Department for Business Innovation & Skills

SIMPLER REPORTING FOR THE SMALLEST BUSINESSES

Discussion Paper

AUGUST 2011

This document has been published by the FRC and BIS to stimulate discussion and gather evidence to help the Government decide whether to take forward any further action in this area. It is therefore not a statement of Government policy.

Contents

Simpler Reporting for the Smallest Businesses

1. Introduction

1.1 Small and medium sized enterprises ('SMEs') have expressed increasing concern that laws and regulations, and accounting and auditing standards governing business have become very much more complex in an attempt to address a world where businesses at the top end of the corporate sector have become larger and more diverse, and their activities increasingly complex. They argue that the current legal and regulatory regimes that they must comply with are burdensome, costly and add little value to them, to their stakeholders, or to other users. They have therefore been calling for a review of the financial reporting regime governing small, non-public interest businesses. These calls are becoming more strident as a result of the legal and regulatory reforms that have been and are likely to be introduced following the financial crisis of the 2007/2008.

1.2 These are important issues that need to be considered. Not least because it is universally recognised that a vibrant economy and increased prosperity is dependent on the existence of a thriving community of SMEs. There were an estimated 5million private sector businesses in the UK at the start of 2010. Small and medium sized enterprises (SMEs) together accounted for 99.9% of all enterprises, 59.1% of private sector employment and 48.6% of private sector turnover in 2010[1].

1.3 To address the concerns expressed by SMEs, there have already been a number of initiatives:

- The European Commission has consulted on a proposal to allow Member States to exempt very small entities from the requirements of the 4th Directive[2]. The Council of Ministers on 30 May 2011 reached agreement on proposals which are now being considered by the European Parliament[3];[4]

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1 http://stats.bis.gov.uk/ed/bpe/BPE_2010_-_Statistical_Release.pdf
2 http://ec.europa.eu/unitedkingdom/press/press_releases/2009/pr0911_en.htm
3 http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=419745&NewsAreaID=2

- financial statements and annual returns can be filed electronically at Companies House; and
- the European Commission recently consulted on the financial reporting challenges that SMEs face in its Green Paper – "Audit Policy – Lessons from the Crisis"[5]

1.4 In addition to this, the Office of Tax Simplification ("OTS") is currently consulting on proposals to simplify taxation for the smallest businesses. Although this focuses on unincorporated businesses, the publication of the OTS paper[6], and the debate that it will prompt, presents an opportunity to consider the possibility of simplification of the corporate and financial reporting requirements currently imposed on the very smallest businesses. This paper therefore seeks views on simplifying reporting requirements for incorporated businesses – these are not covered as part of the OTS review and further work would be required to understand the tax implications and possible benefits of these proposals. This paper has been published to simulate debate and gather evidence, to help the Government decide, with the OTS, whether to take forward further work in this area.

1.5 The SME constituency covers a wide range of companies – from the smallest company to those with an annual turnover of £25.9 million, from those with only one employee to those with 250 employees, and those with one shareholder to those whose shares are traded publicly. It is therefore clear that whilst the activities/initiatives outlined above are helpful, no single approach would be appropriate for the whole SME constituency.

1.6 The Competitiveness Council, in May 2011, defined a "Micro-entity" as a company a turnover of less than Euro €500,000 (£440,000), with total assets of less than Euro €250,000 (£220,000)[7] and employing fewer than 10 people. Approximately 60% of UK

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4 http://nds.coi.gov.uk/content/detail.aspx?ReleaseID=419745&NewsAreaId=2
5 http://ec.europa.eu/internal_market/auditing/otherdocs/index_en.htm
6 This paper can be found at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm
7 Based on an exchange rate of 1 GBP = 1.13204 EUR. In the case of those Member States which have not adopted the euro, the amount in national currency equivalent to the amounts specified in the first paragraph shall be that obtained by applying the exchange rate published in the Official Journal of the European Union on the date of the entry into force of any Directive setting those amounts.

companies registered at Companies House[8] meet these criteria – as do some 3.5 million unincorporated businesses.

1.7 In this Discussion Paper, in order to distinguish between the different ways in which businesses meeting such criteria may be established, the following terms are used:

- Incorporated entities are referred to as "Micro-Companies";
- Other businesses, such as self employed individuals, sole traders and partnerships are referred to as "Micro-Businesses".

Micro-Companies and Micro-Businesses are collectively referred to as "Micro-Entities".

1.8 The OTS consultation and European developments together create the opportunity to discuss the regime governing financial reporting by Micro-Entities and consider

- What financial information should be prepared bearing in mind the needs of the main users of the financial information of the entity concerned;
- The form in which any such information should be prepared;
- What further information would be required; and
- What, if any, information should be made available publicly.

It is essential that these questions should be addressed from the perspective of how businesses are in fact managed on a day to day basis so as to minimise the need for Micro-Entities to put in place unnecessary additional procedures over and above those that they need to run their businesses.

1.9 Against the background of the questions set out in paragraph 8 above, this Discussion Paper seeks views on the prospects for developing a new reporting regime that

- Is based on the minimum that is required to meet the needs of users;
- Involves an approach to the recording and presentation of financial information that could be aligned with the tax system and so improve integration of businesses accounting and tax administration;

[8] FAME database

- o Reduces or removes inconsistencies in the requirements faced by Micro-Companies and Micro-Businesses

With the aim that the regulatory burden on the very smallest businesses could be significantly reduced and the associated cost savings released.

1.10 Written responses to the proposals and questions contained in this Discussion Paper should be provided by 30 October 2011. To facilitate the consultation process, meetings will be convened at which these proposals can be discussed at a number of locations around the United Kingdom.

1.11 Responses to BIS and the FRC should be sent to Julian Thompson at julian.thompson@bis.gsi.gov.uk, or:

Department for Business, Innovation and Skills, Spur 2, 3rd Floor, 1 Victoria Street, London, SW1H 0ET

2. Micro-entities and their role in the UK

2.1 Under European Law, the principles of the 4th and 7th Directives, and the related financial reporting requirements, are applicable irrespective of the size of the company concerned. As a result, all companies, of whatever size, are required to prepare financial statements – and the bigger the company the more detail is required. The only relaxation of the requirements for the benefit of SMEs is that European Law permits Member States to relieve certain companies of the requirement to have their financial statements audited, and to file simpler statements.

2.2 Recognising that the current regime may impose disproportionate burdens on certain companies, the European Commission has been considering whether to recognise a category of company that is very small with a view to then relieving that category of companies from certain requirements. The proposals currently being considered categorise such companies as 'micro-entities' and define that category of companies as those that trade for profit and do not exceed two of the following criteria:

- A net turnover of Euro 500,000 (£440,000);
- A balance sheet total of Euro 250,000 (£220,000);
- Average of 10 employees during the financial year.

Under the European Commission approach, Member States would be able to exempt companies that meet the micro-entity criteria from certain elements of the current financial reporting regime. However, the current proposals would not achieve the full deregulatory effect of the original EC proposals. The European Parliament is currently considering the latest proposals.

2.3 We estimate that:

- some 1.3 million companies in the UK would qualify as micro-entities under the definition set out in paragraph 13 above and although the Commission's proposals do not affect unincorporated businesses, some 3.5 million unincorporated businesses would meet the same criteria. The reduction in regulatory/administrative obligations could save from £250m to £400m[9] per year in costs relating to the preparation of accounts. This, however, would be contingent on achieving similar reductions in reporting for tax purposes. The net benefit would also need to take account of transitional costs and additional operational costs for Government.

2.4 Against the background of the proposals being considered by the European Commission, this Discussion Paper addresses some important issues:

- It provides an opportunity to demonstrate that the EC proposals could be implemented in a manner that could meet the needs of all interested parties and achieve the de-regulatory benefits described above;
- It proposes a means of simplifying the corporate reporting requirements for Micro-Companies.
- It does not disadvantage Micro-Entities with respect to other businesses.

Q1 Would benefits flow from de-regulating the reporting responsibilities of this category of micro businesses? How would you quantify this? Would they outweigh any transitional costs associated with moving to a new regime? Are there other considerations that should be taken into account?

[9] Preliminary figures: based on an estimated benefit range of £60 to £235 per business

3. The information that micro-companies should be required to prepare and file

3.1 UK legislation requires all companies to prepare full financial statements and then file financial information and an annual return at Companies House. In the case of companies that meet the EC definition, the financial information may be provided in the form of Abbreviated Accounts[10]. These requirements were intended to respond to the perceived, and sometimes differing, information needs of users – actual or prospective shareholders, lenders and other creditors, trading counterparties and employees. However, SMEs can, and may choose to, submit more information than they are required to; for example, to provide additional information to users such as credit ratings agencies.

3.2 However, the needs of users are likely to differ depending upon the size and business of the companies concerned and it is questionable whether the same information is required even in relation to each small or medium sized company. In the case of Micro-Entities, the information needs of users apart from HMRC may be limited.

3.3 The purpose of requiring companies to report information publicly is to facilitate economic activity by ensuring that those who deal with companies have access to essential information about those companies and their financial position. If any revision to the reporting requirements of Micro-Companies is to be implemented, it is necessary to

- Identify the user groups whose needs need to be addressed;
- Determine the minimum information that those user groups require; and
- Ascertain whether that information is readily available because it is used to run the company (if it is not readily available, to require its provision would defeat the de-regulatory objective of this initiative).

10 It will always be open to a company to file more financial information than the minimum required. So for example if a small company felt there was commercial advantage in it filing full accounts rather than abbreviated accounts it can.

When determining the minimum information that may be required by users of information about Micro-Entities, it is important to differentiate between the information that is required generally for efficient economic activity and the more specific information that particular users may seek. That is because the latter invariably have the ability to impose information requirements as a condition of doing business.

3.4 Analysis suggests that there are six categories of users, and that those users can be divided into two groups – the owners/shareholders who have access to such information as they require, and those who need to rely upon published information. The information that this latter group of users require varies.

- Employees need to be able to assess the viability of the company they work for or may work for.
- Banks and other lenders need information to enable them to identify the areas where they need specific information from the company and to enable them to determine whether a company to which a loan has been made remains viable.
- Credit rating/reference agencies need data to enable them to calculate key ratios and provide reports, often to customers and trading counter-parties
- Customers and other trading counter-parties need sufficient information to enable them to assess the solvency and future commitments of the company;
- HMRC and other government agencies need sufficient information to undertake risk assessments of tax returns and thereby eliminate the majority from further enquiry.

Of these user groups, those most commonly interested in Micro-Companies are the last two - customers and trading counter-parties, and HMRC. Of the others, either the entities concerned have the commercial negotiating power to obtain the information they require or they have established (often family) relationships with the individuals involved in the Micro-Companies and, therefore, would not rely on published information.

3.5 Against this background, one approach would be to require Micro-Companies to prepare the financial information set out below:

- A simplified Trading Statement (in place of the current Profit and Loss account);
- A Statement of Position – which would include details of shareholder's funds, fixed assets, cash, debtors, loans, and short and long term creditors; and
- A simplified Annual Return

3.6 In addition to simplifying the reporting regime, further benefits might be achieved by aligning financial reporting and tax reporting so that Micro-Companies would only be required to prepare one set of data, from which all reporting obligations could be met.

3.7 It is important to emphasise that companies providing the financial information summarised in paragraph 20 above would not be preparing financial statements that give a true and fair view. However the proposed revised regime would not prevent Micro-Companies from using higher levels of reporting standards if these were thought to be a more appropriate way of meeting their particular business requirements.

Trading Statement

3.8 Central to achieving the simplified approach contemplated would be a Trading Statement (in place of the traditional Profit and Loss Account).

3.9 To ensure reliability, it would be necessary to provide, either by regulation or an applicable accounting standard, for the manner in which the financial information would be prepared. This would include the establishment of a standard set of pro-forma accounting policies - one of which would be that the Trading Statement would be prepared on a cash accounting basis. In that manner, it would be possible to establish a regime under which all transactions were accounted for on a consistent basis, and the treatment of capital expenditure, leasing or hire purchase transactions could be addressed. This would mean, for example, that:

- Income would be recorded on a cash received basis (as opposed to when earned);
- Costs would be recorded when actually paid (as opposed to when incurred);

- Grants would be recorded when received (as opposed to when awarded)

3.10 Such an approach would remove the need to account

- On an accrual basis (removing the need to apportion receipts and payments across accounting periods);
- For stock (although the costs of acquiring or manufacturing that stock would form part of the company's expenditure);
- For changes in working capital; and
- For increases or decreases in the values of fixed assets.

3.11 As at present, losses would be carried forward to be set against future profits.

Statement of Position

3.12 Similarly, the Statement of Position (which would replace the traditional Balance Sheet), could be simplified, and be limited to reporting

- Shareholder Funds;
- Debtors and Creditors (short and long term);
- Debtors;
- Cash;
- Loans; and
- Any major assets - Whilst it is probable that few Micro-Companies own real estate[11] or other significant assets, those that do should record the historical cost of such assets so that, first, the level of any loans can be seen in proper context and, secondly, because the subsequent disposal of such assets could have tax implications (e.g. in relation to capital gains).

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[11] Historically, the cost of real estate, particularly if purchased more than 15 years ago, is likely to be less than £250,000. It has been pointed out by BIS that it is also likely that the turnover and number of employees for Micro-Companies which are small property investment companies falls below the threshold.

3.13 The approach summarised above – requiring a Trading Statement and a Statement of Position – could also be used by Micro-Businesses. If a common approach were to be adopted, the way that incorporated and unincorporated businesses report their financial position would be aligned.

Annual Return

3.14 This simplification approach can also be extended to the information required to be included in the Annual Return to be filed at Companies House.

3.15 an Annual Return[12] would continue to be required, first, as the means by which a company would establish its entitlement to take advantage of the reporting regime available to Micro-Companies and, secondly, to provide the minimum information required by the users referred to in paragraph 19 above.

3.16 At the minimum, that Annual Return would:

- Identify the ultimate owners of the company;
- Disclose the basis on which a company asserts its entitlement to 'Micro-Company' status – by reporting the average number of employees during the past year together with the financial information required.

Any numerical data would be drawn from financial information prepared in accordance with the reporting regime described above. The financial information could be provided either by reporting the company's turnover in the financial year together with the asset value revealed by the Statement of Position, or by attaching the Trading Statement and Statement of Position.

3.17 These proposals would not affect a director's obligation to provide information to the best of his or her knowledge and belief.

3.18 In order to facilitate efficient administrative and tax reporting, and to ensure that the information provided to Companies House should be up-to-date and, therefore, relevant, Micro-Companies might be required

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[12] http://www.companieshouse.gov.uk/forms/generalForms/AR01_annual_return.pdf

- o to file Annual Returns within, for example, 12 weeks of the end of the financial period; and/or
- o to standardise the reporting year;

3.19 There is currently no legal requirement to have Annual Returns and related financial statements independently reviewed. There is no reason to believe that the proposed approach would increase the likelihood of error or dishonesty.

Q2 Would the proposed alternative reporting structure described in this Section meet the needs of users? If not, what changes would you recommend and why?

Q3 Would the Trading Statement and Statement of Position described above provide an acceptable basis of reporting by Micro-Companies? If not, what changes would you recommend and why?

Q4 Would the information to be included in Micro-Company Annual Returns (paragraph 31) be sufficient? If not, changes would you recommend and why?

Q5 Are the proposed filing obligations for Micro-Companies (paragraph 33) appropriate? If not, what changes would you recommend and why?

Q6 Are there any other matters that need to be addressed?

4. Using the reported information to prepare tax returns

4.1 The OTS is currently looking at the possibility of simplified tax reporting requirements for small unincorporated business. This review is due to report recommendations to Ministers ahead of Budget 2012.

4.2 Financial information prepared as set out in the preceding section could provide the basis for an annual tax return by Micro-Entities (being both incorporated and unincorporated businesses) which could offer further advantages to those Micro-Entities because:

- All filings or returns would be drawn from one set of data, so Micro-Entities might no longer be required to prepare reconciliations from financial statements to tax returns;
- Accounts depreciation might be simplified to match capital allowances rates used in the tax system. With no changes to the existing capital allowances regime this might help reduce the number of calculations businesses are required to carry out.
- There could be substantial alignment with the VAT cash accounting scheme, which is already available to the smallest businesses.

4.3 Considerable further work would be required to understand the wider implications and policy choices when applying such proposals to the tax system. This includes scope for tax avoidance, the risk of additional complexity in the legislation, and the arrangements when businesses grow and become no longer eligible for the simplified regime.

Q7 In principle, would the proposed approach to providing financial information to HMRC be an improvement (e.g. by being simpler and/or cost effective)? What key benefits and potential challenges do you foresee?

5. Improving performance through better management information

5.1 Current technology offers the opportunity, at a considerably lower cost

- to obtain essential management information;
- to avoid adverse credit ratings caused by delayed or late filing of financial information with Companies House; and
- to provide information tailored to the needs of particular users, such as banks and contract counter-parties.

Access to better management information

5.2 A consistent theme advanced by economists and commentators is that businesses in the SME sector could make an increased contribution to the economy if they had better financial information available to them. In particular, they would benefit from information that enabled management to understand the trends in the performance of their companies and plan better for the future.

5.3 Integrated software programmes used to prepare financial information, Companies House and if feasible, tax returns, could be developed commercially to provide the information necessary to enable management to make decisions on an informed basis by providing essential management information such as, for example, models, forecasts and budgets which would help businesses understand the consequences of proposed decisions, manage working capital requirements, and monitor debtors[13].

Avoiding adverse credit ratings caused by delayed or late filing of financial information with Companies House

5.4 It is noteworthy that interest in data filed at Companies House is extensive – between April 2010 and March 2011, Companies House recorded 1.5m 'hits' for accounts information. In the vast majority of cases, these hits were made by organisations and

[13] This would require data to be recorded in a basis that would allow management information to be compiled on an accruals basis.

trading counter-parties carrying out credit-related enquiries[14]. The effectiveness of such enquiries would be substantially increased were such financial information to be up-to-date and provided in a form more useful to such users.

5.5 Data suggests that some 60% of SMEs are described as 'high risk' or 'above normal risk', in terms of defaulting on trade payments or getting into financial difficulties because they do not file timely or detailed accounts at Companies House[15]. The absence of such information affects companies' credit scores and, therefore, their ability to access funding, credit from suppliers and trade credit insurance.

5.6 If companies had a simpler and up to date means of filing essential information (or providing it directly to relevant interested parties – see below), such companies would find it easier to carry on business. Not only would this benefit such companies, it would also improve the contribution made by SMEs and Micro-Companies to the level of economic activity.

Responding to particular user requests

5.7 The availability of better management information would enhance the ability of small businesses to secure equity or debt finance and develop their businesses. This has the potential to be of particular importance to small businesses with an unproven or volatile financial record.

5.8 Evidence[16] already exists that demonstrates that banks and other lenders would prefer to provide finance to such businesses if they were confident that they would be able to monitor the performance of those businesses on a regular basis, for example through receipt of management information of a pre-determined nature.

5.9 The proposals in this Discussion Paper provide a route by which the benefits discussed in this Section could be achieved using exactly the same commerical software as would be used to prepare financial information for corporate reporting and, if feasible,

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14 Companies House data

15 Graydon UK research (2009)

16 Lloyds Banking Group has been trialling software that extracts up-to-date financial information from companies seeking loans who give permission to access their monthly balance sheets. That software is used to better inform credit decisions by providing information from monthly management accounts, instead of relying on out-of-date audited yearly results. This software is also being trialled by the credit rating agency, Experian.

tax return purposes – and, most importantly, without any additional effort or cost to the businesses themselves.

6. Summary of consultation questions

6.1 Commentators' views on the proposals and in response to the questions in this Discussion Paper should be sent to BIS and the FRC through:

Julian Thompson

julian.thompson@bis.gsi.gov.uk

Department for Business, Innovation and Skills, Spur 2, 3rd Floor, 1 Victoria Street, London, SW1H 0ET

6.2 Once responses to this discussion paper have been collected, they will be considered by Government and;

- An assessment will be made whether these proposals offer the benefits sought without unintended adverse consequences; and
- Consideration will be given to the legislative and regulatory changes that would be necessary to implement new reporting requirements along the lines considered in this Discussion Paper

Should the Government decide to take forward any of the ideas in this Discussion Paper, it would consult further in the usual way, including preparation of an Impact Assessment.

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Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 5000

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