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SME accounting requirements: basing policy on evidence

Public policy paper

INFORMATION FOR BETTER MARKETS INITIATIVE



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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 policy makers, 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.

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.

The principal author of the report and appendix is Brian Singleton-Green.



SME accounting requirements: basing policy on evidence

Appendix: research evidence

A1. Introduction

In Section 6 of the report, we note that empirical research tells us remarkably little about the effects of regulating or deregulating SME financial reporting. This is not a criticism of the research, which does not in general set out to investigate the relevant costs and benefits.

In this appendix we summarise recent research relevant to SME financial reporting that we are aware of, but some of it is of only tangential relevance to assessing the costs and benefits of regulation. We also include research on private firms and family-owned firms that are not necessarily SMEs. The fact that they are private or family-owned may at least mean, though, that they have something in common with SMEs. We might expect, for example, that where research finds financial reporting differences between listed companies and large private companies, the same differences would be found between listed companies and SMEs, but to an even greater extent. However, the one paper that we report below that looks at the point specifically does not support this assumption.

Many of the studies either identify specific benefits of financial reporting (eg, some people find the information it produces useful) or of financial reporting quality (eg, it leads to a lower cost of capital) or explore what firms do in the absence of requirements (eg, a proportion of them have an audit anyway). Such studies are helpful, but they only give us part of the picture.

- That financial reporting, or financial reporting quality, has benefits is not in itself an argument for imposing financial reporting requirements, or for mandating a certain level of quality.
- Benefits in any case need to be compared with their costs, which is not always done in the research that identifies the benefits.
- Evidence on what firms do in the absence of requirements is ambiguous in terms of its policy implications. On the one hand, if firms do what would otherwise be required, it can be argued that the imposition of requirements would not impose significant additional costs. On the other hand, it can be argued that if firms do anyway what would otherwise be required, requirements are superfluous.

There is an international market for accounting research about listed companies, which is catered for by papers written in English. Accounting for SMEs is of more local interest, and there is doubtless important research on the subject in languages other than English of which we are not aware. A more comprehensive survey of the literature on the subject would therefore need to look at non-English language work as well as at less recent research.¹

The structure of the remainder of this appendix is as follows.

- Section A2 draws attention to a survey of SME accounting requirements in Europe.
- Presumably because of the data problems that we refer to in the report, an unusually high proportion of research on the benefits of SME financial reporting information is based on opinion surveys. We review some of these in Section A3.
- Section A4 summarises some harder evidence on the relative accounting quality of private firms (v listed firms), although the private firms in question are usually not SMEs. In general it finds that even where they are subject to the same financial reporting requirements, private companies show lower accounting quality, which reflects the relative lack of demand they face for high quality financial reporting information. This section also includes some papers that look at private company accounting quality in isolation, ie, without comparing it to that of listed companies.

¹ With one exception all the research papers referred to in this appendix have been published since 2000. Collis and Jarvis (2000) include a review of the earlier UK literature on accounting by SMEs.



- This does not mean that SMEs derive no benefits from financial reporting or from financial reporting quality. Section A5 summarises the evidence on this (again, some of it relates to larger private companies rather than SMEs). Most of it refers to the cost of capital, which for SMEs is in practice the cost of borrowing, while one paper looks at private companies' investment efficiency.
- There are several papers looking at why firms choose to have an audit. While this does not constitute hard evidence of the benefits of audit, it suggests – assuming firms make rational choices – where benefits might be expected to be found. Two papers look at why firms choose to file or not to file full accounts (ie, to make them public). We review all these papers in Section A6.
- The utility of financial reporting information depends in part on the surrounding information environment. Section A7 draws attention to two papers looking at information that either complements or provides an alternative to financial reporting information.
- Section A8 looks at evidence on the appropriateness of the *IFRS for SMEs* for adoption in the EU.

A2. Survey of EU requirements

CNA Interpreta (2011), a consultancy report for the European Commission, is a survey of SME accounting requirements across the EU, covering 20 countries, and of opinions on them. As well as limited companies, the study covers limited and unlimited partnerships and sole proprietorships. It also gives the results of an opinion survey of users, preparers and accounting professionals.

A3. Opinion surveys on the usefulness of financial reporting information



There is conflicting evidence, based on surveys, on how far UK SME owner-managers think their statutory accounts are useful. Much of this evidence focuses on their utility (or lack of it) in running the business.

Collis and Jarvis (2000) look at, among other things, what information the owner-managers of small UK businesses use to run the business. The firms in their sample have a turnover of between £0.5m and £4.2m a year.² They find that: 'The statutory accounts of small companies are not considered to be useful in comparison with other sources of information that might be available for managing the company... The most useful sources of information for managing the company are the periodic management accounts, cash flow information, bank statements and budgets.'

Collis et al (2000), however, using a narrower sample of small companies – firms with turnover between £1.0m and £2.8m – find that the annual report and accounts are rated more highly, coming second in usefulness for management purposes behind only the management accounts. For medium-sized companies, turnover between £2.8m and £11.2m, their findings match those of Collis and Jarvis (2000), with the annual report and accounts rated as only the fifth most useful source of information.

Collis and Jarvis (2000) also find that: 'Financial reporting is seen as serving a confirmatory function and the audit report as increasing the reliability of the information contained in the accounts.' Financial reporting therefore exercises a disciplinary role in relation to the firm's management information. They also find that 69% of the companies in the sample send their statutory accounts to their bank or to other providers of finance. In addition, they find that 52% of respondents read the accounts of other companies (which are not necessarily SMEs), principally those of competitors (33%) but also those of major customers (24%) and major suppliers/creditors (15%).

Collis and Jarvis (2002), using the same sample as Collis and Jarvis (2000), also find that financial reporting information does not rate highly in terms of managing the firm, but the authors find that it plays a role, '...in the context of maintaining relations with the bank'. Other findings include that the preparation of statutory accounts creates an opportunity for the provision of advice by external accountants.

Collis (2008) is a survey of directors' views, commissioned by the UK government ahead of possible relaxations in audit and accounting requirements. The sample is of directors of small and medium-sized companies. Findings include that, '...more than half the directors (56%) considered the published accounts are useful to users. The main user groups – in the directors' opinion – are creditors (64%), credit rating agencies (62%) and the bank/lenders (46%).' On audit: 'The directors perceived the main benefits of having the accounts audited were a check on accounting records and systems (74% agreed), improving internal controls (44% agreed) and the positive effect on the credit rating score (44% agreed).'

Kitching et al (2013) obtain the views of UK SME accounts users and preparers on the filing of abbreviated accounts. Findings include that, 'Credit management professionals insisted that limited disclosure leads stakeholders to act cautiously, with adverse consequences for small companies – as seekers or beneficiaries of client orders, credit, risk-rating and credit insurance decisions. Several respondents reported that, all other things being equal, companies with known turnover and profit data, both available in statutory full accounts, would be more likely to obtain a superior credit rating than others, unless

2 In this appendix we simplify matters by referring only to turnover in defining UK small companies. In fact, as noted in the report, the statutory criteria across the EU refer to turnover, balance sheet size and the number of employees, and companies have to fall below at least two of the three thresholds to be classified as small. The thresholds have been raised periodically, so different research papers refer to different turnover thresholds, depending on when the research was done. Similar requirements, but with higher thresholds, apply in defining UK medium-sized companies.

the published figures reveal poor performance.’ On the other hand, ‘...none of the ... small company respondents reported losing customers or being unable to access sufficient finance because they filed abbreviated accounts’.

The authors stress that financial reporting requirements have benefits as well as costs. They note that: ‘Most [research] studies emphasise the burdens, costs and constraints that regulation imposes ..., which are assumed to deter start-up, investment, innovation and growth. Studies rarely consider whether regulation might enable small enterprises to act in ways that benefit them’.

The pan-European opinion survey in **CNA Interpreta (2011)** found: ‘...a generally low interest in the Survey on the part of the Respondents. Many of the Respondents declared not to make use of accounting documentation to evaluate other entities. In fact, the information deemed necessary (especially for verifying the solvency and good standing of third parties) is often acquired through alternative/additional channels (ie, commercial reports and/or banking information, etc)’.

A4. Accounting quality: evidence



Firms may produce financial reporting information but potential users will not necessarily believe it:

'I do not rely on official facts and figures. You know they are affected by the tax strategy. Asset value, work in progress, inventory – all rubbish. They are always adjusted. You know there are costs and revenues that are not recorded in the books. Entrepreneurs disclose them if you exert some pressure but you have no proof.' Bank manager lending to SMEs in north-east Italy, quoted in Howorth and Moro (2012).

A number of papers look at the accounting quality of private companies and compare it with that of listed companies. In order to make valid comparisons between the two classes of company, it could be argued that the size of firms in each category has to be matched. As a result, SMEs are often excluded from the samples of private companies. The general import of the papers' findings is that financial reporting quality is lower in private companies than in listed companies. Beatty and Harris (1998) and Beatty et al (2002) are exceptions. The authors of the first of these papers in effect suggest that listed firms engage in earnings management in order to provide the market with useful information.

A4.1 US BANKS

Several papers compare financial reporting by listed and privately held banks in the US. Banking regulation in the US means that more data is available for private companies in this sector than in others.

Beatty and Harris (1998) compare earnings management in US listed and privately held banks using data for 1991-1992. They find that '...public banks consistently engage in more earnings management than private banks'. But they also find that '...the portion of [the public banks'] current period securities gains and losses attributable to earnings management is more positively associated with next period's earnings before securities gains and losses'. This suggests that the additional earnings management by listed banks is intended to provide useful information to investors about the firms' future performance, consistent with the greater information asymmetry between managers and investors in listed v private firms.

Beatty et al (2002) compare earnings management in US listed and privately held banks using data for 1988-1998. They find that '...public banks report more small increases and fewer small declines in earnings than private banks'. They also find that '...public banks are more likely than private banks to use income-increasing discretionary loan loss provisions and realized security gains and losses to transform small declines in earnings before discretion to small increases in reported earnings'. The authors suggest that this is because the stock market tends to reward consistent earnings growth and to punish declines in earnings. Managers of private companies are unaffected by such incentives.

Nichols et al (2009) compare conditional conservatism in listed and privately held US banks using data for the period 1990-2003. They find that '...public banks exhibit greater ... conditional conservatism in accounting (the asymmetric timeliness of gain and loss recognition³) than private banks'. They also find that '...public banks record larger and timelier loan loss provisions with respect to changes in non-performing loans than private banks'.

A4.2 OTHER US FIRMS

Hope et al (2013) use a database of information on US private firms, which they note is, '...slanted toward larger private companies'. The authors compare various aspects of accounting quality in US listed and private firms for a sample covering the period 2001-2009. They find that listed firms 'have higher accrual quality and report more conservatively'.

3 That is, losses are recognised sooner than gains.

A4.3 EUROPEAN EVIDENCE

More extensive regulation of private company financial reporting in Europe means that there is more data there for comparisons between listed and private companies.

Ball and Shivakumar (2005) compare one attribute of the earnings quality of UK private companies and listed companies for a sample covering the period 1990-2000. The attribute they look at is timely loss recognition, which they find is ‘...substantially less prevalent in private companies than in public companies, despite the groups facing equivalent regulatory rules’.

Although this suggests that private company financial reporting is of lower quality, the authors emphasise that: ‘Lower quality does not imply sub-optimality because it can arise from either lower demand for or higher cost of supplying quality. Our findings thus should not be interpreted as supporting stricter regulation of financial reporting by private firms. Quite the contrary: our hypothesis is that lower earnings quality in private firms is an optimal outcome in the market for financial reporting’. This is because private companies ‘...are less likely to use public financial statements in contracting with lenders, managers and other parties, and in primary and secondary equity transactions... These differences imply a demand for lower quality financial reporting’.

Burgstahler et al (2006) compare levels of earnings management in private and listed companies from 13 EU countries for a sample covering the period 1997-2003. They find that private firms, ‘...exhibit higher levels of earnings management’.

Peek et al (2010), using data from 13 European countries for the period 1993-2000, find that listed firms show more asymmetric timeliness of gain and loss recognition than private firms. They find that this is due to the demands of creditors of listed firms. They argue that this reflects the relatively greater dependence of listed firm lenders on public financial reporting information v private, relationship-based information. The strength of creditor demand in a country is measured by the strength of the protection the country provides for creditors.

Goncharov and Zimmermann (2006), looking at a sample of listed and private Russian companies for 2001-2002, find that both types of firm manage earnings downwards to reduce taxes, but that private companies do so more than listed companies. This is consistent with listed companies having incentives for higher quality financial reporting that are absent for private companies.

Liu and Skerratt (2015) look at the earnings quality of a sample of UK companies for the period 2006-2013. The authors compare listed, large private, medium-sized, small and micro companies. Micro companies did not in fact exist as a separate legal category during the period covered by the paper, but the authors use the size thresholds subsequently introduced to identify companies as micros. The sample is restricted to companies that filed full accounts, as opposed to abbreviated accounts, and so is not necessarily representative of SMEs as a whole. Earnings quality is measured by smoothness of earnings, ie, the smoother the earnings, the lower the earnings quality.

The authors find that:

‘...the earnings of listed companies have the highest quality... This is closely followed by small and micro companies. In contrast, the smoothing behaviour of large private and medium sized companies is approximately six times as large as listed companies and four times as large as small and micro companies.’

It would be interesting to see whether similar results are obtained in other jurisdictions.



The following papers look at the accounting quality of private companies but without making a comparison with listed companies.

Income smoothing is usually seen as an indicator of low accounting quality. There is evidence that in private firms it is affected by the level of debt-finance and by different country regimes for debt financing. Using a sample of private companies from 24 European countries for the period 1998-2007, **Gassen and Fülbier (2015)** find that, '...smoothness of earnings [is] positively related,' to the extent to which firms are debt-financed. This '...relation [is] more pronounced in regimes with higher bankruptcy and contract enforcement costs.' They also find that '...earnings smoothness is related negatively to the cost of debt', ie, the smoother the earnings, the lower the cost of debt.

A series of papers shows that, in jurisdictions where this is possible, SMEs use asset write-downs to reduce their tax bills. **Garrod et al (2008)** and **Kosi and Valentincic (2013)** look at evidence from Slovenian SMEs, for 2003 and 2004-2005 respectively, **Szczesny and Valentincic (2013)** look at evidence from German SMEs. In Slovenia the tax law was changed with effect from 2005 to stop this happening. Szczesny and Valentincic (2013) also find a correlation between asset write-downs, profitability and dividend payments, suggesting that firms tend to use write-downs in more profitable years to boost earnings in other years, thereby maintaining dividend cover.

Goncharov and Zimmermann (2007), looking at a sample of Russian private companies for the period 1999-2004, find that firms manage earnings in response to banks' monitoring activities.

Bigus et al (2015) examine the effects of legal form on financial reporting using a sample of small German firms for the period 1996-2004. The sample includes incorporated and unincorporated firms (one-person businesses and partnerships). All these legal forms have to report according to German GAAP. The authors find '...significantly higher levels of income smoothing, conservatism and timely loss recognition with corporations than with one-person businesses or partnerships... In addition, corporations are more likely to disclose a small profit than one-person businesses or partnerships.'

The authors attribute their findings principally to the different positions of incorporated and unincorporated firms in relation to lenders. As lenders have recourse to the assets of the owners of unincorporated firms, but not – without additional agreed terms – to the assets of the owners of incorporated firms, the latter have stronger incentives to use financial reporting to maintain lenders' confidence and to protect lenders' interests. They do this by avoiding volatility and losses (income smoothing and small loss avoidance), yet at the same time adopting more conservative accounting, which protects lenders' interests both by reducing payouts to owners (and possibly to managers) and by alerting them in a more timely manner to potential problems at the borrower.

The logic of the authors' argument implies that the phenomena they detect among incorporated businesses should be less pronounced among those incorporated firms where lenders do have recourse to the owners' assets because the owners have provided security for the loans. It would be interesting to investigate this.

A4.4 EVIDENCE FROM TAIWAN

Before 2001 all Taiwanese private companies above a certain size (based on contributed capital, which is not a particularly good measure of a firm's size) were required to prepare and file financial statements. From 2001 this became voluntary. For the period 1997-2005 **Chi et al (2013)** compare the quality of financial reporting of listed companies, private company 'voluntary' reporters (ie, private companies that continued financial reporting after 2001) and private company 'non-voluntary' reporters (ie, private companies that stopped financial reporting after it became voluntary – at which point their financial

reporting data are therefore no longer available). The size thresholds for the private company reporting requirements mean that most SMEs would have been exempt.

The authors find that:

‘...the quality of financial reporting, based on the propensity to report small positive earnings, conservatism, abnormal accruals, earnings smoothness, and auditor choices, is higher for voluntary reporting firms than for non-voluntary reporting firms... Further, voluntary reporting firms also have better corporate governance practice than non-voluntary reporting firms. The differences in reporting quality and corporate governance translate into a lower cost of debt for voluntary reporting firms. Finally, publicly listed firms appear to have the highest reporting quality and the best corporate governance practice, and therefore the lowest cost of debt’.

The majority of the voluntary reporters in the sample were subsequently listed. So – assuming that they would have had this objective in mind for some years before they obtained a listing – this would presumably, as the authors point out, have affected their financial reporting and corporate governance choices.

A4.5 FAMILY FIRMS

Contrary to what might be expected, there is evidence from various countries that family firms (not necessarily SMEs) show higher reporting quality. ‘Family companies’ are a difficult-to-define category, and are usually defined in a way that includes listed companies where there is a dominant family. Definitions can also vary across countries. The majority of the research surveyed in **Prencipe et al (2014)**, a review paper, finds that family ownership is associated with higher accounting quality – a surprising result given the generally accepted view that the incentives for high-quality financial reporting are reduced where firms are dominated by a small group of insiders. The papers discussed by **Cascino et al (2013)**, who provide a briefer review on this particular topic, give a similar picture on balance.

Comparisons between family companies and non-family companies are easiest for listed companies, so these research findings may well not apply to SMEs, but they do at least suggest that the effects of family ownership on financial reporting are unpredictable and need to be researched rather than assumed.

A5. Benefits of financial reporting, accounting quality, and audit



A5.1 GENERAL POINTS

Financial reporting information should reduce information asymmetries between firms and their providers of finance. This should, among other things, mean that firms on average have a lower cost of capital as capital providers' uncertainties are reduced. For some firms, of course, better information will mean a higher cost of capital as their real prospects and risks become clearer.

Equity capital for SMEs is usually but not necessarily provided by insiders and we are unaware of any research relating its cost to the availability of financial reporting information.

The major practical financing issue for SMEs seems to be the availability and cost of debt, and there are a number of research papers, which we summarise below, looking at the relationship between financial reporting and the cost of debt for SMEs. Where financial reporting information is unavailable or of low quality, we may expect (as noted at Section 1 of the report) that lenders and borrowers will develop alternative sources of information, eg, through informal relationships. Lenders are also likely to compensate for information deficiencies in various ways: a higher rate of interest is one way of doing so, but collateral requirements, shorter loan maturities, and tougher monitoring are others. Cost of capital is therefore only one aspect of the question.

Incidentally, 'relationship' banking, an important alternative to banking based on financial reporting information, does not necessarily reduce the cost of borrowing. Firms in such relationships may well be exploited by their banks, which take the opportunity to charge them a higher rate of interest. See, eg, **Hernández-Cánovas and Martínez-Solano (2010)**.

A5.2 COST OF CAPITAL: US EVIDENCE

US firms, unless they come within the SEC's requirements, are in general not required to prepare financial statements, but many do so voluntarily. **Allee and Yohn (2009)** look at a sample of small private firms in the US for 2003-2004. Small firms are defined as those with fewer than 500 employees (by comparison, the EU limit for SMEs is 250 employees). The firms in the sample are not all limited companies. The number of limited companies in the sample is not stated, but the proportion with some form of limited liability (ie, limited liability companies and limited liability partnerships) is 52%.

For the sample as a whole, only 20% of firms prepare financial statements. For limited liability firms, the proportion is not stated, but appears to be only 25%. And 'financial statements' are not what they might be assumed to be as only 49% of the firms that prepare financial statements do so using accrual accounting; the majority (by a small margin) presumably do cash accounting. The authors find that interest rates for '...firms that issue accrual-based financial statements are almost 70 basis points lower than the rates for other firms'.

For US private companies (not necessarily SMEs) that voluntarily choose an audit, this choice is also associated with higher accounting quality and lower borrowing costs. **Minnis (2011)** looks at whether providing voluntarily audited financial statements affects the cost of borrowing for US private companies. He finds that '...firms with audited financial statements have a significantly lower cost of debt by 69 basis points'. He also finds that: 'The expertise (and independence) extended by third party accountants appears to be particularly fruitful in the accrual estimation process as I find evidence that accruals are better predictors of future cash flow for audited firms.'

A5.3 COST OF CAPITAL: UK EVIDENCE

There is evidence that UK SMEs that voluntarily choose an audit have higher accounting quality and higher credit rating scores. These should translate into a lower cost of borrowing, although the two papers below do not investigate this.

Lennox and Pittman (2011) look at the signalling effect of retaining or not retaining an audit for firms where the audit requirement is removed. Their sample is UK firms with turnover between £1.0m and £5.6m, for which the audit became voluntary in 2004; firms that file abbreviated accounts are excluded. They look at the effect of the change on third-party credit ratings, which use a 100-point scale.

The authors find that: 'After auditing becomes voluntary, the companies that remain audited receive a two-point boost to their ratings, while unaudited companies suffer a four-point reduction'. Assuming that the audit itself remains substantially unchanged for those companies that retain it, the implication is that '...these companies enjoy ratings upgrades because their decision to remain audited conveys an incrementally positive signal about their credit risk'. For companies that abandon the audit, however, the ratings downgrade reflects two things: '...the decision to abandon the audit not only communicates that the company is likely to be a high-risk type of borrower but also sacrifices the assurance that had been provided under the mandatory regime'. The authors argue that the presence of an audit requirement prevented firms from signalling their quality via their audit choices.

Lennox and Pittman (2011) also find that '...the opt-out companies were only passively complying with the audit requirement – evident in their attempts to reduce costs through auditor choice and fees – under the mandatory regime'. This parallels the findings of Ball and Shivakumar (2005) regarding reporting quality and perhaps might also be seen as an optimal outcome under a regulatory regime, rather than as an indication that tougher regulation is required. It also suggests that there was at least some signalling of quality even in the presence of an audit requirement.

Dedman and Kausar (2012) also look at small UK firms that became eligible for exemption from the statutory audit requirement in 2004. The sample excludes companies that filed abbreviated accounts. The authors find that '...firms which retain the audit enjoy significantly higher credit [rating] scores than those which opt out of audit', even though the opt-out firms report higher profits. In addition, they find that '...Opt-out firms recognise income-increasing events more quickly and income-decreasing events more slowly than audited firms. Similarly, opt-out firms report lower levels of income-decreasing accruals and higher levels of income-increasing accruals, than those firms which retain the audit'. The authors suggest that the difference in accounting quality may explain why opt-out firms report higher profits but get lower credit rating scores.

A5.4 COST OF CAPITAL: BELGIAN EVIDENCE

Van Caneghem and Van Campenhout (2012) do not measure cost of capital, but their findings are arguably relevant to it. They look at data for Belgian private company SMEs for 2007. They find that '...both information quantity and quality are positively related to SME leverage'. Information quantity is measured by whether a firm files full or abbreviated accounts. Information quality is measured by a range of factors related to whether the firm has an audit, whether its auditor is a Big Four firm, whether the audit opinion is unqualified and, curiously, whether it would be **likely** to have an audit voluntarily and whether it would be **likely** to have a Big Four auditor.



Although the study does not look at the cost of capital, the authors comment that their findings are ‘...consistent with [SMEs with higher information quantity and quality] having lower cost of external capital’. The logic behind this assertion, based on measurements of leverage, is that firms would not have relatively high leverage unless their cost of borrowing was relatively low.

Vander Bauwhede et al (2015) look at data for Belgian private company SMEs for the period 1997-2010. They find that higher accruals quality is associated with lower borrowing costs. Indeed, ‘...the effective interest cost of an SME at the 10th [accruals quality] percentile is on average 194.9 basis points higher than the effective interest cost of an SME at the 90th [accruals quality] percentile’.

The authors’ note that their findings relate to ‘...a context that might be characterized by relationship lending,’ and comment that:

‘...to the extent that flexibility in accounting rules impairs the quality of financial reporting, our findings could be interpreted as a call for stricter accounting regulation with less managerial discretion as this may support SMEs in their struggle to obtain bank loans at lower rates.’

A5.5 COST OF CAPITAL: FINNISH EVIDENCE

Karjalainen (2011) looks at a sample of Finnish private companies for the period 1999-2006. He finds that perceived audit quality, indicated by Big 4 audits and audits with more than one responsible individual identified, are associated with a lower cost of debt capital. He also finds that, ‘...firms with modified audit reports and those with lower-quality accruals have a higher cost of debt capital.’

A5.6 COST OF CAPITAL: SLOVENIAN EVIDENCE

Rather different findings emerge from **Koren et al (2014)**. The authors look at a sample of small (but not micro⁴) Slovenian companies for the period 2006-2010. They find that, ‘...after controlling for obvious sources of demand for voluntary audits (ownership complexity, subsidiary status, bank relations)...voluntary audits increase rather than decrease the cost of debt financing.’ This suggests that voluntary audits may not be credible, and that the decision to have one perhaps sends a signal of poor quality where there is no ‘obvious source of demand’ for them. It would be interesting to see whether similar results are to be found in other jurisdictions.

Koren et al (2014) also find that, ‘Earnings quality analyses show that small private firms with higher-quality financial statements are better able to predict future cash flows. These firms do not have their financial statements audited’.

A5.7 COST OF CAPITAL: TAIWANESE EVIDENCE

As reported earlier, **Chi et al (2013)** find that Taiwanese private company voluntary reporters have a lower cost of debt than non-voluntary reporters.

A5.8 ACCESS TO CAPITAL: INTERNATIONAL EVIDENCE

Hope et al (2011) look at a sample of private companies from 68 companies, using World Bank opinion survey data for 2002-2005. They do not look at the cost of capital, but find that ‘...firms with greater financial reporting credibility (ie, annual financial statements reviewed by an external auditor) experience significantly lower perceived problems in gaining access to external finance’.

4 The paper uses the subsequently introduced thresholds in classifying companies as micros.

A5.9 INVESTMENT EFFICIENCY

There is some evidence that higher accounting quality in private firms is correlated with higher investment efficiency. **Chen et al (2011)** look at financial reporting quality and investment efficiency in private firms in emerging markets. Their sample is 6,727 firm-years for firms from 21 countries – more than 50% of the sample is from Brazil, Pakistan, Thailand and Vietnam – for the period 2002-2005. Investment efficiency is measured by looking at ‘...deviations from expected investment using a model that predicts investment as a function of growth opportunities’. The greater the deviation from the expected level of investment, the less the deemed investment efficiency.

Their evidence ‘...suggests that [financial reporting quality] positively affects investment efficiency’. They also find that: ‘...greater use of bank financing increases the role that accounting information plays’ and that ‘for firms in which tax incentives are likely to dominate incentives to provide useful information for internal decision making as well as a source of information for outside providers of capital, the informational role of accounting is significantly diminished.’

A5.10 AUDIT AND ACCOUNTING QUALITY

Audits should lead to higher financial reporting quality, which should ultimately lead to other benefits, in particular for SMEs a lower cost of borrowing. As noted above, a connection between audit or perceived audit quality and lower borrowing costs or higher credit ratings or better access to external finance is found by Minnis (2011), using US evidence, by Lennox and Pittman (2011) and Dedman and Kausar (2012), using UK evidence, by Karjalainen (2011), using Finnish evidence, and by Hope et al (2011), using international evidence. Van Caneghem and Van Campenhout (2012), using Belgian evidence, find a positive association between various factors related to audit, which they use as a proxy for information quality, and higher leverage, which they argue should indicate lower borrowing costs. Koren et al (2014), using Slovenian evidence, have somewhat contrary findings.

Another paper, using data for UK SMEs, finds a connection between audit and financial reporting quality. **Clatworthy and Peel (2013)** look at the most recent filings available as at April 2010 of a sample of over a million UK small companies (turnover less than £6.5m) and look at the relationship between having an audit and the filing of revised accounts, which implies an error in the originally filed accounts. Their evidence ‘indicates that small private firms filing unaudited accounts are approximately twice as likely to file defective annual accounts as their counterparts opting to have their accounts audited.’ They also find that only 15% of the firms in their sample opt to file full (as opposed to abbreviated) accounts and only 3% opt to have an audit.

Liu and Skerratt (2015), referred to earlier in relation to accounting quality, also look at the relationship between audit and earnings quality for small and micro companies. Over the sample period 2006-2013 as a whole ‘...the results indicate that earnings quality is much the same for both audited and unaudited financial statements’. As noted above, their sample excludes companies that file abbreviated accounts. The authors also find a declining proportion of companies opting to have an audit. For small companies excluding those that would later be classifiable as micros, the proportion having an audit fell from 50.6% in 2006 to 9.5% in 2013. For micros, it fell from 47.3% in 2006 to 4.5% in 2013.

A6. Determinants of voluntary audit and public filing choices



A6.1 AUDIT

Several papers look at the determinants of choices to have an audit, which should indicate where benefits of an audit are likely to be found.

Collis et al (2004) do not look at actual choices, but at what choices directors say they would make if given the chance. The authors ask directors of small UK companies (turnover between £0.5m and £4.2m) required to have an audit at the time of the survey (1999) whether they would opt to retain it if given the choice, and investigate correlations between their stated choices and various potentially related factors. The authors find that ‘...63% of the sample companies would choose to have a voluntary external audit’ and that the most important explanatory factor is, ‘...perceptions of benefits, as measured by the directors considering that the audit improves the quality of the information and/or provides a check on internal records’.

The smallest firms in the sample in **Lisowsky and Minnis (2013)** would be too large to qualify as small in the EU, but some of them would qualify as medium-sized. The authors look at US private firms with total assets of over \$10m. They find that while 79% follow US GAAP, only 37% prepare audited US GAAP financial statements. They also find that ‘...firms with audited GAAP financial statements have greater ownership dispersion and debt levels, complementing prior evidence that external capital providers demand audited GAAP financial statements’.

The authors also find that ‘...profitable, older firms with tangible assets attract external capital without an audit’. The corollary to this is that ‘...younger, growth opportunity firms with intangible assets are those most likely to begin an audit,’ ie, to have an audit voluntarily for the first time.

Dedman et al (2014) look at UK SMEs’ choices on whether to have an audit, covering the period 2004, when the firms in the sample first became exempt from the statutory requirement to have an audit, to 2006. They find that: ‘...companies are more likely to purchase voluntary audits if they have greater agency costs,⁵ are riskier, wish to raise capital, purchase non-audit services from their auditor, and exhibited greater demand for audit assurance [ie, paid more for audit] in the mandatory audit regime.’ They also ‘... document a trend away from audit over time’.

A6.2 AUDIT AND FILING

In the UK, for SMEs that meet the relevant size requirements, firms have choices not only whether to have an audit but also whether to file publicly full or abbreviated accounts. The following paper examines the determinants of both these choices.

Collis (2012) looks at small and micro UK private companies (turnover less than £6.5m and less than £0.62m respectively⁶) to assess which factors determine why companies of this size, for which both audits and full disclosure of accounts are voluntary, choose to have an audit and to publicly disclose full accounts, rather than abbreviated ones. On audit, the author finds that, ‘The most powerful determinant of voluntary audit in non-micro small companies is turnover... The most powerful determinant of voluntary audit in micro-companies is taking the [external] accountant’s advice’. On disclosure, she finds that: ‘The most powerful determinant of voluntary full accounts in non-micro small companies is the view that disclosing turnover is not a major disadvantage... The most

5 The managers of a business act as agents for its owners, their principals. The harder it is for the owners of a business to control its managers, the higher agency costs are likely to be. Agency costs include unauthorised gains made by managers at the owner’s expense, and the costs of monitoring to try to ensure that managers act in the owners’ interests. Dedman et al (2014) use measures of firm size, complexity, leverage, ownership dispersion and board size as indicators of agency costs.

6 The paper uses what were expected to be the subsequently introduced thresholds in classifying companies as micros. The actual turnover threshold in the UK turned out to be slightly different: £0.632m.

powerful determinant of voluntary full accounts in micro-companies is that the company has a voluntary audit.'

A6.3 FILING

Dedman and Lennox (2009) look purely at the filing choices of UK medium-sized private companies, using data obtained in 2006, covering financial years ending mainly in 2004 or 2005. They find that '...private companies withhold information from the public domain when gross profits are higher and when managers perceive that their markets are more competitive'. They comment that '...our evidence is consistent with the view that successful companies maintain comparative advantage by hiding proprietary information from their rivals'.

But giving away information to competitors is an issue even for private disclosures made in the context of relationship banking:

'I don't want to give all the information about my firm, my strategy, new products and plans because I suspect that the bank manager can transfer this to my competitors.' SME entrepreneur in north-east Italy, quoted in Howorth and Moro (2012).

A7. Alternatives and complements to financial reporting



In analysing the costs and benefits of an information source it is important to understand its context, including alternative and complementary sources. Two recent studies do this in relation to bank loans to small US firms. Information about borrowers is useful to banks:

- in making the lending decision; and
- subsequently, in monitoring the loan.

The first study looks at the lending decision, where credit scores are both an alternative and a complement to financial reporting information, the second looks at monitoring the loan, where tax returns are both an alternative and a complement to financial reporting information.

Cassar et al (2015) look at bank lending decisions to small US businesses (fewer than 500 employees) that are not required to use accrual accounting. They can therefore test whether using accrual accounting rather than cash accounting affects banks' lending decisions. The sample is lending decisions affecting firms included in a 2003 small business finance survey. The median firm size in terms of total assets is \$144,544 (which would qualify as micro under EU criteria), and 92% of the firms are owner-managed.

The authors:

'...find little evidence that accrual accounting reduces the likelihood of loan denial; however, higher credit scores [prepared by third parties] are negatively associated with loan denial, suggesting that the information contained in these scores is used in the initial decision to accept or deny the [loan] application, while the incremental information from accrual accounting has little influence on this decision. In contrast, we find accrual accounting is negatively associated with the initial interest rate on approved loans' [ie, accrual accounting is associated with lower interest rates].

However:

'Further analyses suggest that accrual accounting only has a significant influence on interest rates in firms that have weak credit scores and short relationships with the lender... Moreover, any interest rate benefits from the alternative information sources appear to be eliminated when the borrower pledges collateral.'

Minnis and Sutherland (2015) use a US database of information about relatively small bank loans to firms. The data were obtained in 2012, but 39% of the loans originated prior to 2010. The average loan size is \$232,835; the median \$100,000.

The authors find that '...banks request financial statements for 51% of the loans in the sample ... 24% of those are for interim financial statements (the other 76% are annual financial statement requests).' They: '...find an inverse U-shaped relation between financial statements requests and borrower risk – that is, banks most frequently request financial statements from firms with middle tier credit risk, while firms with either high or low credit risk receive significantly fewer financial statement requests.' They suggest that this supports the hypothesis that:

'...the behavior of **low** risk borrowers is constrained by the value of their reputation, thus reducing the benefit of monitoring these borrowers. In contrast, for **high** risk borrowers, monitoring is an inadequate disciplining device because they have little reputation to lose, leading lenders to rely instead on credit rationing and price protection... The cost-benefit of monitoring borrowers is [therefore] highest for middle-risk borrowers.'

Minnis and Sutherland (2015) also find that banks request business tax returns for 43% of their sample. While, as might be expected, ‘...requests for a firm’s tax returns are negatively associated with requests for a firm’s financial statements’ – ie, if banks ask for one of these, they do not usually ask for the other – the authors also find that:

‘...banks are more likely to request **both** financial statements and tax returns when monitoring the borrower is most cost-beneficial (eg, a short or complex relationship or a middle tier credit risk). In other words, the implicit government monitoring of tax returns provides a complementary verification channel for financial statements.’

As noted in the report (Section 1), relationships between lender and borrower are also alternative sources of information for lenders.

A8. IFRS for SMEs



A small amount of research is designed to cast light on the appropriateness of the *IFRS for SMEs*. Both the studies below refer to its possible adoption in the EU.

Fülbier and Gassen (2010) consider the pros and cons of possible adoption of the *IFRS for SMEs* by the EU. They argue that for private firms, the valuation role of financial reporting information is less important than for listed firms and the contracting role correspondingly more important.

The authors take income smoothing to be evidence of a demand for information for contracting purposes. Using a sample from 28 European countries over the period 1991-2008 (mainly 1998-2007), they find that ‘...the income smoothing behaviour of European private firms is shaped by competing incentives: creditors demand more, owner-managers prefer less income smoothing. Besides these firm-level incentives, country-wide determinants also have a direct and significant impact on the equilibrium level of income smoothing. Firms in countries with a strong tax link between financial and tax accounting report significantly smoother earnings streams.’ These and other findings lead the authors to conclude that the ‘...heterogeneous demand [for financial reporting information] makes the benefits of a Europe-wide adoption of *IFRS for SMEs* highly questionable’.

Centre for Strategy and Evaluation Services (2010) is an opinion survey, compiled by a consultancy, on prospective relaxations of the EU accounting directives and the possible adoption of the *IFRS for SMEs*. It shows, among other things, the differing perspectives of users and preparers, with preparers identifying potential cost savings and lenders indicating on more than one point that if information is not required to be disclosed, they will ask for it anyway. The findings do not point to any overall conclusions on the desirability of the proposed changes. On some issues the answers indicate that reduced or increased disclosure requirements have a greater effect on costs the smaller the company, which is what might be expected. Interestingly, though, this is not true for all proposed changes; this may be because some disclosures are particularly relevant to larger companies, so smaller firms would be less affected by these potential changes to the requirements.

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