

SME accounting requirements: basing policy on evidence

PUBLIC POLICY PAPER



ICAEW Information for better markets initiative

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This report is the first in a series of short Public Policy Papers within the *Information for Better Markets* programme. Other reports in the series are currently planned to be:

- *Long-term investment and accounting: overcoming short-term bias.*
- *Incentives and institutions in accounting: thinking beyond standards.*
- *Growth, development and accounting: seeing the bigger picture.*

An online edition of each report will include an appendix summarising key relevant research.

The reports in this series are intended to contribute to a better understanding of the role of accounting in society, so that policy making is more soundly based. They are aimed at all who have an interest in public policy debates on whether and how financial reporting should be regulated.

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1. The problem

How, if at all, should financial reporting by small and medium-sized enterprises (SMEs) be regulated?

In this short report we look at the costs and benefits of regulating SMEs' financial reporting, at why SMEs may require a different regime from other businesses, and at what research can tell us about these questions. We conclude that the evidence available to date is insufficient to develop policies that are soundly based, and that a substantial programme of research is needed.

Financial reporting requirements for SMEs have varied widely in different countries at different times. Sometimes, at least when they are limited companies, SMEs have had to comply with substantially the same requirements as other limited companies, as was formerly the case in the UK. Sometimes they have been subject to no requirements at all, as currently in the US. Usually requirements have been set at some intermediate point on the spectrum.

One feature of interest in this wide diversity of practice is that, whatever the regime, it has not been based on empirical research evidence of what works and what does not. No doubt policy makers have often consulted widely before they introduced new requirements or removed existing ones, but the responses to such enquiries, while useful, are likely to lack the rigour of well-designed research. And sometimes policy makers have indeed commissioned research, which has no doubt been useful, but as far as we are aware it has always been on limited aspects of the question.

The lack of evidence may explain, at least to some extent, why different jurisdictions' responses to the issue vary so widely. In the absence of sound reasons to pursue any particular policy, different jurisdictions might well end up making widely varied, almost arbitrary, choices.

But there is another way of looking at the problem. Financial reporting requirements form part of a country's institutional infrastructure. They affect and are affected by their context: other institutions, markets, the levels of technology and education, and the availability of alternatives to financial reporting information. Financial reporting practices adjust to surrounding markets and institutions, and these in turn adjust to financial reporting practices. So people in one country who look with admiration at another country's requirements for SMEs, or the lack of them, may overlook not only how those requirements reflect the local context, but also how that context has itself adjusted to financial reporting practices or their absence.

For example, financial reporting information can play an important role in facilitating finance for SMEs. But where financial reporting information is missing, or of low quality, lenders and borrowers find ways around the problem. They develop relationships that allow informal information flows between borrowers and lenders. Or lenders compensate for lack of information by demanding security, or charging higher interest rates, or making loans of shorter maturity, or imposing more stringent monitoring.

Seen in this way, the wide variety of approaches to SME financial reporting requirements arguably reflects the wide variety of contexts in which they are embedded. Supporters of this view would argue that the variety of practice is a sign, not of ignorance and arbitrariness, but of well-considered adaptation to local environments.

Unfortunately, it remains the case that it is not well understood why we are where we are in relation to financial reporting requirements for SMEs. Jurisdictions around the world may conceivably have arrived at the ideal solutions for their particular circumstances without bothering with research-based policy making. But we do not have the evidence to say whether or not current solutions are ideal.

WHAT IS AN SME?

When people talk about SMEs they often have widely differing sizes of firm in mind. Sometimes the term is even applied to smaller listed companies. No doubt smaller listed companies are indeed very small by comparison with the largest listed companies but in this report we deal with private company SMEs, not listed ones. We use the term 'listed companies' to refer to companies whose securities are traded on regulated public markets.

Within the category of SMEs it is often useful to distinguish between medium-sized and small firms and, within the category of small firms, between micro firms and the rest. There is an element of arbitrariness about where the lines are drawn in such definitions. But the current EU thresholds will give readers an idea of what we have in mind in this report. These thresholds combine criteria based on turnover, gross assets and number of employees. The latest maximum turnover thresholds, for example, are €40m for a medium-sized firm, €12m for a small firm, and €0.7m for a micro.

To keep things simple, we do not distinguish among different sizes of SME in this report, although in practice it may well be useful to do so.

2. Costs and benefits

It is widely agreed that no single set of financial reporting requirements is appropriate for all types of business entity. It is also widely agreed, although sometimes only implicitly, that the general principle governing what requirements should be imposed and how they should discriminate among different classes of entity ought to be a cost-benefit test.

This underlying level of agreement is sometimes obscured by differences in immediate objectives. In one country, for example, the priority may be creditor protection, in another informing shareholders, and in another tax. But policy makers have to choose which objectives to adopt in the first place. And they usually wish to pursue a number of objectives simultaneously, so questions arise as to how to trade off one objective against another. These choices normally involve an implicit or explicit cost-benefit test.

While there seems to be agreement, therefore, on the general principle of a cost-benefit test, its implications are disputed – possibly, as suggested earlier, because the answers will vary significantly depending on the context. But costs and benefits can be difficult or even impossible to measure, which also leads people to arrive at differing conclusions.

In developing a framework for analysis, we need to answer a number of questions:

- whose costs and benefits should be taken into account?
- what costs and benefits are involved?
- what principles are relevant to discriminating between different classes of entity eg, firms of different sizes or with different forms of ownership? We discuss this in Section 3.

WHOSE COSTS AND BENEFITS?

As setting financial reporting requirements is a question of public policy, in principle everybody's costs and benefits should be taken into account. If we simply ask what are the benefits and costs to SMEs of imposing requirements on them, our focus will be too narrow. Requirements of any sort (not just financial reporting) are rarely imposed on firms mainly for their own benefit; they are usually imposed primarily for others' benefit.

This raises questions about how far it is right to impose costs on one group for the benefit of another. We do not have space to go into these questions here, but they arise with all regulation, not just for SME accounting requirements.

Those with an interest in SME accounting requirements may conveniently be divided into six groups:

1. the firms that are subject to the requirements;
2. the firms' owners;
3. others who transact with the firms eg, lenders, customers and suppliers including employees;
4. those who may be affected in some other way by the firms' activities – competitors, for example;
5. government bodies, such as statistical offices, tax authorities and policymakers, which rely on firms' financial reporting information; and
6. society as a whole, which has an interest in ensuring that the regulation of SMEs promotes, rather than retards, economic growth and development.

Firms that are subject to financial reporting requirements come into the third and fourth categories in relation to other firms. They may object to incurring costs to comply with requirements themselves, but benefit from their imposition on others.

WHAT COSTS AND BENEFITS?

Relevant costs include:

- the direct costs of preparing and disseminating financial reporting information. These include audit costs where the information is audited;
- the costs of using the information. Information takes time and skill to process, and different types and amounts of information or different ways of presenting it can affect these costs;
- the costs to users of obtaining information from other - including private - sources if it is not provided by financial reporting; and
- proprietary costs to the discloser - ie, giving away information to competitors, weakening the discloser's position in contracting with other parties and loss of privacy, which may be particularly relevant to SMEs' financial reporting if the owner's income and the firm's profits are more or less the same thing.

Relevant benefits include:

- better information leading to greater efficiency and better decision making within the firm. Any properly run business - even an SME - needs accounting information, and financial reporting requirements may help ensure better accounting for management purposes. However, these benefits can be obtained without the information being made public - it could be restricted to shareholders;
- protection of various parties' interests: for example, owners who might be exploited by managers; minority shareholders who might be exploited by majority shareholders. This should lead to, among other things, greater trust between the firm and those with whom it transacts, leading to more transactions and/or transactions at lower cost eg, easier access to finance and a lower cost of capital;
- better information leading to better decision making by those outside the business, including investors and governments;
- more accurate assessments by tax authorities; and
- more generally, it could be argued that a society with more extensive and reliable disclosures is more transparent and less vulnerable to fraud and other forms of financial dishonesty.

Of these five benefits, the first is a benefit to the reporting firm and so it should arguably be up to the firm to decide whether the benefit is worth the associated costs. The second can be a benefit to the firm (lower cost of capital etc) but is not necessarily so. Even where benefits accrue to the firm rather than to others, there may be a case for regulation where this saves costs overall eg, because uniform requirements avoid the costs that would be incurred if every firm had to agree with its stakeholders what it should do.

It will be noted, however, that a number of the prospective benefits of financial reporting requirements are to parties other than the firms that have to comply with them.

WHAT SORT OF REQUIREMENTS?

There are a number of distinct questions as to what sort of financial reporting requirements should apply to SMEs.

- Should SMEs be required to produce financial statements at all?
- If so, what information should they contain?
- Should they be audited?
- Should they be publicly available?

Although to some extent these questions are interdependent, as far as possible the costs and benefits of imposing requirements need to be considered for each of them separately.

3. Grounds for discrimination

The main grounds for discrimination among firms in setting financial reporting requirements are size, ownership and liability.

SIZE

The relative costs of financial reporting vary with size because of economies of scale. There are economies of scale both in preparing and in auditing financial reporting information, so its costs tend to be proportionately higher for SMEs. The benefits of financial reporting vary with size principally because on average the larger the firm, the more money is at stake and the greater the number of people who transact with it and are otherwise affected by its activities.

OWNERSHIP

A distinction is commonly made in financial reporting requirements between listed companies and privately held companies, including SMEs, with significantly more extensive requirements imposed on listed companies. Insofar as the distinction is based on ownership, it has two related aspects: separation of management and ownership, and widely dispersed ownership.

Separation of ownership and management

Financial reporting by businesses is basically reporting by the firm's managers to its owners, although others may well be interested in using its accounts. In an SME, the firm's owners and managers are usually the same people, so the basic purpose of financial reporting becomes less clear, and the calculus of costs and benefits is fundamentally different from where ownership and management are separate. But in some SMEs, managers and owners are different people. With the growth of crowdfunding and employee share schemes, this may happen more frequently in future.

Widely dispersed ownership

The ownership of listed companies is typically widely dispersed, with shares bought and sold by members of the public. It is difficult for a widely dispersed group to exercise effective control of managers, including agreeing on financial reporting requirements with which managers should comply. Externally imposed, standardised reporting requirements are therefore a way of making widely dispersed ownership more attractive. This should benefit both owners and firms. Owners benefit as they are less likely to be exploited and are better able to exercise control over managers. Firms benefit as they should be able to raise capital at lower cost if information asymmetries are removed.

For SMEs, ownership is usually concentrated, but there have always been exceptions - where, for example, family ownership of a business becomes fragmented with time. And, again, the growth of crowdfunding and employee share schemes may make dispersed ownership of SMEs more common than in the past.

LIABILITY

There is a view that publication of accounts is the price of limited liability. The argument is that limited liability is a privilege that advantages shareholders at the expense of creditors. To protect creditors from being exploited, there may need to be requirements to make publicly available information that allows them to form a view on the company's capacity to pay its debts. Implicit in this argument is a contrast between the position of shareholders in a limited liability company and that of owners who have unlimited liability (sole proprietors, partners in an unlimited partnership or shareholders in an unlimited company). Businesses whose owners have unlimited liability should not be required to publish accounts as there is no reason why they should pay the publicity 'price' of limited liability.

The argument that publication of accounts is the price of limited liability is not universally accepted. In a number of countries, limited liability SMEs make minimal public accounting disclosures (if any), and there is no need for their accounts to be audited. If other parties do not wish to contract with a firm whose shareholders have limited liability, they are not compelled to do so. In practice, lenders often overcome the problem of limited liability by requiring some form of security from the firm's owners. They may also require access to unpublished management information about the borrower.

It is not clear in any case that the distinction between owners with and without limited liability should be decisive. Creditors' money is at risk (although perhaps to a lesser extent) even where a debtor has unlimited liability, and creditors' need for information exists in both cases.

It could be argued that, where creditor protection depends on the individuals behind a business, there should be public disclosures by these individuals. But we are aware of only three countries (Finland, Norway and Sweden) where it is generally regarded as acceptable to impose public accountability disclosures on individuals, and even in these countries it is only taxable income that is disclosed, not a full set of financial information. The motive behind these disclosures is the maintenance of public confidence in the integrity of the tax system. The disclosures may also be useful to creditors but this is not their purpose.

In the rest of the world, a person's income and financial position are seen as private matters, and the costs of breaching privacy in this respect are seen as outweighing any benefits to creditors (or to the transparency of the tax system) that might accrue from the publication of personal financial information.

Public interest entities

It is widely accepted that where firms (eg, banks) take deposits from members of the public or engage in similar activities that involve significant liabilities to members of the public (eg, insurers), this justifies, for the protection of depositors and others in a similar position, more extensive financial reporting requirements than would otherwise be the case. Entities of this sort, where outsiders need special protection, are usually regarded as public interest entities.

Where an SME is also a public interest entity (eg, an SME that is also a bank) this trumps the argument that SMEs should enjoy a lighter regulatory regime. Such public interest entities are outside the scope of this report.

THE BENEFITS OF UNIFORMITY

The benefits of differentiating financial reporting requirements among types and sizes of firm vary from case to case, but there are some costs of differentiation that apply in principle in all cases.

These are that differentiation:

- introduces additional complexity into the system as a whole, meaning that some users and auditors (among others) have to learn about multiple sets of accounting requirements; and
- reduces the comparability of financial reporting information. This is true not only between different categories of firm where they are subject to different requirements, but within a category of firms where there are no requirements. The question in relation to many SMEs, though, is: 'Who, if anyone, is making comparisons?'

It might be argued that, ideally, financial reporting requirements would be finely divided to discriminate among different types of firm according to size, ownership and liability. But there is also merit in simplicity (for those who have to apply requirements and for those who use the information they produce), and in not having too many different categories of financial reporting requirements or requirements that are too complex. In thinking about this, we should not consider SMEs in isolation.

4. Why SMEs are different

It is clear from the considerations we have just outlined that a good case can be made in principle for having significantly less extensive financial reporting requirements for SMEs, or even none at all.

- Because of their size, the costs of meeting financial reporting requirements fall on SMEs proportionately more heavily, while the benefits are likely to be much less than for larger firms.
- Typically they are owner-managed, their ownership is not widely dispersed, and their shares are not bought and sold by members of the public, so the benefits of financial reporting are likely to be much less than for listed companies. This raises questions as to whether size is the most appropriate criterion for discriminating among different types of firm in setting financial reporting requirements. Perhaps ownership, or some other criterion, would be more appropriate?

On the other hand:

- SMEs do not exist hermetically sealed off from the rest of the world. They have customers and suppliers, they may have employees, they may have minority shareholders or shareholders who are not necessarily involved in managing the business, they may borrow money, and they pay taxes. All these interactions imply at least some potential benefits from financial reporting.
- Where SMEs are limited liability entities there is a stronger argument for ensuring that those who may lose out as a result of this status - ie, lenders and trade creditors - are properly informed.

In short, and particularly when we take into consideration all the factors listed in our discussion, there is a complex array of arguments on the regulation of SMEs' financial reporting, which on a priori grounds might justify full regulation, laissez faire, or anything in-between. To further complicate matters, the right answers will almost certainly differ from country to country and over time, depending on differences in other institutions, markets, levels of technology and education, and what alternatives to financial reporting information are available. This is eminently a topic on which empirical research is needed.

5. IFRS for SMEs

IFRS for SMEs: International Financial Reporting Standard for Small and Medium-Sized Entities, was issued by the International Accounting Standards Board (IASB) in 2009. The standard makes clear that it is not in fact aimed at SMEs, but at private companies regardless of size that are not public interest entities. This is logical as full IFRS is aimed at listed companies rather than at large companies. The standard was prepared primarily to address the concerns of countries that had adopted IFRS for all companies, but felt that this imposed undue burdens on many firms, particularly SMEs.

As the *IFRS for SMEs* acknowledges, which entities it applies to in practice depends, as with full IFRS, on the decisions of governments and regulators. Jurisdictions have responded to the standard in different ways but it has been adopted or adapted in a number of countries as the basis for accounting requirements for private companies including, sometimes with additional modifications, SMEs.

It will be interesting to see how adaptations of the standard vary from country to country in response to local differences in the context of financial reporting. Such adaptations have already been made in the UK, for example.

6. Research

There is a good deal of interesting and useful research evidence on private company financial reporting, some of it specific to SMEs, but much of it wider in scope or focused on larger private companies. The research includes work on the effects of having an audit. We summarise this evidence in the appendix available with an online edition of the report at [icaew.com/bettermarkets](https://www.icaew.com/bettermarkets)

Valuable though this research is, it tells us remarkably little about the effects of regulating or deregulating SME financial reporting. Such research would require comparisons of the costs and benefits of different regulatory regimes and/or measurements of the costs and benefits experienced as a result of changes in regulation. Extant research looks instead at such questions as:

- whether financial reporting by SMEs leads to a lower cost of borrowing;
- whether owner-managers of SMEs find their statutory accounts useful in running the business;
- whether directors of SMEs think that their statutory accounts are useful to users;
- whether firms prepare accounts in accordance with GAAP when they are not required to do so; and
- whether firms still have an audit once it becomes voluntary.

All these studies are useful but they provide only a fraction of the evidence that would ideally be available in formulating policy.

Why is there so little relevant research?

- The data that provide the raw materials for most accounting researchers' work do not exist for SMEs. There are, for example, no stock market prices, no share trading data, no analysts' forecasts, no cost of equity capital or market liquidity data.
- What information there is on SMEs is often not publicly available. The trend towards deregulation in some jurisdictions has exacerbated this problem.
- Listed companies are a more glamorous topic of research. These are the companies that are in the headlines every day; SMEs are not.
- The US tends to lead the world in accounting research, and the absence there of any regulation of SME financial reporting means that there is little interest in the US in its effects. This attitude is likely to affect researchers in the rest of the world who aspire to international recognition for their work.

There is, however, a long tradition of research into international financial reporting differences, which has usually focused on listed companies. Some of this work will no doubt be helpful in understanding how SME financial reporting requirements have developed differently around the world.

It is not only in relation to SME accounting requirements that there is insufficient research to make soundly based policy decisions; the same is often true even for listed companies. The problem is particularly stark for SMEs but by no means restricted to them.

7. Conclusions and questions for further work

Public policy debates on SME financial reporting requirements are not well informed. In the present state of knowledge, a variety of conflicting claims are all possible but essentially independent of the evidence. It might therefore be claimed, with equal plausibility in each case, that:

- deregulating SME financial reporting has a deleterious effect on business decision making, on SMEs' access to finance, on the tax system, and on financial honesty in society generally; or
- SME financial reporting could be totally deregulated without any ill effects; or
- each jurisdiction has developed financial reporting requirements for SMEs that suit its own particular circumstances.

We believe that there is a need for substantial research on the effects of regulating and deregulating SME financial reporting. The broad objectives would be to compare the costs and benefits of different regulatory regimes and to measure the costs and benefits experienced as a result of changes in regulation.

Given the close relationship between SME financial reporting requirements and their varying contexts in different jurisdictions, general challenges for research in this area are:

- How can we make judgements about the costs and benefits of one element of a system eg, financial reporting requirements for SMEs, separately from judgements on the system as a whole eg, the institutional framework supporting the provision of finance to business?
- How can we make judgements about the costs and benefits of a system as a whole?

More specific questions include the following.

- Are size criteria the most appropriate basis for discriminating among firms in setting financial reporting requirements or would other criteria be more appropriate? Other relevant criteria might be: ownership, creditor protection, or use of accounts for tax purposes.
- What are the costs to SMEs of different degrees of financial reporting regulation?
- Do financial reporting requirements for SMEs lead to a lower cost of capital or to better access to capital?
- Do financial reporting requirements for SMEs lead to better management accounting and so to better management?
- What, if anything, is the evidence of market failure (eg, inability to raise capital) in countries where there are no requirements for financial reporting by SMEs?
- What financial reporting information do operators of crowdfunding websites require?
- What are the effects of their requirements?
- How far does comparability matter for SME accounts?
- Where SME financial reporting is unregulated or deregulated, does this result in higher tax compliance costs for firms or higher costs for the tax authorities or a less effective system of taxation?
- Where SME financial reporting is unregulated or deregulated, does this result in higher levels of fraud or higher fraud prevention costs?
- In countries where there is disclosure by individuals of their taxable income, does this help protect creditors of SMEs?

The answers to these questions will almost certainly vary from country to country, and it is important to understand how well or badly each country's requirements fit its own particular context. But through answering these questions it will be possible to begin to understand how SME financial reporting requirements can best be designed to fit a particular set of local circumstances. At the moment, policy making on this subject is essentially guesswork.

This sets a number of challenges for policy makers, accounting researchers, and others who are interested in the public policy debate on SME accounting requirements. We would welcome comments on this report and its conclusions; please send them to bettermarkets@icaew.com

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None of the commentators should be assumed to agree with the views expressed in this report or the appendix, and they are not responsible for any errors or omissions.

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