THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

Response from
The Institute of Chartered Accountants of Scotland to
The Department for Business Innovation and Skills and the
Financial Reporting Council

Discussion Paper: Simpler Reporting for the Smallest Businesses

3 November 2011

INTRODUCTION

The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to respond to the Department of Business Innovation and Skills (BIS) and the Financial Reporting Council's (FRC) discussion paper on Simpler Reporting for the Smallest Businesses.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

GENERAL COMMENTS

Regulation is a necessary evil to business and there will always be those who see any regulation on business as bad, burdensome and of limited value.

The Institute's view is that in certain instances regulation is necessary to create an environment where businesses can thrive and grow and that good regulation will quietly do its job effectively in the background. Where this is not the case, and regulation interferes with the smooth running of business and the confidence of doing business, there is a problem that needs to be addressed.

We believe that the themes raised in this discussion paper, if introduced, would fall into the latter category and therefore we would ask the Government to re-think its stance on micro-entities and to remember its commitment on stopping EU "gold-plating".

We are aware of the current European Parliament debate on micro-entities and the support in some quarters for the turnover and balance sheet thresholds to be increased. We would ask the Government to resist any such move.

At a time where growth is paramount, not just in the UK but also on an EU and Global level, we would urge the Government, when considering any new regulation or legislation for business, to ask itself one simple question: is this measure going to encourage business growth? Unless there is an unequivocal yes, then we believe the Government should take a step back and re-think its proposals. We firmly believe that the issues raised in the discussion paper would not lead to any increased confidence in markets, lenders or the wider business community and therefore not assist micro businesses to grow.

We would acknowledge that the current reporting regime, including Abbreviated Accounts, is not perfect but we do not believe it needs to be totally re-written, especially with something that is in our view "not fit for purpose".

Our proposals for improving the current reporting regime without adding to the regulatory burden on business are contained in Appendix A and include measures on disclosing the business turnover and introducing a full creditors' note.

Our specific responses to the questions posed in the discussion paper are as follows:

<u>REPONSES TO THE LIST OF QUESTIONS</u>

<u>Section 2: Micro-entities and their role in the UK</u>

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

(i) ICAS is an avid supporter of removing unnecessary regulation that hinders businesses of all sizes from operating effectively and damages their growth potential. However, we do not believe that the themes put forward in this discussion paper will lead to any tangible benefits flowing to micro-entities. As they stand, the issues raised in the discussion paper will lead to a weaker system of financial reporting (and by extension potentially financial management) for micro-entities at a time when, we would suggest, businesses are in most need of assistance to guide them through very difficult economic and trading conditions.

(ii) As we do not believe that there will be any benefits to such businesses, there is nothing to be quantified.

(iii) As we do not believe that there would be any benefits but rather additional costs to be borne by business, our response to this question is "no". We would also highlight that any transitional costs, and there clearly would be some, would merely be an additional cost on business at a time when it can least afford to absorb such costs.

(iv) We believe the Government should focus on providing much needed assistance in areas such as access to finance and increasing consumer and business confidence. It should not be side-tracked by believing the issues raised in the discussion paper will assist micro-entities in any of these important areas when they could potentially do more harm than good.

We question the logic behind creating another layer of businesses at a time when the Government is committed to reducing burdens on business and to stopping the so-called EU "gold plating". We would argue that a growing micro-business will face an even greater regulatory upheaval when it needs to move to the next level of financial reporting requirements. It is not clear that consideration has been given to this matter.

We would urge the Government to consider whether their ideas will address the real issues and actual regulatory burdens that micro-businesses face. We believe that in terms of the benefits to UK micro-businesses of growth and job creation, the discussion paper's themes are at best questionable and at worst potentially damaging to the very businesses they are trying to help.

<u>Section 3: The information that micro-companies should be required to prepare and file</u>

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

(i) No, we do not believe that such a reporting structure would meet the needs of users. The discussion paper ideas appear to be a hotpotch of cash based accounting coupled with a balance sheet of sorts. The failings of cash accounting have been clearly illustrated in the EU sovereign debt crisis, with countries such as Greece failing to recognise the true value of the liabilities it was accumulating. The UK Government has also moved away from cash accounting in recent years recognising its inadequacies. In our view cash accounting fails to properly present to users the financial performance and position of micro entities and will lead to decisions being made by those users on the basis of poorer quality information. Additionally, it is not just users who would lose out, we have serious concerns that the introduction of such a system would lead to the directors of micro-companies themselves having poorer quality financial information on which to base their decisions. The end result might be the creation of even greater uncertainty in this particular business sector and the evaporation of business confidence.

(ii) We are sceptical about the claims that the current regime of financial reporting filing requirements for micro-companies imposes disproportionate burdens on such entities.

The filing of financial statements on the public record is the price that company directors pay for the privilege of limited liability status. This is a cornerstone of UK business practice and to dilute this would, in our opinion, be an unwelcome backward step.

The overwhelming majority of micro-companies already take advantage of filing abbreviated accounts instead of full financial statements with Companies House which vastly reduces the amount of information placed on the public record. We would not support the introduction of a system that advocates placing even less on the public record.

We would like to take this opportunity to refer you to an ICAS sponsored research publication "Small Company Abbreviated Accounts: A regulatory burden or a vital disclosure?" a copy of which is enclosed with this response. The research highlights the division amongst stakeholders of abbreviated accounts, with preparers believing they are less of a regulatory burden and more for maintaining confidentiality, whilst users seeing them as less of a vital disclosure and more part of the "information jigsaw" used to assess whether or not they want to do business with that company.

Abbreviated accounts were viewed as "better than nothing" and at least a starting point for users, putting these companies in a better position than those businesses who had not filed accounts at all.

Following the publication of the research a working group from the Institute's Business Policy Committee reviewed the usefulness of abbreviated accounts. It concluded that being more supportive and positive about the benefits that filing abbreviated accounts provide, along with introducing some changes to their existing format, should be promoted.

A summary of these proposals can be found in Appendix A.

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

We do not believe that the proposed Trading Statement and Statement of Position as described in the discussion paper are an acceptable basis of reporting by micro-companies. They appear to be a confusing mix of cash accounting (for the Trading Statement) and accruals basis (for the Statement of Position with the inclusion of debtors and creditors).

We believe that the Government is failing to recognise that the majority of micro-company (and micro-business) owners would struggle to understand these concepts, notwithstanding whatever "regulation or applicable accounting standard, for the manner in which the financial information would be prepared" is introduced as pointed out in section 3.9 of the discussion paper. Would they really have the time to attend to these matters with the necessary diligence?

We would suggest the above statements will do nothing but increase the burden on these businesses and take up valuable management time which would be better spent focussing on the core aspects of their business. We would therefore caution the Government about the potential unintended consequences of the discussion paper, especially in light of the current economic situation.

Would potential lenders be happy to accept and lend on the basis of a set of figures prepared on a cash basis? We very much doubt this would be the case and are sure that the Government will agree that lending based on such rudimentary information is inappropriate. Indeed, lenders may well ask for a set of accounts based on an accruals basis as a first step in assessing the creditworthiness and financial health of the entity concerned.

A move to a cash accounting system is in our view a backward step and not one that should be entertained or encouraged. We believe the Government should be promoting good fiscal and financial management amongst micro-businesses to try and ensure they are being run as prudently and profitably as possible – a message that moving to cash accounting does not convey.

(ii) As noted above, a summary of our proposals on where the current reporting under abbreviated accounts could be promoted and improved are contained in Appendix A.

Q4: (i) Would the information included in Micro-Company Annual Returns (paragraph 31) be sufficient? (ii) If not, what changes would you make and why?

(i) Given that there is no paragraph 31 in the discussion paper, it is difficult to accurately answer this question.

(ii) We believe that the information that is currently contained in an Annual Return provides the minimum information necessary for micro-companies to place on the public record and we would note that there have already been several measures introduced over the past few years, such as the removal of the need for a Company Secretary that will have helped many micro-companies.

As we have previously noted, placing information on the public record is the price that company directors pay for the privilege of limited liability status and, as such, we do not believe this should be diluted.

The Government could perhaps consider introducing a reduced fee for those micro-companies that file both their annual return and financial statements on time (and/or at the same time) as an incentive to file.

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

(i) Given that there is no paragraph 33 in the discussion paper, it is difficult to accurately answer this question.

(ii) We are concerned that the Government does not fully understand how micro-companies operate in practice, based on the assumption that it believes it is possible to either file financial statements within 12 weeks of the end of the financial period or to standardise the reporting year.

Given the number of micro-companies that will be affected by the discussion paper's ideas, including a considerable number of "one-man band" operations, asking them all to file financial information within 12 weeks of their financial period is an unrealistic target and one that some companies with a far higher level of turnover and greater resources at their disposal would struggle to meet.

The prospect of standardising the reporting year for this population is also unrealistic and in our opinion shows a worrying and complete lack of understanding on the Government's part of this population of companies. These are a huge range of small but complex businesses, each with their own unique pressures and highs and lows of demand which means that any random date chosen by the Government will have unintended consequences for some of this population. We would argue that anything which might disadvantage a proportion of micro-entities should not be introduced.

We do not believe that a change to the current reporting deadlines for micro-businesses is needed or realistically achievable without placing additional burdens and pressures onto these businesses.

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

Firstly we would like to highlight our concerns about the discussion paper that is, in our opinion, based on questionable ideas, incorrect referencing and the use of statistics with no basis (such as the preliminary cost saving figures of between £60 to £235 per business as highlighted in footnote 9 on page 9, which has no evidence to support this claim).

Related to this we believe there is a need for the Government to properly engage with all stakeholder groups before issuing papers of this nature. ICAS would be more than willing to assist the Government in this process as we are all working to the same objective to help encourage UK businesses to grow on a sustainable basis.

Section 4: Using the reported information to prepare tax returns

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

(i) We believe that the one page dedicated to this important, wide ranging and complex issue in the discussion paper is insufficient to make a reasoned response.

With the Office of Tax Simplification (OTS) already looking at the possibility of simplified tax reporting requirements for small unincorporated business (to which the ICAS Small Business Tax Sub-Committee recently responded to), we believe any questions in relation to the taxation of micro-entities should be left until the OTS have released their recommendations. We have attached a copy of the above ICAS response.

ICAS is supportive of any sensible measures that would streamline the differences between the accounting and tax profits of businesses but would caution against creating a complex two-tier system and placing unrealistic expectations and demands on the time business owners would need to spend addressing these.

(ii) Due to the lack of detail provided in the discussion paper we are unable to respond to this particular question.

Section 5: Improving performance through better management information

Whilst we note there is not a question in this section, we would like to offer the following observations.

This section seems to imply that having current technology is some sort of panacea for better management information and will help avoid an adverse credit rating caused by delayed or late filing of financial information with Companies House. We would argue that while this can be the case, it is completely reliant on the assumption that the correct information was entered initially by the user into the software package and for the user to have a level of proficiency that enables them to spot an erroneous posting and correct this accordingly.

The use of computerised accounting software has increased over the last ten years or so but we would suggest this is being used to record only the most basic information and that nuances, such as the correct expense heading, are not uppermost in the mind of most users, especially where the distinction between revenue and capital expenditure can be blurred.

With regards to the comments on adverse credit ratings, we would be surprised if the credit ratings agencies view a change to a cash accounting basis (however and whenever this would be filed), as a positive move. It seems clear that the statements made in the discussion paper have been made without reference to credit rating agencies (there are no footnotes to state otherwise) and we would have expected some Government engagement with them in compiling the discussion paper.

We would again draw your attention to the Abbreviated Accounts research where the views of the credit ratings agencies were sought as they are one of the main user groups of this information.

We would also comment that in the current financial climate, where businesses are seeking funds from a number of different places, not only from their local bank where they may have a relationship, that the emphasis should be on good quality reporting which is not, we would suggest, what the discussion paper is promoting.

For any business to approach a potential lender with the information that is suggested in the discussion paper would, in our opinion, receive short shrift from that potential lender. As comes out in the research, even the Abbreviated Accounts that are currently filed are insufficient for this purpose and potential lenders are seeking more information on the business – not less – and we hope that our proposals to extend what is contained in Abbreviated Accounts are a step in the right direction.

APPENDIX A

Summary of Proposals for the Future of Abbreviated Accounts

The Institute of Chartered Accountants of Scotland, following on from the publication of the recent research paper entitled "Small Company Abbreviated Accounts: A regulatory burden or a vital disclosure", has considered the usefulness of Abbreviated Accounts from both the preparers' and users' perspectives.

The Institute recognises that the need for users to have meaningful financial information on which to base decisions has to be balanced with the confidentiality benefits that preparers' desire. We do, however, believe that a compromise is achievable – but only with the buy-in of both users and preparers.

Financial reporting in general is at a crossroads, and the clamour for greater transparency from corporates, of all sizes, in their reporting, cannot be overlooked and must be addressed.

The Institute believes there is still a use for Abbreviated Accounts, subject to a few key alterations being introduced, and more importantly clarity on the reasons for such changes.

As an alternative to the proposals put forward in the Government's discussion paper on Simpler Reporting for the Smallest Businesses, the Institute believes there is a need to:

- Focus on the benefits that can be gained from preparing and submitting Abbreviated Accounts along the lines we propose such as the possible missed opportunities when their accounts are downloaded by a potential customer. This is premised on the assumption that companies would otherwise not be required to file anything;
- Turn around the current negativity associated with Abbreviated Accounts, by showing them in a positive light, ie as a useful "selling document" to prospective customers, demonstrating that the company is one they want to do business with, or as part of the jigsaw of information that helps achieve that purpose; and
- Make Abbreviated Accounts much more relevant and useful.

Turnover

The current Government proposals for a Trading Statement will show on public record the turnover and expenses of the business on a cash basis.

Our Proposal

We propose that Abbreviated Accounts should be maintained and produced under the current basis and that a supplementary note be added giving companies the choice to disclose their turnover, either as a single number or indicating which band their turnover falls into in. For turnover of up to £1,000,000 there would be 4 bands in steps of £250,000. For turnover between £1,000,000 and £3,000,000 there would also be 4 bands but in steps of £500,000. If the company turnover is more that £3,000,000, then the turnover note would simply state that fact.

Creditors falling due within and after one year

The current Government proposals are unclear on what will be shown in the Statement of Position with simply "creditors" and "loans" highlighted in the discussion paper.

Our Proposal

We propose that Abbreviated Accounts should be maintained and produced under the current basis and that a supplementary note be added giving a full breakdown of both the creditors due within and after one year figure, which will reconcile to the figures in the balance sheet. We believe that understanding how a business is funded is a key requirement and should be clearly signposted in a set of Abbreviated Accounts.