime. The following research questions should receive a documented answer in the context of the application of IFRS for SMEs: Why most EU Member States do not allow IFRS for SMEs? Does dividend distribution play a role?

3. RESEARCH METHODOLOGY

The methodology involves the comparative analysis of IFRS for SMEs and current accounting regulations on one side and of fiscal and company law legislation on the other side in order to identify the diferences that might have an impact on taxable and distributable profit.

3. 1. Tax Implications Of Ifrs For Smes In Romania

We propose within this section to illustrate the fiscal implications of the application of IFRS for SMEs in Romania. Our analysis will aim the provisions of the Fiscal Code and current accounting regulations (OMFP 3055/2009 as amended by OMFP 2869/2010 and 2870/2010). The main connection between tax and accounting is related to the calculation of the income tax. In Romania there is a direct relationship between financial accounting and tax, involving a "quasi-dependent approach". Taxable income is computed on the basis of the accounting results, with specific adjustments required by tax law when accounting criteria are not suitable for tax purposes
According to the Declaration for the calculation of tax on profit (101) taxable profit is determined after the following formula:
Fiscal profit = Accounting profit (gross result) + Elements assimilated to income- Elements assimilated to expenses- fiscal deductions- non-taxable income+ non-deductible expenses- fiscal loss to be recovered
Revaluation reserves and gains related to the sale and cancellation of own participating titles are assimilated to income while losses from the sale of own participating titles are assimilated to expenses. The following incomes are not taxable: dividends received from a Romanian legal person or from a EU legal person in certain circumstances, favourable differences of value for participation titles that are recorded as the result of the incorporation of reserves, benefits or issuance premiums by the legal persons where the participation titles are held, as well as valuation differences for long-term participating titles and bonds issued (such differences are taxable on the date of their transfer for free, assignment, withdrawal of the participation titles as well as on the date of the withdrawal of the social capital in the legal person in which the participation titles are held), incomes from the cancellation of expenses for which no deduction was allowed, incomes from the reduction or cancellation of provisions for which no deduction was allowed and incomes from the recovery of non-deductible expenses, non-taxable incomes expressly provided in accordance with memoranda approved by normative acts.
The fiscal treatment of fixed assets is described by the fiscal code and it is not dependent on their accounting treatment. The normal period of use and depreciation methods applicable from a fiscal point of view are described by the fiscal legislation. The accounting regulation defines separately the accounting useful life and acceptable depreciation methods. Cost formulas (FIFO, LIFO, WAC) used for accounting purposes are recognised also for tax purposes. The fiscal treatment of research and development costs follows the current accounting treatment. Special

conditions are prescribed for the deduction of interest and foreign exchange losses but they do not concern valuation (accounting valuations are recognised for fiscal purposes).

As a general rule all accounting incomes *are taxable* excepting when they are explicitly non taxable by law. Because of this connection any change of the accounting framework has consequences on taxable income if no change is operated to the Fiscal Code. Because an accounting income is implicitly taxable it must be certain as each tax payer to know the amounts payable and avoid a different interpretation by the fiscal authority. It means that revenue recognition methods involving estimates are not acceptable from a fiscal point of view and adjustments will be necessary. Recognition of gains based on fair values would bring more volatility to taxable profit calculation which is not desirable if the fiscal authority wants a reliable projection of fiscal income. A solution would be as the fiscal authority to establish different tax bases for assets valued at fair value. According to the general tax deductibility principle, expenses are deductible only if they are incurred with a view to generating taxable income. An expense is deductible if it fulfils the following conditions: a causal relationship exists between the expense and a taxable income, the expense is properly backed-up by supporting documents, the expense is not explicitly non deductible by law or it doesn't have a limited deductibility by law.

Under current circumstances even if companies would generally be in favour of an introduction of a more relevant financial reporting framework they would oppose it because of expected tax effects especially if the consequence would be an increase of taxable profit. Impairments of tangible and intangible assets and write downs of inventories are not deductible for tax purposes. Write downs of trade receivables and provisions are deductible within the limits describes in the Fiscal Code.

For cases where Romanian tax calculations follow financial reporting rules the tax authorities would need to establish new tax rules that would have to be much the same as the existing Romanian financial reporting rules but different from IFRS for SMEs. These, could lead to new adjustments from accounting profit to taxable income. The application of IFRS for the individual accounts of banks starting 2012 will require a fiscal solution and other entities willing to adopt an IFRS based framework could benefit from it.

We present below the possible effects of adopting IFRS for SMEs on accounting profit and implicitly to the taxable profit if no change is made to current Fiscal Code.

Table no 1. Effects of adopting IFRS for SMEs on accounting profit

Accounting policy in compliance with IFRS for SMEs	**Possible effect on accounting profit**
No LIFO (assuming increasing prices)	+
Profit on uncompleted contracts based estimated percentage of completion	+
Development cost expensed	-
Losses recognised for derivatives	-
Gains recognised for derivatives	+
Losses on biological assets at fair value	-
Gains on biological assets at fair value	+
Gains on investment property	+
Losses on investment profit	-
Abandonment of matching approach for grants –recognition of grant income	+
No capitalisation option for borrowing costs	-

- realised by the authors-

Key:
+ = more or faster recognition of profit
– = less or slower recognition of profit

In IFRS for SMEs set up cost research and development costs are expensed. According to OMFP 3055 development costs are capitalized if they meet conditions similar to those prescribed by IAS 38 and fiscal rules are based on current accounting rules. According to IFRS for SMEs investment property is carried at fair value if fair value can be measured without undue cost or effort with pluses and minuses in the income statement. OMPF no. 3.055/2009 does not define specific accounting policies for investment property. The accounting policies specific to PPE are applied. The percentage of completion method is not accepted by OMFP 3055 for construction contracts. The revenue is recognized when the reception document for the outcome completed is signed by the beneficiary. Costs incurred for the contract but not yet accepted by the beneficiary should be recognized as work in progress (within inventories category).The accounting treatment is recognised from the fiscal point of view. The use of LIFO is allowed by OMF 3055/2009. The accounting policies specific to inventories or tangible fixed assets are applied for biological assets and agricultural produce. Valuation at fair value less cost to sell is not allowed under national regulation. The prescriptions of OMFP 3055/2009 for government grants are in line with IAS 20 while section 24 of IFRS for SMES does not allow an entity to match the grant with the expenses for which it is intended to compensate or the cost of the asset that it is used to finance. Discounting of revenues is not required by OMFP 3055. For customer loyalty programmes the sellers recognise under OMFP 3055 a revenue for the gross amount and a non deductible provision for their obligation to provide free or discounted goods or services.According to OMFP 3055/2009 borrowing costs *may* be capitalized for assets that necessarily take a substantial period of time to get ready for its intended use or sale. Capitalization is prohibited by IFRS for SMEs. Fair value is not used for derivatives under OMFP 3055.
In order to determine taxable profit tax payers should draw up the Register of Fiscal Records (the use of this register is regulated by OMFP no 870/2005 modified by OMFP no 1857/2006 and OMFP no 949/2005). This register reflects all information relevant for the calculation of taxable profit and income tax. The filling procedure will be defined by each taxpayer considering the specificity of its activity and its own needs. This Register will be used more if IFRS for SMEs is adopted.

3.2 Effects on distributable profit
The accounting profit is implicitly distributable after deductions prescribed by the Company Law and OMFP 3055/2009. Dividends may be distributed only from real profits. Companies are required to set up a legal reserve which is calculated as 5% of the gross accounting profit until this reserve reaches 20% of the paid in share capital. If the correction of an error generates a loss carried forward it must be covered before any distribution. The unrealised revaluation reserve is not distributable. In so far as formation expenses have not been completely written off, no distribution of profits shall take place unless the amount of the reserves available for distribution and profits brought forward is at least equal to that of the expenses not written off. In so far as development costs have not been completely written off, no distribution of profits shall take place unless the amount of the reserves available for distribution and profits brought forward is at least equal to that of the expenses not written off. Any change made to the accounting profit will affect distributable profit. The use of fair value will bring volatility in distributable profit which could affect the ability of the company to pay dividends. The changes that will affect the accounting profit identified above will affect also distributable profit.

CONCLUSIONS

Being inspired from IFRS, IFRS for SMEs focuses on the financial position of a company rather than to the historical performance shown by the income statement. This contrasts with tax principles requiring the tax base to be computed by with reference to the past results (Freedman, 2004:71-79). The fair value accounting conflicts with other tax principles, such as ability to pay, enforceability and tax revenues stability. The use of fair value will bring volatility in distributable profit also which could affect the ability of the company to pay dividends. Including or deducting any unrealized gains or losses may imply, for the taxpayer, liquidity constraints to pay taxes and, for tax authorities, a fall in the ability to raise revenues. Any income or expense involving a certain degree of subjectivity will conflict with the need of certainty and gives a boost to tax avoidance. It results that the fiscal authority will have to define fiscal treatments different from those of IFRS for SMEs. Fair value accounting increases the volatility of profits and, hence, does not match with the need to rise revenues with sufficient stability over the fiscal years (Freedman, 2004:71-79). The fiscal authority will have to define tax bases for assets and liabilities diferent from their fair value. The substance over form principle is also problematic. Tax system is based on the legal form of transactions and, only with the aim to contrast avoidance attitude, specific exceptions are introduced. The application of substance over form in its accounting understanding is not acceptable from the fiscal point of view in all cases. The comparative analysis above releals that the application of IFRS for SMEs will have an impact on taxable profit and distributable profit as defined by current legislations. Under these circumstances regulators should analyse if changes are acceptable considering the purpose of specific regulations and modify where is the case the legal framework.

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