Articles

Integrated Reporting and SMEs

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Summary:

At present, there are two basic processes in the in the field of reporting of small and medium-sized enterprises (SMEs):

- The International Integrated Reporting Council (IIRC) guides the development of a global framework for Integrated Reporting.
- The European Commission requires simplifying the Accounting Directives as regards financial information obligations to reduce administrative burden, particularly for SMEs.

The first process is now at its original stage, whereas the second one is in its final stage. The paper treats the issue of the relation between the two processes and whether they are in line with the goals and opportunities for development of the SMEs within the European Union.

Small and medium-sized enterprises are the backbone of the European economy and the main contributors to the creation of employment in the EU. The thesis that is maintained is that the time has come to move on from the reporting of the performance of organizations on the basis of their capital to the reporting of their performance on the basis of all "capitals" (financial, manufactured, human, intellectual, natural and social), part of which are beyond the management's responsibility for the resources owned by the organization and reflected in the balance sheet.

The basic premise of integrated reporting is that current financial accounting standards and practices fail to capture all of the information necessary to manage enterprises effectively in the 21st C. Whilst we would expect that the concepts underlying integrated reporting are equally applicable to small- and medium-size enterprises this is not really the core issue. The main issue is how they are to be applied in practice and the changes that are necessary to take account of differences in scale. There is much support for a 'think small first' approach when developing requirements for small and medium enterprises and care would need to be taken that by predominantly working with larger companies first one did not fail to take account properly of the needs of smaller enterprises. It is essential to have proper regard to materiality when applying requirements especially to smaller organizations.

In order to ensure that the mechanism of integrated reporting be effective with regard to SMEs, it is suggested that guiding principles of the integrated reporting should be subjected to the "universalizability test." The question of the meaning of 'integrated thinking' is raised and that every successive step

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involves seeking the opportunity to impact the organizations' management in order to change frame of thought and responsibility not only to investors, but also to all stakeholders and to society at large.

The overview of the envisaged amendments to the two Accounting Directives (on annual and consolidated financial statements) gives grounds to draw the conclusion that these amendments will not only reduce the administrative burden for small enterprises, but they will also create conditions for the development of integrated reporting for SMEs. The management report as an integral part of the financial statements of SMEs is the point at which the development of their integrated reporting could possibly begin. There is no doubt that the Integrated Report will be specific not only in terms of industries, but also for each enterprise. Furthermore, it will reflect the challenges and opportunities the enterprise is faced with. 'Relevance' should affirm itself as the basic qualitative characteristic of the information laid down in the Integrated Report.

Key words: integrated reporting, financial reporting, small and medium-sized enterprises

JEL: G38, L21, L25

Introduction

Integrated reporting is a new approach to reporting that demonstrates the linkages between an organization's strategy, governance and financial performance and the social, environmental and economic context within which it operates. Its real value lies in its the potential to be adapted to and applied in a variety of organizational settings. The main issue at stake is how the integrated reporting will be applicable to SMEs and whether there is any contradiction between two processes - the need for integrated reporting for SMEs and the requirement to simplify the financial reporting. The purpose of the paper is to present the logic behind the statement suggesting that there is no contradiction between these two processes. The overview of the envisaged amendments to the two Accounting Directives (on annual and consolidated financial statements) gives grounds to draw the conclusion that these amendments will not only reduce the administrative burden for small enterprises, but will also create conditions for the development of integrated reporting for SMEs. Integrated reporting will allow SMEs to release more inclusive and useful reports on all aspects of performance, including environmental, social, and governance, as well as economic, in a concise and user-friendly format.

The innovative element in integrated reporting is related to challenges. The question that remains unresolved for now is how the integrated reporting will be applied to organizations. It is possible to make a parallel between Kant's moral philosophy and the approach to reporting as an accountability of the enterprises. In order to ensure that the mechanism of integrated reporting be effective with regard to SMEs, it is suggested that guiding principles of the integrated reporting should be subjected to the "universalizability test". The application of such an approach requires that the Framework of integrated reporting should be based upon a set of guiding principles that are sufficiently generic and high level so as to provide the basis for the development of IR requirements tailored to SMEs, while ensuring compatibility with those applicable for larger listed enterprises. This means that not only "the world has changed", but also that the managers of the organizations should change their frame of mind to "integrated thinking".

To be useful, information must be relevant to the decision-making needs of users. The experience in financial and management accounting shows that information has the quality of relevance, when it influences the decisions of users by helping them to evaluate past, present or future events or by confirming or correcting their evaluation of past events, providing them the opportunity to forecast and plan the future. Therefore "relevance" should affirm itself as the basic qualitative characteristic of the information laid down in the Integrated Report.

1. Sector Analysis

SMEs are defined by the European Commission as having less than 250 persons employed. They should also have an annual turnover of up to EUR 50 million, or a balance sheet total of no more than EUR 43 million according to Commission Recommendation of 6 May 2003.[1] They have been the backbone of economic development in most European countries, providing a primary source of employment and economic growth. In 2008 SMEs accounted for 99.8% of non-financial business activities and over two thirds of total employment in the 27 countries of the European Union. Nine SMEs out of 10 did not exceed 10 occupied persons and an annual turnover of 2 million euro and were therefore considered as microenterprises. Data issued by the European Commission indicate that SMEs have been the main driver of European economic growth between 2002 and 2008: SMEs have constantly grown in number at a faster rate than large enterprises in the same period; the difference is even clearer when comparing the number of persons employed, which has doubled in SMEs (+1.9%) compared to large enterprises (+0,8%) over the same period. The share of added value at factor costs by SMEs has achieved an annual growth averaging 4.2% in the period from 2002 to 2008, whereas the contribution of large enterprises has increased at a slightly lower rate, annually averaging 3.9 %. In particular, in Bulgaria SMEs account for 99.7% of the production sector overall as well as locally.[2]

Perhaps the most striking phenomenon of SMEs is their contribution to employment. No less than two thirds of the EU-27's non-financial business economy workforce was active in a SME in 2008. The contribution of SMEs to total value added was lower than their contribution to employment (66.7 %)[3], resulting in a lower level of apparent labour productivity. Large enterprises tended to record higher labour productivity ratios than SMEs. It may be suggested that this was due to specific characteristics of SMEs such as their inability

[1] See: European Commission, Key figures on European business with a special feature on SMEs, 2011 edition, Online, http://www.scribd.com/antonis_politis/d/85406227-Key-figures-on-European-business-with-a-special-feature-on-SMEs

[2] Source: Eurostat (online data codes:sbs_sc_ind_r2,sbs_sc_con_r2,sbs_sc_dt_r2, sbs_sc_1b_se_r2)

to benefit from economies of scale, their relatively low level of capital intensity, or their failure to adopt or develop innovations.

While the individual impact of SMEs on the environment is small; their collective impact is believed to be considerable. Albeit difficult to measure, a recent DG ENTR study shows that SMEs account for approximately 64% of the industrial pollution in Europe. Sector variations are generally within the 60% to 70% range. Even though specific data on SMEs impact on the environment cannot be found both in Europe and globally, there is no doubt that SMEs need to make a significant contribution to control CO_2 emissions. For lending institutions (such as banks), suppliers, governments and the general public it will be increasingly important to understand the impact SMEs have on the wider environment.

Small and medium-sized enterprises (SMEs) may be viewed as important players with regard to the well-being of local and regional communities, with considerable potential for employment creation. SMEs are the engine of economic development - through job creation, social inclusion, innovation, etc - and they are now mainstreamed in all policies of the EU and this is reinforced by the "think small first" principle.[4] They can play an important role in Europe's 2020 strategy, contributing to the economic health of the European economy.

In such a scenario, the actual concept of "integration" may not exclude small and medium-sized enterprises, as their present impact on a series of extremely relevant socioeconomic variables. Small and medium sized enterprises are important to integrated reporting. Integrated reporting will allow SMEs to release more inclusive and useful reports on all aspects of performance, including environmental, social, and governance, as well as economic, in a concise and user-friendly format. This information will allow SMEs to provide an assessment of the long-term viability of an organization, as well as meet the needs of investors and other stakeholders.

At the same time the Europe 2020 Strategy[5] for smart, sustainable and inclusive growth aims to reduce administrative burdens and improve the business environment, particularly for SMEs and to promote the internationalization of SMEs. The European Council called for the overall regulatory burden, in particular for SMEs, to be reduced at both European and national levels and proposed measures to increase productivity such as removing red tape and improving the regulatory framework for SMEs. This proposal takes into account the better regulation programme of the European Commission, and in particular the Communication on „Smart Regulation in the EU" of October 2010.[6]

One of the ways to reduce administrative burdens on SMEs is a simplification of the two Accounting Directives (on annual and consolidated financial statements). This is fundamental for growth and jobs, as it will address unnecessary and disproportionate administrative requirements. It is reasonable

[4] See: Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - "Think Small First" - A "Small Business Act" for Europe {SEC(2008) 2101} {SEC(2008) 2102}, Online, http://www.eurosfaire.prd.fr/7pc/doc/1299058632_sec_2008_2102_sba.pdf

[5] More details about the Europe 2020 strategy are available at http://ec.europa.eu/europe2020/index_en.htm

to ask whether there is any contradiction between these two processes - the need for integrated reporting for SMEs and the requirement to simplify the financial reporting. In my opinion it is important not just to state why there is no contradiction, but what is the logic behind the statement that there is no such contradiction.

2. From Responsibility to Accountability

In my native language (Bulgarian) the words "responsibility" and "accountability "are even translated by the same word: "ot-govornost ". The reason to reflect on the different meanings of the words is the article written by Robert Kinloch Massie "Accounting and Accountability: Integrated Reporting and the Purpose of the Firm".[7] My curiosity was satisfied when I read "I prefer to use the word Accountability to refer to making, keeping, and managing agreements and expectations. And I prefer to use the word Responsibility for the feeling of ownership."[8] I personally do not share the arguments laid down in the aforementioned statement, but I made no attempt to find other arguments. The very statement is important for me, because it gave me an occasion to find an explanation of what has prompted the transition from Financial Reporting to Integrated Reporting.

The thesis that I maintain is that the time has come to move on from the reporting of the performance of organizations on the basis of their capital to the reporting of the performance of organizations on the basis of all "capitals" (financial, manufactured, human, intellectual, natural and social), part of which are beyond the management's responsibility for the resources owned by the organization and reflected in the balance sheet. In this case "Accountability" goes beyond the limits of ownership. This means that not only "the traditional reporting model was developed for an industrial world" [9], but also that the managers of the organizations should change their frame of mind and their beliefs about the model of value creation.

Integrated Reporting reflects what can be called "integrated thinking"- application of the collective mind of those charged with governance (the board of directors or equivalent), and the ability of management, to monitor, manage and communicate the full complexity of the value-creation process, and how this contributes to success over time. It is a matter of culture to what extent integrated thinking is being adopted within the SMEs. In this respect a number of problems will arise, which call for finding the most appropriate solution.

An Integrated Report displays an organization's stewardship not only of financial capital, but requires consideration of resource usage and risks and opportunities along the organization's full value chain. I was inspired by "Shared Value

[3] See: European Commission, Key figures on European business with a special feature on SMEs, 2011 edition, Online, http://www.scribd.com/antonis_politis/d/85406227-Key-figures-on-European-business-with-a-special-feature-on-SMEs

[6] See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0543:FIN:EN:PDF

[7] Massie, R.., 2010. The Landscape of Integrated Reporting Reflections and Next Steps. Accounting and Accountability: Integrated Reporting and the Purpose of the Firm. Massachusetts, USA, pp. 9-12

[8] See: The Difference Between Accountability and Responsibility, 2007, Online, http://www.christopheravery.com/blog/the-difference-between-accountability-and-responsibility/

[9] International Integrated Reporting Committee. Towards Integrated Reporting. Communicating Value in the 21st Century, 2011, Online, http://theiirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011_spreads.pdf

Concept" as presented by M. Porter and M. Kramer.[10] The idea is an appealing proposition that can rightly be called „sustainability value", which describes corporate initiatives that address social concerns including environmental pollution, natural-resource depletion, public health and the needs of the poor. It emphasizes profit-making not just as a possibility but as a priority. Will the companies still behave in their self-interest in ways that draw criticism? There are promising signs that an increasing number of companies are pursuing market strategies that fit the shared-value model.

At the same time I must admit that I have grown up in a former socialist country and I can still recall the happy memories of my parents' peace of mind with regard to the health, education and safety of their children, and their responsible attitude to food and energy. The events that occurred over the past years, however, make me doubt the capability of some countries to cope with the dynamically changing economic, social, and ecological conditions and problems, on the one hand, and meet the needs and demands of their citizens, on the other. In my view the question of who will be "the major player" and serve as "the triggering mechanism" in the contemporary conditions remains open.

As mentioned above, integrated report exposes an organization's stewardship not only of financial capital, but perspective requires consideration of resource usage and risks and opportunities along the organization's full value chain. Integrated Reporting aims to provide insights about the material components of value creation and, more importantly, the relationships between them and a broader explanation of performance than traditional reporting.

Integrated reports will meet the needs of a broad range of stakeholders. This is important because issues such as whom the stakeholders are, who have different perspectives, involves consideration of what "value" means to whom and how it should be measured. The very meaning of "value", "capital" and "performance" depends upon the stakeholders being addressed. SMEs will be required to meet the same information obligations as large firms. The question remains of how the integrated reporting will be applied to SMEs.

3. Immanuel Kant and Integrated Reporting

At this point, integrated reporting is more of a concept than a practical reality—a kind of vision that flows from intuition, rather than a specific set of steps. The basic premise of integrated reporting is that current financial accounting standards and practices fail to capture all of the information necessary to manage firms effectively in the 21st C. This information largely revolves around public expectations about how companies govern themselves and their impacts on communities and the environment.

The innovative element in integrated reporting is related to challenges. Whenever international regulators and standard setters set about developing policy, regulation and

[10] Porter, M. and M. Kramer, 2011. Creating Shared Value: How to Reinvent Capitalism — and Unleash a Wave of Innovation and Growth. Harvard Business Review, January-February 2011, Online, http://www.waterhealth.com/sites/default/files/Harvard_Buiness_Review_Shared_Value.pdf

standards they seem to tend to consider large listed enterprises with international reach in the first instance. When developing policy and regulation it is vital for the sake of equity and efficiency that one carefully considers the suitability of the proposed policy or regulation to the entire population of enterprises that might one day be subject to the same regulation, including SMEs.

In this regard, the topic of discussion is the approach of implementing Integrated Reporting. The IIRC expects that the concepts underlying Integrated Reporting will be equally applicable to small- and medium-sized enterprises. Others, including the Committee of the International Federation of Accountants (IFAC), expressed concerns over its possible implementation. IFAC has reasons for skepticism - the general reason being that regulation and standards originally designed and fashioned for larger listed enterprises get cascaded down to SMEs. IFRS is often cited as an example of this. Recent research conducted by the European Commission suggests that well established reporting requirements originally developed for larger listed enterprises and then simplified for SMEs may not adequately meet the information needs of users of SMEs.[11]

In this respect, the approach discussed is based on a bottom-up rule, rather than on a top-down one. This implies considering the relevance of integrated reporting to SMEs first and then adding further guidelines or aspects related to larger and more complex enterprises. Such an approach may require some re-engineering of the project of IIRC.

What is my view and what are the common features that I find between Immanuel Kant's philosophy and integrated reporting? Even though I must admit that I am not well read in Kant's philosophy, I still have the feeling that his philosophy contains something rational which may be readily applied to integrated reporting. It is my deep conviction that we could draw a parallel between the approach to reporting as an accountability of the enterprises and the basic assumption in Kant's theory of what could be regarded as a moral norm in society.

Despite my limited knowledge about Kant's philosophy, his rationale (logic) allows me to suggest the following procedure for testing the expedience and applicability of integrated reporting with regard to all enterprises, including the SMEs.

First step: The "universalizability test" could be applied to the guiding principles of the integrated reporting. This requires that we should imagine a possible world in which all enterprises could apply the principles of integrated reporting. It should be analyzed whether some contradictions or irrationalities occur with regard to the capacity of all categories of enterprises as a result of the adoption of these principles. If a contradiction or irrationality arises, acting on the principle is not allowed in the real world. If there is no contradiction, then acting on the principle is permissible and required.

Second step: The necessary mechanisms must be envisaged which

[11] See: http://ec.europa.eu/enterprise/policies/sme/business-environment/files/study_on_accounting_requirements_for_smes_final_report_en.pdf

could possibly change the frame of mind of the organizations' management in compliance with the 'Formula of the End in Itself'. A view of humanity as an end in itself requires managers to work toward ensuring happiness for all in society, which means that they must care for the welfare of others.

Third step: Establishment of the 'Formula of Autonomy' - all rules which stem from autonomous legislation ought to harmonize with a possible realm of ends. The regulatory framework of integrated reporting should impose on the organizations' management the sense of accountability to society at large.

I believe that the application of such an approach requires that the Framework of integrated reporting should be based upon a set of guiding principles that are sufficiently generic and high level so as to provide the basis for the development of IR requirements tailored to SMEs, while ensuring compatibility with those applicable for larger listed enterprises. The Framework should provide high-level guidance to organizations that prepare integrated reports, helping them to provide consistency of content and approach in a way that demonstrates the extent to which integrated thinking is being adopted. What is highlighted as an important issue in the integrated reporting is that it is integrated thinking that matters most. The ideal is to combine integrated thinking and integrated management.

4. Financial Accounting and Integrated Reporting

integrated reporting advances the proposition that sustainability reporting and financial reporting are inherently linked, and thus would benefit from merging. However, integrated reporting has established itself during a time of heightened concern over 'red tape' and burden of regulation on SMEs. Different objectives within the EU coexist: on the one hand, reducing SMEs administrative burden (by 25 %) by 2012 and, on the other, more visibility, transparency, accountability and sustainable behavior.[12] Unnecessary and disproportionate administrative burden imposed on small companies obviously hampers economic activity. Resources consumed by administrative work are resources diverted away from the core business, especially for small companies. Disincentives to growth means underutilized economic potential within the EU in terms of job creation, innovation and it also means competitive disadvantage.

The Commission Communication "Think Small First" - "Small Business Act" for Europe (SBA)[13], adopted in June 2008 and revised in February 2011[14], recognizes the central role played by small and medium-sized enterprises (SMEs) in the Union's economy and aims at improving the overall approach to entrepreneurship and at anchoring the

[12] See: Commission working document COM (2006) 691: "Measuring administrative costs and reducing administrative burdens in the European Union", Online, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0691:FIN:EN:PDF

[13] See: Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - "Think Small First" - A "Small Business Act" for Europe {SEC(2008) 2101} {SEC(2008) 2102}, Online, http://www.eurosfaire.prd.fr/7pc/doc/1299058632_sec_2008_2102_sba.pdf

[14] The European Economic and Social Committee and the Committee of the Regions: "Single Market Act – Twelve levers to boost growth and strengthen confidence, 'Working together to create new growth'", 2011, Online, http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf

"think small first" principle in policy-making from regulation to public service.

The European Commission's approach is outlined in the Europe 2020 Strategy[15] which aims to make the EU a smarter, more sustainable and inclusive economy, as well as in the Single Market Act.[16] The European Commission is taking action to produce SMEs friendly legislative proposals, like that exempting SMEs from unnecessary legal requirements in accounting directives.[17] The main purpose of the revision of the accounting directives is to provide an opportunity to revisit the relevance of certain sections, based on recommendations from stakeholders.

Expectations in the work of the Commission are: simplification of the two Accounting Directives (on annual and consolidated financial statements). The Danish Presidency aims to reach a first-reading agreement with the European Parliament by summer 2012.[18] On the one hand, the aim is to reduce the administrative burden for small companies by making the preparation of financial statements easier and simpler. On the other hand, the proposal will make company financial information more comparable, and clear and easy to understand for users such as investors, banks, suppliers and employees. In practice, the proposal will introduce a „mini-regime" with simpler accounting requirements applicable to all EU small companies and will make disclosure requirements for medium-sized and large companies more gradual. In parallel, the company size thresholds for the latter categories will be increased so that more individual undertakings will qualify as small and medium-sized.

In such a scenario, will it find a place to practice integrated reporting of SMEs? What impresses us in considering changes in the Accounting Directives is the following:

Prescribing „mini-regime" with simple accounting requirements applicable to all EU small companies in the package of reports is included in management report. However, there are no substantive changes to the provisions governing the content of this report compared to those currently provided by the Fourth Council Directive 78/660/EEC and the Seventh Council Directive 83/349/EEC.[19]

The management report shall include at least a fair review of the development and performance of the undertaking's business and of its position, together with a description of the principal risks and uncertainties that it faces. The information should not be restricted to the financial aspects of the undertaking's business, and there should be an analysis of environmental and social aspects of the business necessary

[15] More details about the Europe 2020 strategy are available at http://ec.europa.eu/europe2020/index_en.htm

[16] The European Economic and Social Committee and the Committee of the Regions: "Single Market Act – Twelve levers to boost growth and strengthen confidence, 'Working together to create new growth'", 2011, Online, http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf

[17] See: Proposal of a Directive repealing and replacing the Accounting Directives 78/660/EEC and 83/349/EEC, Online, http://ec.europa.eu/internal_market/accounting/sme_accounting/review_directives_en.htm

[18] Delivering the Single Market Act: State of Play, SWD(2012) 21 final, Online, http://ec.europa.eu/internal_market/strategy/docs/20120216-implementation-report_en.pdf

[19] See: http://europa.eu/legislation_summaries/internal_market/businesses/company_law/l26009_en.htm

for an understanding of the undertaking's development, performance or position.

Obviously the management report is the document from which financial reporting will gradually transform into integrated reporting of SMEs. In this part of the report, as long as it is applicable and appropriate, content elements of the integrated report may be developed, in particular: [20]

- Organizational overview and business model
- Operating context, including risks and opportunities
- Strategic objectives and strategies to achieve those objectives
- Governance and remuneration
- Performance
- Future outlook

Integrated reporting is likely to differ across different sized organizations and compliance costs may well be higher for SMEs. Therefore in developing a framework that does not unfairly burden SMEs and ensures that the strategic benefits it offers to larger companies could be transferred to a smaller scale. At the same time "relevance" should be acknowledged as the major qualitative characteristic of the information provided in the integrated report. For it to be useful, the information must be appropriate with regard to the decision making process.

The experience in financial and management accounting shows that information has the quality of relevance, when it influences decisions of users by helping them to evaluate past, present or future events or by confirming or correcting their evaluation of past events, providing them the opportunity to forecast and plan the future. If information is to assist users in making decisions about the allocation of scarce resources, it must assist them in making predictions about future situations and in forming expectations, and/or it must play a confirmatory role in respect of their past evaluations. The predictive and confirmatory roles of information of the integrated reporting are interrelated. To make a difference in the decision process, information must possess predictive value and/or feedback value.

Conclusion

What is most important in integrated reporting for SMEs?

1. The first thing which should be done as part of the integrated reporting project is to simplify financial reporting. This process is already reaching its final stage.
2. The integrated report for SMEs should disclose significant information not only from the point of view of the enterprise's owners, but from that of all stakeholders. Consequently the integrated reporting should facilitate the breaking down of reporting silos and the introduction of integrated thinking.
3. Integrated reporting will differ not only by industries, but it will also reflect the challenges and opportunities that each enterprise faces. The integrated report for SMEs should be a report which combines financial accountancy, eco-

[20] International Integrated Reporting Committee, 2011, Towards Integrated Reporting. Communicating Value in the 21st Century,2011, Online, http://theiirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011_spreads.pdf

and social accountancy. One of the tools used by the organization may be called priority orientation. Managers should choose one or more top-priority subjects (subjects of most interest to stakeholders) and follow them throughout the whole report.

4. "Relevance" should affirm itself as a basic qualitative characteristic of the information provided in the integrated report.

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