

International Financial Reporting Standards Convergence Process for Small and Medium-Sized Entities

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Abstract. The "International Financial Reporting Standards (IFRS) Convergence Process for Small and Medium-Sized Entities (SMEs)" seeks to address the unique challenges and requirements faced by smaller businesses in adhering to international accounting and reporting standards. This initiative recognizes that SMEs operate in diverse economic environments and have distinct financial reporting needs compared to larger enterprises. The primary purpose of this convergence process is to enhance the relevance, accessibility, and practicality of IFRS for SMEs, fostering consistency in financial reporting practices across global markets. A project to create accounting standards appropriate for small and medium-sized businesses (SMEs) is being worked on by the International Accounting Standards Board. This abstract provides an overview of the convergence process involving International Financial Reporting Standards (IFRS) for Small and Medium Sized Entities (SMEs). With the global landscape of financial reporting constantly evolving, the integration of IFRS tailored specifically for SMEs marks a pivotal transition towards harmonizing financial reporting practices. This paper examines the essential elements and implications of this convergence, addressing the challenges and benefits faced by SMEs as they align with these international standards. The analysis delves into the driving factors behind the convergence, including the necessity for a unified and transparent financial reporting framework, aiming to facilitate comparability and accessibility of financial information across borders. Furthermore, the abstract discusses the potential impact on SMEs' financial reporting quality, decision-making processes, and access to capital. Through a comprehensive review of the convergence process, this abstract seeks to contribute to the understanding of the significance and implications of adopting IFRS for SMEs, thereby providing valuable insights for practitioners, regulators, and stakeholders in the financial reporting ecosystem.

Keywords: Small and Medium Sized Entities, International Financial Report Standards

Introduction

SMEs, as the backbone of many economies, often encounter difficulties in complying with complex and resource-intensive accounting standards designed for larger corporations. The goal is to develop a set of tailored standards that strike a balance between ensuring transparency and providing a feasible framework for SMEs to prepare and present their financial statements. By doing so, the convergence process aims to facilitate comparability among SMEs globally, making it easier for investors, creditors, and other stakeholders to assess their financial performance and make informed decisions.

The methodology involves a meticulous approach, starting with a needs assessment to identify the specific challenges faced by SMEs. Through consultations, feedback mechanisms, and pilot programs, the process ensures that the adapted standards are not only aligned with SME requirements but are also practical and implementable. Collaboration with stakeholders, including SME representatives, regulatory bodies, and standard-setting organizations, is integral to garnering support and achieving widespread adoption.

International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) have been implemented by 7000 companies in the EU list since 2005. Thanks to this development, which is very important for the international uniformity of international financial reporting standards, international financial reporting standards are compulsorily applied in 65 countries worldwide. This number reaches 100 when the countries implementing the standards are included [1]. From this perspective, large enterprises generally adopt international financial reporting standards. However, it is not possible to reach the same conclusion for small and medium-sized enterprises (SMEs). The fact that there are 28 national accounting standards for SMEs makes the standardization of accounting practices of SMEs very difficult. This number reaches 100 when the countries implementing the standards are included.

Therefore, the IASB has decided that from July 2001:

- No public liability
- It is working on an "accounting standards development project" for entities that prepare and present general-purpose financial statements for use by third parties. Third parties include existing and potential lenders and credit rating agencies not involved in business management.

In June 2004, the International Accounting Standards Board (IASB) published a Discussion Paper - Preliminary Views on Accounting Standards for SMEs. This paper sought answers to the following questions [2]:

- The Board should develop specific financial reporting standards for SMEs.
- What should be the objectives of establishing these standards for SMEs?
- Which businesses should these standards for SMEs cover?
- Is it possible for SMEs to use these standards?

Responses to the discussion paper at the January 2005 meeting of the Board were evaluated and presented to the public. Subsequently, in August 2005, a report was presented to the Board containing the recommendations and views of the Working Group;

- Entities with public responsibilities should apply General IFRSs,
- SME IFRSs will be monitored by entities without public accountability.

Also, in the report, enterprises without public responsibility [3];

- with employment below 50 persons and,
- It is defined as enterprises with an annual turnover of less than EUR 10 million.

However, an entity providing "essential public services" must follow general IFRSs regardless of the number of employees and turnover volume. In January 2006, the Exposure Draft, consisting of 223 pages and 38 chapters, was presented to the Board by the Working Group. The "Financial Instruments" section of the draft, continuously revised since then, was discussed in detail in July 2006. In the last quarter of 2006, the Exposure Draft was opened for comment, and comments are expected by October 1, 2007. The draft is planned to be effective as financial reporting standards for SMEs by mid-2008 [4].

1. Main Reasons for Preparing Separate Financial Reporting Standards for SMEs

Today, two trends call for a separate set of International Financial Reporting Standards for SMEs. The first trend is the increasing use of IFRSs as the basis for national standards worldwide. This trend is prevalent in countries significantly influenced by the Anglo-Saxon approach and in the countries of the Eastern Bloc. Many countries have adopted IFRS as a cornerstone for a better accounting system.

The mandatory adoption of IFRSs by listed companies in the EU in 2005 also played a decisive role in this process. However, in almost all countries, a larger share of the volume of economic activity is accounted for by unlisted enterprises. Most of these enterprises are SMEs [5].

A second and more recent trend in the demand for a set of IFRSs for SMEs is the need for a single set of financial statements for communication with capital markets worldwide. The work between the International Accounting Standards Board and the International Organization for Stock Market Regulation is part of this process. Multinational companies whose shares are listed on international financial markets also play a dominant role in this process. As a result, standards are becoming more complex, with increasingly detailed regulations and disclosures to ensure investor confidence and transparency. The main objective of the IASB is to develop a single set of global accounting standards to assist participants and economic decision-makers in the world's capital markets. However, IFRSs designed for use by large listed companies have become increasingly complex and challenging to use. Therefore, the IASB initiated the project to develop a separate set of standards in July 2001, considering that most enterprises are SMEs.

The drawbacks of SMEs applying national accounting standards instead of international financial reporting standards can be listed as follows [6]:

- National accounting standards for SMEs aligned with IASB standards are not.
- National accounting standards for SMEs should be based on the external does not respond to the needs of its users.
- Financial statements of SMEs are not internationally comparable.
- National accounting standards for SMEs need to facilitate the transition to the application of international financial reporting standards for SMEs seeking to enter capital markets.

The need for accounting standards for SMEs is different from the need for public companies. The users of SME financial statements are business shareholders, banks, suppliers, employees, and the government. However, public companies also have different users, such as capital market analysts. Users of SME financial statements are interested in issues such as short-term cash flows and liquidity. At the same time, capital market analysts focus on such topics as long-term cash flows, dividends, and firm valuation [3]. As the expectations of SMEs and large companies from accounting differ, they inevitably need different accounting standards. On the other hand, while applying international financial reporting standards, which are complex in some respects, will not pose problems for large enterprises working with experienced accountants, it will pose significant problems for SMEs [7].

2. Appropriateness in Principle of Different Reporting Standards

The adoption of a separate set of financial reporting standards for SMEs is debated in terms of its compliance with the reporting principle. The IASB's corporate document "Framework for Preparing and Presenting Financial Statements" approaches this issue from the perspective of supporting the integration of capital markets and includes the following concepts [8]:

- The needs of users of financial statements,
- Qualitative characteristics of financial statements in terms of understandability and comparability,
- Cost-benefit balance.

2.1. In terms of Financial Statement Users

The IASB identifies the users of general purpose financial statements as 'investors, employees, lenders, suppliers of products, customers, governmental organizations and the public.' As long as the content of financial statements meets the needs of investors, they are ready to meet the needs of other potential users. Investors in the stocks of large listed companies need to have sufficient information for decision-making processes such as buying, selling, and holding financial instruments.

Since SME equity investors, many of whom are family members, have limited inclination to make decisions such as disposing of their financial instruments, they are more interested in values related to business management. In this respect, while investors in securities of large corporations are interested in future cash flows, investors in securities of SMEs are interested in historical cost values rather than current asset values. Banks lending to SMEs, on the other hand, consider the quality of existing assets rather than long-term cash flows [9].

On the other hand, the Board's (IASB) users of financial statements do not include "managers." It is accepted that managers can access the financial information of the entity when necessary. External investors cannot request specific information in the same way. In SMEs, general-purpose accounts are important for management in performance evaluation. This understanding is based on measurements such as daily cash flow management and sales trends rather than profit. Among the users of financial statements defined by the Board, tax authorities take the most crucial place among public institutions. As is well known, financial statements are significantly affected by tax treatments (items such as valuation allowance, inventory, and trade payables provision) [10].

2.2. Understandable and Comparable

According to the IASB, the fundamental quality of the information provided in financial statements is measured by its understandability by users. This assumes users have accurate information about an entity's economic activities and accounting. On the other hand, users of financial statements should be able to compare an entity's financial statements across periods and entities to identify trends in position and performance. From this perspective, the IASB considers comparability in two different ways: between periods and between entities. What is important for SMEs is the ability to compare financial statements from period to period. This is because most of the users of SME financial statements (investors, managers, trading partners and lenders) are local or national. Therefore, the need for cross-business financial statement comparisons at the international level is more limited.

2.3. In terms of Cost-Benefit Balance

Balancing the costs and benefits of obtaining information from the accounts is always considered by the Board to be a challenge. Using IFRSs by preparers of SME financial statements involves practical difficulties and therefore relative costs. Thus, a separate set of standards should be established for SMEs regarding the cost-benefit balance.

3. Scope of International Financial Reporting Standards for SMEs

3.1. In terms of Transactions

An essential practical issue in setting a separate set of standards for SMEs is which enterprises can use these standards. The quantitative measures used to identify enterprises (such as turnover, total assets, and number of employees) are based on the EU definitions of SMEs. However, precise measures of the size of enterprises risk being misleading across countries and sectors. Qualitative characteristics need to be sufficiently descriptive.

The critical criterion adopted by the IASB is whether entities have a public responsibility. Listed entities, banks, insurance, insurance companies, enterprises of great utility and economic importance are not eligible to use alternative standards [11].

The Board chose to employ qualitative criteria—expressed in the concept of "public accountability"—rather than quantitative criteria when defining SMEs under the project's scope of accounting standards for SMEs. The standards created due to the IASB initiative are suitable for organizations that: (a) prepare general-purpose financial statements for third parties; and (b) are not accountable to the public. Credit rating agencies, current and prospective creditors, and shareholders not participating in the entity's management are third parties. The Board defines enterprises with these two features as SMEs.

A business has public responsibility if it meets the following conditions [6]:

- Its financial statements are, or are in the process of being, listed or quoted for issuance on a securities exchange or other regulatory body in a market open to the public,

- Holds assets in trust for persons other than a broad group, such as a bank, insurance company, brokerage firm, pension fund, investment fund, or investment bank.
- Is a public utility or an entity that provides essential public services,
- Economically significant in the local market based on total assets, total revenue, number of employees, market dominance, and the nature and extent of external borrowings.

3.2. In terms of Subjects

An essential issue in adopting international financial reporting standards for SMEs is whether these alternative standards cover all the issues covered by the general international financial reporting standards (IFRSs). Some standards relate specifically to listed entities (such as IAS 33 - Earnings per Share and IAS 14 - Segment Reporting) and do not need to be included in SME standards. Standards that are specific to a particular sector (such as construction contracts or agriculture) are applied by a limited number of entities. The issue of consolidation is more complex. There are many relevant standards (IAS 27 Consolidation, IFRS 3 Business Combinations, IAS 28 Investments in Associates, and IAS 31 Interests in Joint Ventures).

IAS 38 Intangible Assets, IAS 36 Impairment of Assets). If these issues are excluded from the standards for SMEs, it would be a considerable simplification. In addition, SMEs in developing countries have little need for these standards. In the UK, as an example of a developed country, company law exempts small businesses from consolidation accounts [12].

Therefore, it is necessary to determine a core set of standards for SMEs to be included in international financial reporting standards.

However, at this point, the question of what steps a company should take to address a problem that needs to be discussed by SME norms regarding valuation, recognition, and disclosure emerges. As a guide for best practices, the United Nations Conference on Trade and Development (UNCTAD) uses general international financial reporting standards. According to the IASB, rules for SME IFRSs should be included since a return to general IFRSs is necessary [13].

Countries' tax systems are often based on national accounting standards. This strong relationship between the tax and accountingsystems is why SMEs must publish their financial statements. However, according to the IASB, IFRSs for SMEs do not address the needs of national tax authorities, and SMEs will be required to prepare financial statements both in accordance with IFRSs and by the requirements of tax authorities. Therefore, IFRSs for SMEs should refrain from creating new legal obligations and SMEs should retain the option to prepare financial statements by national accounting standards. In other words, IFRSs for SMEs should not be coercive [14].

There is also an important debate on whether IFRSs for SMEs will simplify recognition and valuation principles. This issue needs to be addressed separately in terms of tax regulations, complex issues, and trivial issues.

3.2.1. Tax Aspect

i) Evaluation of Inventory Costs According to International Accounting Standard (IAS) 2

This issue will bring additional costs for SMEs. According to IAS 2, entities evaluate both fixed and variable inventory costs. According to some national accounting standards, only variable costs are included in the valuation. Regarding cost allocation, it is sufficient for SMEs to evaluate the identified direct costs because the allocation of overhead costs and the cost of changes that require the conversion of overhead costs are optional for SME financial statement users.

ii) Deferred Income Tax Accounting by International Accounting Standard (IAS) 12

It is noteworthy that IAS 12 is overly complex for SMEs. IAS 12 also imposes additional costs on SMEs that could be more rational. Deferred tax accounting is a standard for large enterprises. In this case, it seems appropriate to allow SMEs to use the "taxes payable method". Income tax for the reporting period can be calculated based on "taxable profit" within the established rules.

If an SME has reported a loss in the last two years, it should be allowed not to recognize a deferred tax asset. For example, if the asset can offset the deferred tax liability, then the deferred tax asset should be recognized. Still, the IASB's Exposure Draft does not distinguish this section from IAS 12.

iii) Capitalization of Development Costs of Intangible Assets after Determining Commercial Relevance by International Accounting Standard (IAS) 38

It would be more appropriate to refrain from imposing unnecessary technical obligations on SMEs on this issue, which is quite complex in taxation. Especially the tracking of actual costs is a complex issue for SMEs. In the draft, it is considered appropriate to give SMEs the freedom to write off development costs by not capitalizing them and to use both the cost and fair value model in valuation [15].

iv) Fair Value Accounting Method for Biological Assets and Harvest Phase of Agricultural Products by International Accounting Standard (IAS) 41

While the tax systems of some European countries are based on acquisition costs, IAS 41 is based on the fair value method. This is unnecessarily complex and costly for SMEs. As is well known, appropriate values are not readily available continuously, and valuations require specialized knowledge. Therefore, in accounting for biological assets and the harvesting phase of agricultural production, SMEs should be allowed to use the cost method instead of the fair value method. Still, the Draft includes a simpler appropriate value model based on estimation than in IFRS.

3.2.2. In terms of Complexity of the Subjects

i) Using the Percentage of Completion Method for Construction Contracts by International Accounting Standard (IAS) 11 and Service Revenue by (IAS) 18

IAS 11 and IAS 18 are significantly mandatory for SMEs. According to IAS 11, the percentage of completion method is compulsory for long-term projects. In some European countries, the use of the percentage method is optional. This imposes additional costs for SMEs. Therefore, according to IAS 11 and IAS 18, the percentage of completion method should remain mandatory for SMEs.

ii) Assessment of Social Benefits or Other Post-Employment Benefit Obligations Determined by IAS 19 (Employee Benefits)

IAS 19 is expected to be a challenge for SMEs both technically and in terms of cost. In particular, calculating liabilities on a fair value basis and preparing the related disclosures on an annual basis will increase the costs of SMEs. Allowing three-year calculations instead of annual valuation is considered

appropriate for SMEs. In addition, it should be preferred to reflect any changes in liabilities in the profit and loss account and not to use any other way [16].

iii) Impairment Approach for Buildings, Plant and Equipment by International Accounting Standard (IAS) 36

IAS 36 needs to be simplified for SMEs. SMEs should be allowed to recognize impairment losses on intangible assets when there are indications of impairment, rather than annually, thus avoiding lost costs. Clarify how goodwill should be accounted for, as business combinations are an everyday activity for SMEs. When goodwill is subject to impairment, short-term amortization is appropriate.

iv) Evaluation of Share-Based Payments by IFRS 2

IFRS 2 is not suitable for SMEs as it mainly considers listed entities. Therefore, SMEs should be exempted from the assessment of share-based payments under IFRS. This is because the obligation to find the fair value of shares would impose additional costs on SMEs. It should be sufficient for SMEs to disclose the main terms of their share-based payments. It is also unlikely that an unregistered entity would use its shares to pay for goods and services. [17].

3.2.3. In terms of Importance of Issues

i) Lease Accounting according to International Accounting Standard (IAS) 17

Technically, IAS 17 is a manageable standard for SMEs. The lease accounting rules for SMEs under IAS 17 should not require separate classification of land and buildings. Such leases typically fall within the definition of operating leases. However, since SMEs generally enter into lease agreements without a distinction between buildings and land, separate lease accounting rules are optional.

ii) Consolidation of Subsidiaries by International Accounting Standard (IAS) 27

SMEs with subsidiaries must prepare their consolidated financial reports by IAS 27. However, this is a legal regulation. If all shareholders do not unanimously agree that consolidation is necessary, SMEs may be exempted from consolidation, provided they make the required disclosures.

iii) Evaluation of Provisions and Contingent Liabilities by International Accounting Standard (IAS) 37

There are no significant differences between the views of IAS 37 and the Financial Accounting Standards Board (FASB). It is, therefore, appropriate to adopt IAS 37 for SMEs. There is also no need for an exemption in assessment and identification.

In addition, the international standards that are not considered necessary to be included in SME standards are as follows [18].

- IFRS 2 Share-based Payment
- IFRS 3 Business Combinations
- IFRS 4 Insurance Contracts
- IFRS 5 Non-current assets held for sale
- Assets and Discounted Transactions
- IAS 14 Segment Reporting

- IAS 33 Earnings per Share
- IAS 34 Interim Financial Reporting
- IAS 41 Agricultural Activities

4. Differences between Full International Financial Reporting Standards and Standards for SMEs

The International Accounting Standards Board (IASB) created the International Financial Reporting Standards (IFRS) as a collection of worldwide accounting standards to promote uniformity in financial reporting among various legal systems. The purpose of these standards is to give financial reporting a "common language" so that financial statements from multiple businesses and nations can be compared.

The IASB created the IFRS for SMEs, a condensed form of IFRS, recognizing that Small and Medium-sized Enterprises (SMEs) may need help to completely comply with all the requirements of full IFRS due to their size and the complexity of some standards.

The self-contained IFRS for SMEs standard was created with SMEs and users of their financial statements in mind. It is a more streamlined and approachable version of the complete IFRS, with fewer disclosure requirements and streamlined recognition and measurement guidelines [19].

The International Financial Reporting Standards (IFRS) and the IFRS for Small and Medium-sized Entities (SMEs) differ in several key aspects [20]:

1. Scope and Applicability:

- **Full IFRS:** Designed for larger, publicly accountable entities. It covers a wide range of complex accounting topics and is comprehensive in nature.
- **IFRS for SMEs:** Tailored for smaller and medium-sized entities that don't have public accountability. It simplifies and focuses on the fundamental accounting principles relevant to these businesses, excluding certain complex accounting topics covered in full IFRS.

2. Complexity and Depth:

- **Full IFRS:** More intricate, with detailed guidance on various accounting topics, allowing for greater discretion and judgment in accounting treatments. It caters to the complexities faced by larger, multinational corporations.
- **IFRS for SMEs:** Less complex and more streamlined, reducing the depth and complexity of accounting treatments. It aims to provide a more straightforward and cost-effective set of standards suitable for smaller entities.

3. Financial Reporting Requirements:

- **Full IFRS:** Requires extensive disclosures and detailed reporting on a wide range of accounting issues, enabling a comprehensive understanding of the financial position and performance of a company.
- **IFRS for SMEs:** Has reduced disclosure requirements and simpler accounting treatments compared to the full IFRS. This is to lessen the reporting burden on smaller entities while still providing relevant financial information.

4. Updates and Revisions:

- **Full IFRS:** Regularly updated due to the evolving nature of business practices, regulatory changes, and the need to address complex transactions and structures.
- **IFRS for SMEs:** Updates are less frequent and more stable, ensuring that the standards remain relevant for SMEs without overwhelming them with constant changes.

5. Legal Requirements and Acceptance:

- **Full IFRS:** Often mandated for use by larger, publicly traded companies in many countries around the world.
- **IFRS for SMEs:** Adoption is often voluntary in many jurisdictions. Some countries provide the option for SMEs to use the IFRS for SMEs as their financial reporting framework.

Understanding these differences is crucial for entities in selecting the appropriate set of standards based on their size, nature of operations, stakeholders' needs, and the regulatory environment they operate in. This choice significantly influences the financial reporting and transparency of a business [21].

Conclusion

In conclusion, the International Financial Reporting Standards (IFRS) Convergence Process for Small and Medium-Sized Entities represents a crucial step forward in the realm of global financial reporting. As an author, witnessing the evolution of this initiative underscores the commitment to addressing the specific needs and challenges faced by small and medium-sized enterprises (SMEs). The journey of convergence is not merely about adapting standards; it is a profound recognition of the vital role SMEs play in diverse economies and their unique position in the business landscape.

Through a meticulous methodology that encompasses needs assessment, stakeholder collaboration, and practical testing, the convergence process endeavors to create a set of standards that is not only tailored to the distinctive features of SMEs but is also pragmatic in its implementation. This approach aims to strike a delicate balance, ensuring that SMEs can fulfill their financial reporting obligations without undue burden, while still providing the transparency and comparability essential for informed decision-making by investors and other stakeholders.

The collaborative nature of the process, involving SME representatives, regulatory bodies, and standard-setting organizations, reflects a shared commitment to fostering a global financial reporting framework that serves the best interests of SMEs worldwide.

Since 2001, the International Accounting Standards Board (IASB) has continued its efforts to develop global, transparent and not overly complex international financial reporting standards for SMEs. Preferences for global SME standards have increased in many countries. However, due to the complexity of full IFRSs and their frequent updates, SMEs approach these efforts with some apprehension. The IASB has stated that it will not issue detailed guidance to identify entities that are and are not eligible to use SME standards. The IASB will only identify entities not eligible for SME standards, and local authorities will define the end users. In addition, an entity that follows SME standards would need to disclose that it does not follow full IFRSs so that users of the financial statements understand this. It is appropriate that the reporting facilities required for SMEs should be in the presentation and disclosure elements. If a recognition and valuation requirement is included in full IFRSs but not in SME standards, entities

should apply full IFRSs. This indicates that full IFRSs are at the top of the hierarchy of accounting policies.

International Financial Reporting Standards (IFRS) for Small and Medium-Sized Entities (SMEs) represents a significant stride towards harmonizing financial reporting globally. Beyond adapting standards, the process includes ongoing support mechanisms such as educational materials and training programs to aid SMEs in implementing the new reporting requirements. A robust monitoring and feedback mechanism is established to assess the impact of the convergence and identify areas for improvement. Overall, the main purpose is to create a harmonized, global framework that acknowledges the distinct nature of SMEs, enabling them to navigate financial reporting obligations more effectively and contribute to the broader goals of financial transparency and comparability on an international scale. This process aims to provide SMEs with a standardized framework, ensuring improved transparency, comparability, and accessibility in financial information, thereby fostering confidence and facilitating growth in the international business landscape.

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