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How owner-managers use accounts

Jill Collis and Robin Jarvis
Kingston University

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Jill Collis
Robin Jarvis
Kingston University

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Introduction

Small businesses play a significant role in the UK economy, as 99% of active businesses are small firms (DTI, 1999c). This study focuses on small incorporated businesses in a wide range of industries in the UK, and the utility of the statutory audited accounts to the management of the business. A survey was designed to obtain the views of the principal directors, who previous research (Page, 1981, Carsberg, Page, Sindall and Waring, 1985; Barker and Noonan, 1996; Dugdale, Hussey and Jarvis, 1998) identifies as the main users of small company accounts.

After preliminary interviews, a postal questionnaire was sent to a systematically selected sample of 2,288 companies. Although the sampling frame did not include businesses with a turnover of less than £0.5m, in all other respects the sample was representative of companies that fall within the current EU definition of 'small'. A total of 385 usable replies were received and there was no evidence of response bias. This permits the results to be generalised the population of similar sized companies. The data was analysed statistically using SPSS for Windows.

The research is set in the context of a number of debates that reflect the dynamic financial reporting environment of the 1990s. One concerns financial accounting theory and the need for a set of coherent underlying principles, which has resulted in the publication of the Statement of Principles for Financial Reporting (SoP) (ASB, 1999a). The SoP seems to be based on the needs of investors in large, public companies, for whom the statutory accounts serve a stewardship function. However, the agency relationship (Jensen and Meckling, 1976) between shareholder and manager that is present in large companies is seldom significant in small companies, the majority of which are owned and controlled by the same individuals (Bolton, 1971; Carsberg et al, 1985; Poutziouris, Chittenden and Michaelas, 1998).

Another major difference between large and small companies lies in the financial strategies they pursue. Whereas profit-maximisation and growth are likely to be the main aims of both shareholders and directors of large companies, small companies are more likely to pursue satisficing (Simon, 1960) or 'lifestyle' strategies in pursuit of survival and stability (Jarvis, Kitching, Curran and Lightfoot, 1996). This raises further questions about the utility to small companies of financial statements prepared according to a large company template.

Since the ASB was established in 1990 there has been an increase in the volume and complexity of reporting requirements, which has led to an escalation of the Big GAAP/Little GAAP debate and a gradual relaxation in small company reporting. The main changes allow qualifying small and medium-sized companies to adopt options that simplify, abbreviate or otherwise reduce the amount of information disclosed. In addition, of the smallest companies are exempt from the statutory audit. These developments have implications for the 'relevance' and 'reliability' of the financial statements, which the SoP identifies as the primary characteristics of accounting information that is useful to users.

In 1999 the DTI put forward a proposal to increase the turnover threshold that permits small companies to file abbreviated accounts and adopt the FRSSE from £2.8m to £4.2m, and increase the balance sheet total from £1.4m to £2.1m. In addition, it was proposed that the turnover threshold for audit exemption should be raised from £350,000 to a possible maximum of £4.2m[1] in order to reduce the disproportionate burden placed on small companies. However, deregulation is taking place without detailed and up-to-date knowledge of the needs of the directors of small companies or the perceived benefits of financial reporting.

Characteristics of the sample companies

Most small companies are at the smaller end of the scale:

- 62% have a turnover of under £1m (max. £4.2m); 49% have total assets of under £0.5m (max. £2.1m) and 52% have 10 or fewer employees (max. 50).
- 31% have been incorporated for up to 10 years, 33% between 11 and 20 years and 36% for more than 20 years.
- Small companies are found in all regions of Great Britain, with the highest density (43%) in London and the South of England. They have primary activities in a wide range of industries and are almost evenly represented in service industries (48%) and non-service industries (52%).

Key findings

Benefits and costs of meeting financial reporting requirements

- The directors of small companies see the main benefit of financial reporting as the confirmation and verification of the annual financial results and this view is associated with companies with a turnover of £1m or above.
- The main disadvantage of financial reporting is the cost, in monetary terms as well as in terms of time and inconvenience. This view is associated with owner-managers of companies with a turnover of under £1m. The disclosure of information that may be useful to competitors does not feature as a perceived disadvantage of financial reporting. This may be an indication that current reporting options offer sufficient protection to those who do not wish to provide full information.
- Contrary to the findings of previous research (Keasey and Short, 1990), these results show that size of the company is significant factor in the cost/benefit debate. However, the situation is complex, as the results show that the majority of directors identify both costs and benefits to financial reporting.

[1] Since this study commenced these thresholds have been extended further (see Chapter 1).

Reasons for the financial reporting choices made

- The main reasons for filing full accounts is to fulfil statutory requirements or because the directors are following their accountant's advice. A small proportion file full accounts because they have always done so or because they actively want to make full disclosure.
- The main reasons given for filing abbreviated accounts is that the directors wish to disclose the legal minimum, thus preserving commercial confidentiality.
- Whether they choose to file full or abbreviated accounts, a significant proportion of directors do so on their accountant's advice.
- Cost benefits were cited as reasons for filing both full accounts and abbreviated accounts, but only by a minority of respondents. Although the deregulatory debate is strongly focused on relieving cost burdens, these results show that cost is not a major factor in the filing choices of small companies.
- The majority of owner-managers are uncertain about whether to adopt the FRSSE and intend to seek their accountant's advice before deciding. This shows that it is too soon to assess the popularity of this latest development of 'Little GAAP', but highlights the importance of the guidance given by practitioners on the financial reporting choices available.

Utility of the audit report

- Directors consider the audit report on their own accounts is more useful than the audit report on the accounts of other businesses. However, this finding is related to the fact that only about half of the directors read the accounts of other businesses, such as their major competitors, customers and/or suppliers/creditors.
- The audit report is mainly perceived as improving the credibility and quality of the information, and providing a check on internal books and records; thus adding to its reliability. The majority of directors perceive sufficient benefits in having their accounts audited that they would opt to do so on a voluntary basis. These companies have an average turnover of £1.3m. Therefore, it would appear that the government's proposal to raise the audit threshold from £350,000 to a possible maximum of £4.2m would only be seen as a benefit by the very smallest companies.

Factors that influence the utility of the statutory accounts

- Financial reporting is seen as serving a confirmatory function and the audit report as increasing the reliability of the information contained in the accounts. Since the majority of small companies would continue to have their accounts audited, one of the main factors that influences the utility of the financial statements would appear to be the regulatory requirements to publish audited annual accounts.
- Only a small number of respondents offered opinions on current levels of disclosure in the statutory accounts. The most commonly cited view was that more detailed financial information should be given in the accounts of their own and other businesses. This implies that commercial confidentiality may be of less importance in some cases than the needs of management.
- A small proportion of directors believe that financial and personal information relating to the directors should be confidential. This may indicate that that some companies are not aware

that the Companies Act permits small companies to file abbreviated accounts and omit certain information relating to directors' emoluments from the notes to the accounts (SI 1997/220 as amended by SI 1997/570).

- The average time lag from year-end to receipt of the accounts of 17 weeks for the statutory accounts and 15 weeks for any the additional detailed accounts provided. In contrast with large companies, there was no indication that increased timeliness would improve the utility of the statutory accounts to the directors. This result seems surprising in view of the confirmatory role played by the statutory accounts, but may be connected with the purposes for which the accounts are put (see below).

The relative utility of the statutory accounts

- 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. This is not surprising, since financial reports are designed to provide information that is useful to a wide range of users (ASB, 1999a) and have been developed from a large company perspective where investors' needs are paramount.
- The statutory financial statements are received as part of a package of annual information, and the majority of the directors receive management advice or further analysis at the same time. More than a third of small companies also receive additional detailed annual accounts.
- The most useful sources of information for managing the company are the periodic management accounts, cash flow information, bank statements and budgets. The majority of small companies use management accounts and bank reconciliation statements on a monthly basis; in addition, up to half use cash flow forecasts and budgets at least quarterly.
- The majority of small companies have a computerised or partly computerised accounting system and this is positively associated with the frequency of availability of management information.

Ways in which the statutory accounts are used in managing the company

- The most useful purposes of the annual accounts are deciding directors' remuneration, comparing performance with previous periods and in connection with loans/finance. The view that the statutory accounts are useful for deciding directors' remuneration is associated with directors who find them useful for management purposes and companies where there is more than one executive director.
- Apart from the Registrar of Companies and shareholders, owner-managers send the statutory accounts to a number of external parties. The main non-statutory recipients are the bank and other providers of finance, the Inland Revenue and management.
- Companies whose directors send their accounts to the bank are those who consider the statutory accounts are useful for management purposes, would opt for a voluntary audit, have a turnover of £1m or above and primary activities in non-service industries. These results extend the findings of previous research (Carsberg et al, 1985) by providing evidence of a positive association between the utility of the accounts to management and bank borrowing. This supports the notion of an agency relationship between the directors of small companies and the bank.

Conclusions and recommendations

The main focus of the current deregulatory trend is on relieving burdens for small companies and cost is the main argument put forward for increasing the threshold under which smaller entities become eligible for concessions. The results of this study demonstrate that this step would be advantageous for companies at the smaller end of the scale. However, the regulators seem to have overlooked the perceived benefits in their search to unpack what they see as the regulatory burden.

Previous studies identify the directors of small companies as an important beneficiary of the production of the statutory accounts. The results of the present research reveal new insights into the reasons why this is the case. Whilst the main objective of financial reporting by large companies is to assess the stewardship of management, this is not the case in small companies. This study demonstrates that the stewardship function is largely absent in small companies. Instead, the accounts appear to play an agency role between the owner-manager and the bank.

Whilst the statutory accounts of large companies are prepared with the needs of investors in mind, the main benefit of financial reporting by small companies is confirmation and verification of the results. This, in turn, relates to the main uses of the accounts of small companies, which are in connection with directors' emoluments, comparison with previous periods and to support borrowing.

The results of this study should ensure that the development of the conceptual framework for financial reporting is not influenced by past or future armchair empiricism. The study also contributes to the Big GAAP/Little GAAP debate by providing empirical evidence of the needs of the directors of small companies. The findings will be of interest to those involved in policy formation and the regulation of financial reporting, practitioners and their small business clients as well as academics in accounting and small business fields. This is reflected in the following recommendations:

- Further changes in the regulation of financial reporting by small companies should take account of the fact that there are both costs and benefits to the directors of small companies, who are the main users of the accounts.
- The present Companies Act threshold of £2.8m already captures 80% of companies under £4.2m and this should guide future changes to size thresholds that are not related to indexation.
- Those responsible for regulation should be wary of using a large company template to examine the needs of small companies. It may be more appropriate to examine the process of how owner-managers use the statutory accounts and this could result in a conceptual framework for small company reporting.
- In the complex, rapidly-changing environment of 'Little GAAP', it is important that accountants keep up to date with developments, as the directors of small companies rely on them for advice on the various financial reporting options available to them.

- Because the directors of small companies rely on professional guidance from their accountant regarding financial reporting options, further research should be conducted with practitioners regarding the relevance of current and future concessions.
- If the audit exemption threshold is raised, it should be recognised that companies with a turnover of more than £1.3m would wish to have their accounts audited on a voluntary basis.
- Small companies should be encouraged to establish computerised accounting systems to generate periodic management accounts, cash flow information and bank reconciliation statements.
- Further empirical evidence is required from members of the accountancy profession, as they are in a strong position to provide feedback on how well 'Little GAAP' is working for small companies.
- Further qualitative research should be conducted with the directors themselves, and their accountants, to gain further insights into how, when and precisely what information in the statutory accounts is used, what further information they would find useful and the reasons for not wishing to disclose certain information.

Chapter 1 Background to the study

1.1 Introduction

This study focuses on small companies which, together with other forms of small business, play a significant role in the British economy. The importance of small businesses is such that the government refers to them as the 'engines for growth' in the economy. Latest figures from the DTI (1999c) show that at the start of 1998, there were an estimated 3.7m active businesses in the UK. Of these 99% were small firms,[2] which accounted for 45% of non-government employment and 38% of total turnover.

Financial reporting by all companies, regardless of size, is governed by a regulatory framework, which has evolved with the needs of large, public companies in mind, despite the fact that only 1% of companies do fall into this category (DTI, 1998). The main purpose of financial reporting is to provide information 'for assessing the stewardship of management and for making economic decisions' (ASB, 1999a, p. 23). The stewardship role of corporate reports 'places an obligation on stewards or agents, such as directors, to provide relevant and reliable financial information relating to resources over which they have control but which are owned by others, such as shareholders' (Hussey, 1995, p. 313). However, as most small enterprises are managed by their owners (Bolton, 1971; Carsberg, Page, Sindall and Waring, 1985), there is seldom any divorce between ownership and control. Therefore, it is difficult to assert that the financial statements of small companies fulfil an agency role.

Previous research shows that in the case of small companies the owner-managers are the main users of the annual accounts (Page, 1981; Carsberg et al, 1985; Barker and Noonan, 1996; Dugdale, Hussey and Jarvis, 1998), but there is little detailed evidence of the uses (Jarvis, 1996) or the factors that affect the utility of the financial statements to management. This gap in the literature is of particular importance at the present time when the regulators are concerned to lift the burden of financial reporting on small companies and the Accounting Standards Board (ASB) is developing a conceptual framework for corporate financial reporting.

The aim of this study is to remedy the deficiency in the literature by providing empirical evidence of the views of the owner-managers of private limited companies on their use of the statutory accounts. The research took the form of a survey with a view to generalising from the results and focused on companies with a turnover of between £0.5m and £4.2m, a balance sheet total of £2.1m and up to 50 employees. This allowed opinions to be collected from those whose companies currently fall within the definition of 'small' under UK law, as well as those that would be reclassified as 'small' if thresholds are raised to EU levels.[3]

The study is set within the context of the general trend towards the deregulation of financial reporting by small companies in the UK, and this chapter reviews these developments. The chapter commences with an overview of the regulatory framework as it applies to unlisted,

[2] Defined as those with under 50 employees.

[3] Since the research commenced the proposed maxima have been increased as a result of indexation to £4.8m turnover and £2.4m balance sheet total (DTI, 2000).

private companies. This is followed by an examination of specific aspects of company legislation and accounting standards that provide concessions to small companies in terms of filing choice, audit exemption and application of accounting standards. The final section outlines the structure of the remainder of the report.

1.2 Overview of the regulatory framework

In the UK, the generally accepted accounting principles (GAAP) that form the regulatory framework comprise both mandatory and non-mandatory elements. The key elements are company legislation, accounting standards, the pronouncements of the Urgent Issues Task Force (UITF) and Stock Exchange Listing Rules (for listed companies only).

All incorporated bodies (except some unlimited companies) have a legal obligation to file a copy of their annual report and accounts or abbreviated accounts with the Registrar of Companies. Thus, the statutory accounts of limited companies, regardless of size, are public documents. Since the first mandatory requirement that companies present a balance sheet to shareholders introduced by the Companies Registration and Regulation Act 1844, there has been steady pressure on companies to increase the amount of information they disclose. This pressure has come from company legislation and from accounting standards.

The Companies Act 1985 (as amended by the Companies Act 1989 and subsequent statutory instruments) lays down the broad requirements and format of the financial information that must be disclosed by both public and private limited companies. The details of how and what should be disclosed are contained in the accounting standards. Accounting standards apply to all financial statements intended to give a true and fair view of the financial position and of the profit or loss for the period of the reporting entity[4]. As there is no legal definition of the term 'true and fair view', this concept can only be interpreted by the courts.

Accounting standards have proliferated since the establishment in 1970 of the first standard-setting body the Accounting Standards Committee (ASC) and its successor, the Accounting Standards Board (ASB), in 1990. Accounting standards offer a number of benefits to users since they ensure the disclosure of more financial information than is required by legislation alone, as well as providing information about the basis on which the accounts have been drawn up. This allows inter-company comparisons to be made and the results for one accounting period to be compared with another. The main disadvantage of accounting standards is that they impose additional work and, therefore, additional costs in producing the accounts. It is widely considered that this imposes a disproportionate burden on small companies. From the standard setters' point of view, there is also the problem of deciding which accounting method is appropriate for all companies in all circumstances and in all industries.

Prior to the Companies Act 1981, companies in the UK were governed by identical financial reporting and disclosure requirements, regardless of size, industry or public interest. However, a number of interested parties began to question whether it is equitable to expect smaller, owner-managed and/or private companies to be burdened with the extensive range of reporting

[4] This includes UK sole traders, partnerships and companies, as well as overseas entities incorporated in the UK.

requirements that govern and are relevant to large (often multinational) companies. This gave rise to the so-called 'Big GAAP/Little GAAP debate' which focuses on the question of whether small companies should be exempt from some aspects of GAAP. The nub of the debate lies in the difficulty in determining 'the criteria that should be used to exempt companies, as well as widespread concern that accounts that do not comply with accounting standards would not present a true and fair view of the company's activities' (Hussey, 1995, p. 213).

In various forms, differential reporting has existed for many years.[5] For example, financial reporting requirements for public companies differ from those that apply to private companies and it is widely accepted that they are more demanding for public companies than for private companies. In addition, the adoption of the provisions of the EC Fourth and Seventh Company Law Directives in the UK, through which the disclosure requirements for large, medium-sized and small companies have been varied, already allow small companies more extensive exemptions in recognition of the cost implications and the need for different levels of privacy.

1.3 Company legislation

Under the Companies Act 1985 a company may qualify as small if it satisfies any two of the three conditions shown in Table 1.1 during the financial year. In 1999 the government announced proposals (DTI, 1999a) to raise these thresholds by as much as 50% to bring them in line with levels permitted under EC Directive 94/8/ED, which amends the EC Fourth and Seventh Directives. These proposals could result in approximately 11,000 medium-sized companies being reclassified as small (Jarvis, 1996).

Table 1.1
Current size thresholds for small companies

	Current UK levels	**Maximum EU levels[6]**
Annual turnover not exceeding	£2.8m	£4.2m
Balance sheet total not exceeding	£1.4m	£2.1m
Average number of employees not exceeding	50	50

In addition to satisfying basic size tests, companies must also meet other qualification criteria. Banking companies, insurance companies and authorised persons under the Financial Services Act 1986 are excluded on the grounds of public interest.

In 1997 the DTI amended the Companies Act 1985 (SI 1997/220) by introducing a revised Schedule 8 and a new Schedule 8A, which set out in full the provisions of Schedule 4 that apply to small companies. Under the provisions, a small company may choose to file full or abbreviated accounts with the Registrar of Companies, but must provide full financial statements for shareholders. A small company choosing to file abbreviated financial statements is not required to file a profit and loss account or a directors' report and may file either an abbreviated or shorter-form[7] balance sheet and notes thereto.

[5] See Harvey and Walton (1996) for a summary of the arguments for and against differential reporting.
[6] Since the commencement of the research these levels have been raised as a result of indexation (see footnote 1).
[7] 'Shorter-form' is used to refer to the individual or group financial statements small companies are permitted to prepare for shareholders by virtue of section 246(2)-(4) of the Companies Act 1985.

Under section 246(3)(b) of the Companies Act (inserted by SI 1997/220 and amended by SI 1997/570), a small company's privacy is protected by not having to disclose certain information from the notes to the accounts. In particular, information from Schedule 6 regarding directors' emoluments can be omitted: the numbers of directors exercising share options and receiving shares under long-term incentives schemes; details of the highest paid director's remuneration; details of directors' and past directors' excess retirement benefits.

In view of the extensive range of exemptions allowed in abbreviated accounts, they cannot be held to give a true and fair view. For this reason there is no requirement for them to comply with the disclosure provisions in accounting standards. However, since the accounts are based on full shareholder accounts, the measurement methods adopted will be consistent with those set out in accounting standards.

Abbreviated accounts must be accompanied by a special auditors' report, unless the company is exempt from the requirement for an audit by virtue of sections 249A(1) or (2) or section 250 of the Companies Act 1985 (see below). This report must state that in the auditors' opinion the company is entitled to deliver abbreviated financial statements and that the statements are properly prepared in accordance with the relevant sections of the Companies Act.

The EC Fourth Directive permitted national governments to dispense with the requirement for small companies to undergo an audit. This prompted the government in 1994 to amend section 249A of the Companies Act 1985 (SI 1994/1935) to exempt companies with an annual turnover of up to £90,000 and a balance sheet total of up to £1.4m. Companies with a turnover of between £90,000 and £350,000 were given the option of filing a simpler audit exemption report in place of the full audit report.

Following the publication of a consultation document (DTI, 1997) the audit turnover threshold was revised to £350,000 (SI 1997/936), thereby removing the statutory requirement for the audit exemption report. In June 1999 proposals were announced to raise the thresholds again, possibly up to the maximum levels set by the EU shown in Table 1.1 (DTI, 1999b).[8] The rationale for this increase focuses mainly on potential cost savings for increased numbers of small companies. It is difficult to estimate how many companies would be affected by such a change. There are some 380,000 companies that file abbreviated accounts and since such accounts do not include turnover figures it is not possible to calculate how many of them fall within the current or proposed exemption levels (DTI, 1999d). Based on the accounts of 750,000 companies at Companies House where the turnover data is available, Table 1.2 shows the proportion of companies that are currently able to opt for audit exemption, as well as those that would be able to do so if the threshold is raised to £4.2m.

Table 1.2
Breakdown of companies whose registered accounts include turnover

Turnover	***No. of***	***% of***

[8] In most EU countries the threshold is substantially higher than in the UK (typically, £2m-£4m), but there are also legal and regulatory differences, as well as variations in the company populations and size distributions. These factors make inter-country comparisons problematic.

	companies	*companies*
Up to £350,000 (already exempt)	520,000	69.3
£350,000 up to £4.2m (maximum proposed)	185,000	24.7
Subtotal	**705,000**	**94.0**
Over £4.2m	45,000	6.0
Total	**750,000**	**100.0**

Source: Adapted from DTI, 1999d, p. 5.

This analysis shows that 69% of companies filing turnover data are currently within the exemption threshold, and that lifting the level to £4.2m would increase the proportion to 94%. The DTI estimates that in addition to the 185,000 companies with a turnover of between £350,000 and £4.2m in Table 1.2, a further 90,000 companies filing abbreviated accounts would be able to opt out if the threshold was raised to the maximum. This would bring the total number of companies to approximately 275,000. If the audit level were raised to £1m, the number of companies affected would be approximately 150,000 (DTI, 1999d, pp. 5-6).

Exemption from the audit removes the need for the directors to engage an independent, professionally qualified and regulated person. To some extent, minority shareholders, who might not otherwise be able to obtain accounts with any external assurance, are protected by provisions that allow for an audit if it is required by at least 10% of the shareholders. Companies that are exempt from the statutory audit are still required to prepare their accounts in accordance with UK GAAP.[9]

1.4 Accounting standards

Although the issue of accounting standards and small entities was considered by the ASC in 1983, it was not until five years later that a statement on the application of accounting standards to small companies was published (ASC, 1988). The next development was in November 1994 when a working party of the Consultative Committee of Accountancy Bodies (CCAB) was set up at the request of the ASB to carry out a consultation exercise to assess whether companies should be exempted from compliance with accounting standards on the grounds of size or public interest. The working party concluded that the needs of the 'less complex entities and those who deal with them would be best served by straightforward, uncomplicated accounts and that some of the requirements of accounting standards tend to conflict with these needs' (CCAB, 1994, p. 15).

The result of the consultation showed clear support for some relief based on size, or a combination of size and public interest, and the working party recommended the promulgation of a specific financial reporting standard for smaller entities (CCAB, 1995). Accordingly, the ASB published an exposure draft (ASB, 1996) and subsequently issued the Financial Reporting Standard for Smaller Entities (FRSSE) (ASB, 1997; revised 1999b). The FRSSE is applicable to all reporting entities that qualify as small under the Companies Act 1985 and collects together

[9] The arguments for and against the compulsory audit of small company accounts have been cogently summarised by Freedman and Goodwin (1993).

in one document, and in simplified form, the accounting standards and other requirements for preparing and presenting the financial statements of smaller businesses.

If the entities within its scope choose to adopt the FRSSE, they become exempt from applying all other accounting standards and UITF abstracts. Alternatively, they can choose not to adopt it and remain subject to the full range of accounting standards and UITF abstracts. The measurement bases in the FRSSE are the same as, or a simplification of, those in existing accounting standards, and the definitions and accounting treatments are consistent with the requirements of company legislation. The disclosure requirements exclude a number of those stipulated in other accounting standards.

It would appear that the aim of the FRSSE is to reduce compliance costs. 'The main way in which the FRSSE should ease the burden for preparers of smaller entities' financial statements is likely to be its *reduced disclosure requirements*' [original italics] (ASB, 1998, p. 2). But in the view of Ken Wild, who chaired the CCAB working party, the driving force is improving communications rather than lifting burdens: 'It's about turning the accounts from a useless piece of paper into something useful' (*Accountancy*, 1995, p. 29).

This focus on the utility of financial statements is reflected in the FRSSE's objective. This states that the financial statements of entities falling within its scope should provide 'information about the financial adaptability of the entity that is useful to users in assessing the stewardship of management and for making economic decisions, recognising that the balance between users' needs in respect of stewardship and economic decision-making for smaller entities is different from that for other reporting entities' (ASB, 1999b, p. 9). However, 'while there is a body of research into the needs of users of the accounts of large companies, particularly listed companies, much less is known about who uses the accounts of small companies and what information they are seeking' (CCAB, 1994, p. 5).

The development of the FRSSE without the benefit of empirical evidence of users' needs has not gone unnoticed in the professional press. For example, one practitioner noted, 'Until one can ascertain the users' needs and requirements, it is not possible to decide what should or shouldn't be disclosed or measured within those accounts. Research into the users and usage of accounts has been carried out, so it must be possible to collate and build on this research. The accounts are, after all, our final product; and what other profession or industry produces a final product without first making sure that the consumer's needs are known?' (Holgate, 1995, p. 93).

According to the Small Practitioners Association (1997) the development of the FRSSE started from the wrong end of the scale. It began with standards designed for large quoted companies and then went through a nine-question approach to decide which to include in the FRSSE. Dugdale, Hussey and Jarvis (1997) suggest a more logical approach would be to conduct empirical research and develop positive standards that satisfy the user needs identified.

The government has expressed a strong desire to reduce the burden of red tape on small businesses, but some suggest that it is not possible to regard the 'regulatory burden' as a single entity (Better Regulation Task Force, 2000). 'There are different trade-offs to be considered in different cases' (ibid., p. 5). The Big GAAP/Little GAAP debate, which focuses on the regulation of financial reporting, has added to the increased pressure for change in policy making. Indeed, government guidance now urges policy makers to 'think small first' (ibid., p. 4). The present study makes a contribution to the debate by providing evidence of the needs and practices of the main user group of the statutory accounts of small companies. As in the case of their larger counterparts, the main users of small company financial statements are the investors. However, in small companies the investors are likely to be both owner and manager, and this has implications for financial accounting theory.

The research includes the views of owner-managers of companies that are already able to take advantage of the financial reporting concessions available to smaller entities, as well as those who are likely to be able to do so if thresholds are raised in the near future. Therefore, the results of this study should be of interest to both academics and the accountancy profession alike.

1.5 Structure of the report

This chapter has introduced the regulatory background to the study and the next chapter provides an overview of theoretical framework that underpins the research. Chapter 3 gives details of the research questions addressed by the study and methodology adopted. It also presents key demographics of the sample companies.

Chapter 4 presents the survey results concerned with the ownership and management of the participating companies. This is followed in Chapter 5 by an examination of the results that relate to the financial reporting choices made and the participants' views on the costs and benefits of financial reporting. In Chapter 6 the views of the owner-managers on the statutory audit are analysed. These include their perceptions of the role played by the auditors' report and its value in terms of their own company's accounts and those of other businesses. Chapter 7 focuses on the usefulness of the annual accounts in the context of other sources of information available for managing the company. The final chapter draws together the findings of the study and makes recommendations.

Chapter 2 Review of the literature

2.1 Introduction

It can be argued that the majority of attention in the literature has focused on the uses of large companies' accounts and that, in general, small companies have been ignored (Jarvis, 1996). This chapter reviews the key studies that have examined the uses of small company reports and the other sources of accounting information available to owner-managers. Unfortunately, there is no consensus on how a small business should be defined (Curran, 1986) and researchers employ a range of different size criteria, which makes comparisons between studies problematic. In addition, regulators adopt different measures for different purposes and comparison is further complicated by periodic adjustments to thresholds for indexation and other reasons.

This review of the literature provides the theoretical framework for the study. The chapter draws on the corporate reporting literature and theories emanating from the small business literature. It commences with an overview of recent approaches in financial accounting theory and the development of a conceptual framework for corporate reporting in the UK. This includes an examination of financial reporting by small companies and the role of the statutory audit from an agency perspective. This is followed by a review of previous studies that have investigated the users and uses of small company financial statements and the availability and sources of accounting information in small firms.

2.2 Financial accounting theory

In the 1970s the literature commonly referred to as financial accounting theory was predominantly normative and the way in which the accountancy profession attempted to achieve uniformity in financial reporting followed a deductive approach. Thus, researchers took a prescriptive view and were concerned with determining what the objectives of financial statements should be, rather than rationalising what happened in practice. By the 1980s there was growing concern that theories were only acceptable if they could be tested empirically and this led to a move towards positive accounting theory (Watts and Zimmerman, 1979; 1986). This inductive approach is neither normative nor prescriptive,[10] but capable of explaining accounting practices and making predictions.

The ASC had been set up in 1969 with no overt conceptual framework and was criticised for issuing standards that were neither coherent nor consistent (PricewaterhouseCoopers, 1999). As its authority came increasingly into question in the 1980s, and financial statements became longer and more complex, the need for a conceptual framework to guide the development of accounting standards was given greater attention.

Lee (1971) was one of the first researchers to argue for utility and relevance in corporate reports. He contended that by concentrating on the production of general-purpose statements and the solving of problems on an *ad hoc* basis, the users and uses of financial information were largely being ignored. However, in 1974 Carsberg, Hope and Scapens published a study which

[10] The literature tends to use these words interchangeably.

was to have considerable influence on developments in the UK. After a brief review of the literature (mainly drawn from the extensive American sources), the researchers conducted interviews with 26 accountants and a questionnaire survey of 121 members of the accountancy profession. They concluded that 'the traditional stewardship objective of accounting is still widely acknowledged as important. There appears to be a growing consensus, however, that the provision of information to assist shareholders with their investment decisions should be recognised as a second important objective of accounting statements' (Carsberg, Hope and Scapens, 1974, p. 173).

Peasnell (1974) pointed out that the findings did not support the authors' conclusions and inferences, and that they had made light of the differences in the information needs of sophisticated and unsophisticated investors. The latter criticism refers to studies which suggest that the users of corporate reports can be divided into sophisticated users, who have an educational background in accounting and can interpret the data, and unsophisticated users, who do not have such knowledge and are less able to interpret the information (Foster, 1975; Watts and Zimmerman, 1986).

Lee (1975) contended that the Carsberg study was based on such a small sample that it did not give any clear indication of the profession's views. A further important criticism is that the research did not investigate any potential differences between the information needs of the users of small private company reports and those of large public companies. Despite these limitations, the idea of decision usefulness has continued to remain central to standard setting.

In 1975 the Accounting Standards Steering Committee published a discussion paper, *The Corporate Report*, which has also had an abiding influence. Its basic philosophy was that the fundamental objective of corporate reports was to seek to satisfy the information needs of users. Therefore, it was necessary to identify those users' needs in order to arrive at the fundamental objectives of corporate reports[11]. *The Corporate Report* identified seven user groups and similar lists were created in subsequently in reports by McMonnies (1988) and Solomons (1989). However, none of these authors 'explicitly discuss size of company as an issue in terms of corporate reporting' (Jarvis, 1996, p. 12).

The impetus for the ASB's current work in developing a conceptual framework for financial reporting comes from the Dearing Report (1988), which reviewed and made recommendations on the standard-setting process. The complete exposure draft of the Statement of Principles for Financial Reporting (SoP) was issued by the ASB in 1995 (and revised in 1999). The regulators acknowledge the previous work of other standard setters, which include the Financial Accounting Standards Board (FASB) in the USA as well as the International Accounting Standards Committee (IASC), and state that they have adopted a deliberate policy of using the words of the IASC framework wherever possible.

The statutory accounts are described as 'general purpose financial statements' (ASB, 1999a, p. 14) and the aim of the SoP is to ensure that financial statements yield information that is useful.

[11] One anomaly common to many conceptual frameworks is the assumption that inanimate financial statements can have objectives. Strictly speaking, only people can have objectives (Chambers, 1976; Peasnell, 1982; Hussey, 1990).

Starting from the premise that the threshold quality of useful accounting information is 'materiality', the SoP identifies the primary characteristics as 'relevance' and 'reliability'. The secondary characteristics are defined as 'comparability' and 'understandability'. The SoP suggests that relevance and reliability are limited by three factors: the balance between the primary and secondary characteristics, timeliness and cost/benefit considerations.

Lunt (1982, p. 121) points out that 'timeliness is important for all financial statements' and the sooner the annual information is available, the more useful it is to users. In the small company context, this view is supported by Carsberg, Page, Sindall and Waring (1985), who conducted interviews with 50 small companies in Leicester and London. Their findings show that increasing the timeliness of production of the accounts was one of the most frequently cited ways in which owner-managers considered the annual accounts could be made more useful to management.

In common with *The Corporate Report* (ASSC, 1975) and the other reports that were to follow it (McMonnies, 1988, Solomons, 1989), the SoP identifies seven user groups: investors, lenders, suppliers and other trade creditors, employees, customers, governments and their agencies, the public (ASB, 1999a, p. 21). Investors are identified as the defining class of user. However, 'financial statements are multipurpose documents; they serve different functions for different groups of people. If financial statements are designed to serve a function which is of use to one group, they do not necessarily serve a different function for the same or another group' (Carsberg et al, 1995, p. 79). Moreover, 'the intensity of use by different groups of users is likely to be different for small private companies as compared with large public companies. Where there is no public disclosure the only groups which receive the information as of right are management, shareholders and perhaps agencies of government, for example the tax authorities' (Page, 1984, p. 271).

The rationale given in the SoP for identifying investors as the defining class of users is that 'financial statements that focus on the interest that investors have in the entity's financial performance and financial position will, in effect, also be focusing on the common interest that all users have in that entity's financial performance and financial position' (ASB, 1999a, p. 25). Not only does this imply that users' needs are homogenous, but the SoP explicitly states that it is intended to be relevant to all profit-oriented reporting entities, regardless of their size (ibid., p. 15).

The SoP states that the objective of financial reports is 'to provide information about the financial position, performance and financial adaptability of an entity that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions' (ibid., p. 23). However, in contrast with large companies, the directors of small companies are not merely managers charged with a stewardship role, but are the sole or major investor in the company. Since the first major study of small firms (Bolton, 1971), research has consistently shown that 'small firms are almost exclusively under their proprietors' control' (ibid., p. 6). In 1985, the survey by Carsberg, Page, Sindall and Waring found that 'in about 90% of cases the directors own more than half of the shares; in two thirds of cases they own all of the shares' (ibid., p. 3). Therefore, there is seldom any divorce between ownership and control and the directors of small companies might more accurately be referred to as 'owner-managers'. In addition to this relationship, a large proportion of small firms 'are family businesses of one sort or another' (Bolton, 1971, p. 6). As far as small private companies are concerned, a recent study of 343 small and medium-sized companies by Poutziouris, Chittenden and Michaelas (1998a) found that 54% are owner-managed and family controlled.

In large public companies the separation of ownership and control leads to a situation of information asymmetry between the shareholders, who are external to the company, and the directors, who are charged with responsibility for managing the business. Under agency theory (Jensen and Meckling, 1976) the firm is depicted as a nexus of contracts between self-interested individuals, particularly those between the owner (the principal) and the manager (the agent). As the majority of small privately owned companies are managed by their owners, there is little scope for a similar agency relationship, although other agency relationships may exist, such as between the owner-manager (principal) and auditor (agent) or between the owner-manager (agent) and the bank (principal).

The requirement to prepare and publish accounts is an important element of the framework of company law and is often described as part of the price paid by companies for the privilege of limited liability. In large companies the burden of financial reporting can be viewed as the cost of the agency relationship between shareholders and management. Although both parties may recognise that their welfare depends on the company's survival, management may not always act in the best interest of the shareholders. Therefore, the shareholders may establish incentives to limit aberrant activities by management and incur monitoring costs to measure managers' behaviour. Managers may benefit from incurring bonding costs that guarantee that they will not take actions that would harm the shareholders' interests, or that the shareholders will be compensated if managers do so. A third cost incurred is what Jensen and Meckling refer to as a residual loss. This is the monetary equivalent of the reduction in welfare experienced by the shareholders due to the divergence between the management's decisions and those that would maximise the welfare of the shareholders.

Simunic and Stein (1987) contend that agency costs increase in proportion to the size and complexity of the firm's operations. Since small companies are typically owner-managed, there is little delegation of control. Moreover, operations are likely to be less complex than those of large firms. Consequently, the risk of internal and external moral hazard is considerably reduced. As the firm grows, however, it will need to establish adequate systems of internal control and agency theory suggests that it will be willing to bear the cost of an external audit.

The references to stewardship and to investors as the defining class of user in the SoP demonstrate that the regulators have adopted a large company perspective. Some references are explicit. For example, the preface states that the chapter on measurement 'focuses exclusively on the system used by most large UK listed companies' (ASB, 1999a, p. 11). References to economic decision-making suggests an assumption that investors behave in economically rational ways (Weber, 1968) and are profit maximisers. This assertion is supported in the value to the business rule, which makes reference to 'the most profitable use of an asset' (ASB, 1999a, p. 87).

Although there is little dispute that profit-maximisation and growth are likely to be in the interests of both principal and agent in the case of large public companies, the majority of small private companies do not pursue such goals. Research shows that the founders of smaller entities have a variety of reasons for going into business (Gudgin, 1984; Kelly, 1987; Mason, 1989; Monck, Porter, Quintas, Storey and Wynarczyk 1990; Hussey and Hussey, 1994) and are more likely to be seeking survival and stability (Jarvis, Kitching, Curran and Lightfoot, 1996). This view is echoed by those in the profession. 'The fundamental concern of most small entities and their financiers, not surprisingly, is survival' (Murphy, 1996, p. 102). Providing the survival of the business is not at risk, owner-managers of small entities are able to trade off financial and non-financial goals in order to achieve a personally satisfying outcome or 'lifestyle', often placing a higher value on autonomy than the pursuit of financial growth. Thus, they might be described as following satisficing strategies (Simon, 1960).

2.3 The role of the audit

The audit can be viewed as an integral part of corporate financial reporting, where the assurance provided stems from trust in the judgement of the auditor. From an agency perspective, the demand for the financial statements to be audited arises from the assumption that human nature is weak, untrustworthy and in need of some kind of checking. The audit is designed to demonstrate 'the completeness, accuracy and validity of transactions which, when aggregated, make up the financial statements' (Power, 1997, p. 24). The auditor must plan the audit to provide a reasonable expectation of detecting material mis-statements (APC, 1990). Some suggest that reporting fraud to users, regardless of size, is necessary for the purpose of stewardship and decision making (Elliot and Willingham, 1980), although searching for fraudulent practices is not the duty of the auditors. Others assert that responsibility for the prevention of fraud rests firmly with management, through systems of supervision and internal control (Pound and Courtis, 1980). Woolf (1996) contends that the responsibility of management and the auditors overlaps, since any material fraud is likely to affect the true and fair view verified by the auditor.

Current government policy is aimed at reducing the regulatory burden on small businesses and the DTI (1999b) has been consulting on raising the turnover threshold under which small companies may qualify for audit exemption. Although it is acknowledged that the audit increases the reliability of accounts and thus increases value of the financial statements to users, the government's view is that costs as well as benefits need to be considered. Moreover, it is maintained that the balance of advantage changes as company size increases.

A MORI survey of companies with a turnover of between £350,000 and £1.5m (ACCA, 1998) provided some empirical evidence of the value of the audit to SMEs, although no details of the characteristics or size of the sample. The majority of respondents (80%) considered that the information provided by the statutory audit is useful to the business itself. In addition, they considered it is useful to those outside the company, particularly to the bank (83%) and the Inland Revenue (82%). All the bank managers surveyed considered that the information provided within the statutory audit is useful to all users. The same survey found that:

- 92% of companies and 94% of banks agreed with the statement that banks are more willing to lend to companies if they have seen audited accounts;

- 81% of companies and 88% of banks agreed that banks and other finance providers would require far more reassurance from a company whose accounts had not been audited;
- 92% of companies and 94% of banks agreed that there would always be a need for a reliable and independent statement of a company's financial health.

Prior to the audit concessions introduced in 1994 (see Chapter 1), Freedman and Goodwin (1993) conducted a questionnaire survey of 126 companies with a turnover of under £1m. They concluded that many companies at the upper end of the Companies Act definition of small at that time had several shareholders, bank borrowing and complex tax affairs. 'Many such companies would continue to have their accounts audited even without a statutory obligation but it could then be argued that a change in the law was not worthwhile' (ibid., p. 129).

This finding is supported by another, more recent but even smaller questionnaire survey of 85 incorporated SMEs (Pratten, 1998). The sample included 26 companies that qualified for audit exemption, 10 of which had opted for a voluntary audit for reasons that included the following:

- to provide information to another shareholder;
- because they were advised to do so by their accountant;
- as a discipline for management or good practice;
- for continuity with the past;
- for a profit-related pay scheme.

None of the companies that had opted for audit exemption reported that their bank had commented on this or that exemption had created difficulties when they sought to obtain credit or enter into contracts. More than half reported benefits from exemption, principally a reduction in costs and saving time. Pratten also conducted interviews with venture capitalists, business angels and bankers and concluded that 'overall the effects of audit exemption have been muted' (Pratten, 1998, p. 43).

Apart from the difficulty of synthesising the findings of research that focuses on different sizes of 'small' firms, the studies cited above suffer from the weakness that the numbers surveyed are too small to be representative of the wider population. The last major study of the views of the directors of small companies in the UK, which did not suffer from this problem, was conducted by Page in 1984. In common with Freedman and Goodwin (ibid.) Page's survey was conducted prior to the introduction of any audit exemption for small companies. Using a postal questionnaire, he surveyed the chief directors of 413 unlisted small companies and found that 84% would continue to have their company's accounts audited if it were no longer compulsory for the following main reasons:

- for the efficient running of the company (58%);
- for external users of the accounts, such as the bank (17%);
- for the shareholders(9%).

Only 15% thought they would dispense with the audit if it were no longer compulsory.

The government contends that the cost of the audit is proportionately greater the smaller the company (DTI, 1999b). This is substantiated by Freedman and Goodwin (1993), who concluded that 'for many owners of micro companies, the statutory audit fee is an additional cost which appears to bring little benefit, either to themselves or others, and which bites into small profits and scarce management time' (ibid., p. 127).

Although there has been much debate about potential cost savings, there is little empirical evidence. Pratten (1998) found that the average reduction in the nominal fees for auditing, accountancy and tax services was 15% for the 16 companies in his sample that opted for audit exemption. None of the managers reported adverse effects from opting for exemption and in some cases he concluded that it was likely that the directors would seek additional help from their accountants in preparing the accounts if there was no audit requirement. The findings of the MORI survey (ACCA, 1998) suggest that most auditors would expect to be able to compensate for a reduction in audit fee income from small company clients with a turnover of around £1m.

The studies investigating the views of the directors and owner-managers are complemented by other research that has sought the views of the profession. In interviews with the auditors of the small companies' accounts, Page (1981) found that the main benefits of the audit were perceived as the easier acceptance of tax computations (37%), assurance of efficient financial operation (23%) and satisfying bank lending requirements (19%). The majority (64%) considered that there would be a reduction in fees of up to 25% if no audit were performed, but there was division of opinion over whether the accounts of small companies should be audited.

This division of views in the 1980s is still apparent in the professional press (Acher, 1999; Graham, 1999; Langard, 1999; Masters, 1999). For example, one practitioner argues that the current turnover threshold of £350,00 should be raised on the grounds that '92% of accountants responding to a Small Practitioners Association survey supported exemption for all private, owner-managed, small limited companies' (Mitchell, 1999, p. 21). On the other hand, another member of the profession supports the maintenance of present levels: 'The inescapable fact is that the government's proposals advocate the removal of the audit but not the requirement for the directors to deliver true and fair annual financial statements. Since 90% of the work is done by accountants in the compliance function, it is foolish to take away the value-added aspect which comes with the audit' (Beckerlegge, 1999, p. 21).

The arguments for and against the compulsory audit of small company accounts have been cogently summarised by Freedman and Goodwin (1993), who contend that there should be unanimous agreement of shareholders to the decision not to have an independent audit. 'Even in the very smallest company disputes can arise between shareholders and audited accounts can be an essential protection' (ibid., p. 128). Moreover, as Marriott and Marriott (1997, p. 34) point out 'if accounts are not audited, who could say with confidence whether turnover thresholds for exemption purposes had not been breached?'

Since audit concessions were first introduced in 1994 there has been little information on take-up levels. Pratten (1998) suggests that some 60% of companies with a turnover of under £350,000 take advantage of the audit exemption option. However, a qualitative study by

Marriott and Marriott (1999) found that many owner-managers are not aware of whether their accounts are audited. Recent estimates by the DTI (1999b) indicate that around 50% of eligible companies below the £350,000 threshold no longer have an audit. Although the MORI survey (ACCA, 1998) found that approximately 40% of companies with a turnover of between £350,000 and £1.5m would opt for exemption if it were available, there appears to be a gap in the literature regarding the likely behaviour of companies with a turnover of above £1.5m. The present study remedies this deficiency.

2.4 Uses of small company accounts

With few exceptions, the majority of research into the users and uses of the statutory accounts has focused on large companies. Olsson (1980) suggests that management may want to use the statutory accounts to encourage potential investors, whilst Korn Ferry (1986) and Martin (1989) contend that corporate image is of increasing importance in the annual report and accounts. As far as the views of the private shareholders are concerned, a seminal study by Lee and Tweedie (1975) found that the three main objectives of annual financial reports were considered to be:

- to make company directors accountable to shareholders (59%);
- to give shareholders an indication of the value of the company (50%); and
- to justify proposed dividend payments (30%).

Other research has examined the views of investment analysts and institutional investors (for example, Arnold and Mozier; 1984; Day, 1986; Bence, 1996). Compared to these users, the private shareholders of both large and small companies can be considered to be unsophisticated users of accounting information. Indeed, a study in the small business literature by Page (1981; 1984) shows that although the directors control all operations in small companies, they have little knowledge of accounting.

One of the main subjects of research into the use of the annual accounts of small companies has been their use by banks for lending purposes. Banks are widely recognised as the main source of finance for small firms (Chittenden, McConnel and Risner, 1990; Storey, 1994, Cosh and Hughes, 1998). The main reason claimed for this reliance is that there is no effective capital market for small firms (Jarvis, 1996). A survey by Berry, Citron and Jarvis (1987) found that statutory accounts were used as a source of information on lending decisions, irrespective of whether the company was large or small. However, the emphasis placed on specific items of information differed according to the complexity of the applicant's business, the availability of up-to-date information and the more short-term view taken of smaller businesses.

Berry, Faulkner, Hughes and Jarvis (1993) conducted qualitative research in banks and found that accounting information was important when making lending decisions relating to small businesses, but was used in different ways and given different weightings depending on various internal and external factors. Further qualitative research by Berry, Crum and Waring (1993) attempted to assess the actual processes used by banks in evaluating corporate loan applications by potential borrowers, which included a large proportion of small businesses. These findings showed that banks converted the information contained in the annual accounts to complete standard evaluation forms, but that errors were sometimes introduced through lack of consistency in the definitions used. The information was not used to predict trends and little or no reference was made to the risk/return trade-off in discussions with managers. The survey showed that information surplus to that required on the standard evaluation forms was discarded.

Berry and Waring (1995) produced case study evidence showing that little attention was given by the banks to data other than that shown in the profit and loss account and the balance sheet. This led the authors to propose caution in introducing financial reporting reforms until further research has been conducted into the reasons why other available supplementary data are not used.

These studies provide evidence that the statutory financial statements of small companies play an important role in the lending decision, but no indication of whether they are used to monitor borrowing, which might indicate an agency role. However, research into the use of the accounts by the directors of small companies seems to suggest that this might be the case. Page (1984) asked the principal directors that took part in his survey to rate a number of potential uses of the company's annual accounts in order of importance. Carsberg et al (1985) asked a similar question in their interviews with the directors of small companies in Leicester and London. Both studies found that the main use of the annual accounts was the provision of information to management, followed by the bank and other lenders. An interview survey of 100 small companies in North East England (Keasey and Short, 1990) found that 60% of respondents considered the production of annual accounts useful in management of the business, in obtaining credit facilities or just generally useful.

Page (1984) found that the use of the accounts by shareholders and creditors was perceived as unimportant and there was only sporadic use of the accounts of other companies with which the directors had business contacts. Only 28% had cause to refer to the financial statements of a business contact within the last year and a mere 8% stated that they would use the annual accounts of a new business contact to assess creditworthiness. The survey was conducted before the 1981 Companies Act was passed, which introduced 'modified' accounts for qualifying small companies, and this has some bearing on the finding that 52% of respondents wanted less disclosure; specifically mentioned were directors' emoluments. In addition, 22% thought the accounts for private companies were intrusive into the owner's private affairs.

More recently a small questionnaire survey of 85 small and medium-sized companies (Pratten, 1998), found that the most common uses of their accounts were to inform the Inland Revenue, to inform the executive directors and to provide the company's bank with information. However, there is some inconsistency in the results of this study, as the most important users were ranked as the bank, the executive directors, other shareholders and the Inland Revenue.

An exploratory questionnaire survey of 89 small and medium-sized companies in London and the South of England by Dugdale, Hussey and Jarvis (1998)[12] found that for small companies

[12] This exploratory research was the precursor to the present study and was designed to piggyback on a survey examining the financial performance of small and medium-sized companies (Hussey and Hussey, 1994). The 89 companies were the sub-sample who had answered all the questions that were pertinent to the

the three main non-statutory recipients of the annual accounts are the bank and major lenders, the directors and the Inland Revenue. For medium-sized companies they are the bank and major lenders, the directors and major customers. Confirming the findings of Pratten (1998) it was found that both small and medium-sized companies use their accounts to provide information to major customers and major suppliers/creditors.

A DTI report (1985) examining the regulatory burdens on small firms found that additional costs were imposed on small firms. This suggests that the burdens a firm faces may be a function of its size. However, Carsberg et al (1985, p. 83) concluded that the burden 'does not seem to be a matter for primary concern among people in small companies.' This view is supported by Keasey and Short (1990, p. 310), who found that 'in general, the perceived relative burden of annual accounts is not influenced by the specific factors investigated', which included size as one of the potential explanatory variables.

Previous studies examining the views and practices of the directors of small companies have been supplemented by research that has investigated the views of the auditors of small company accounts. Questionnaire surveys by Page (1981) in the UK and Barker and Noonan (1996) in Ireland (North and South) found that auditors consider that the directors/management are the most important users of small company accounts. This is confirmed by an interview survey by Carsberg et al (1985), which found that auditors consider the most important use of small company annual accounts is to provide management information.

2.5 Sources of accounting information

In order to evaluate the relative importance of small companies' statutory accounts to management, it is necessary to identify what other sources of accounting information are available to the directors. The exploratory study by Dugdale, Hussey and Jarvis (1998) began to address these deficiencies. The findings showed that for small companies the three most useful sources of information were the management accounts for the period, the annual report and accounts, and cash flow information. For medium-sized companies it was the management accounts for the period, cash flow information, and budgets. A consequent ranking of the mean scores put the annual report and accounts in second place as a source of management information for small companies, but fifth for medium-sized companies. This difference was found to be statistically significant.

Composite variables suggested by factor analysis showed that for both size groups, the sources of information could be classified according to three main purposes: planning/monitoring, evaluating/comparing and confirming/verifying. For both small and medium-sized companies, the statutory accounts were classified with information used for confirmatory/verification purposes and these findings are explored further in the present study.

In a questionnaire survey of 928 small businesses with up to 20 employees in Australia, Holmes and Nicholls (1989) investigated the information prepared or acquired by owner-managers. The results showed that most owner-managers engage an external accountant to prepare statutory

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pilot study.

and budgeted accounting information, although the provision of additional information was limited. One explanation for this is that accounting information is prepared predominantly to comply with statutory requirements (Keasey and Short, 1990). Alternatively, it could be that small businesses do not find non-statutory information useful and the information prepared or acquired to comply with statutory requirements is sufficient for their needs. However, caution must be taken when drawing conclusions from the Holmes and Nicholls study, as there was evidence of non-response bias to some of their questions.

In the UK, Page (1981 and 1984) found that in most small companies the statutory accounts prepared by the auditors are supplemented by a detailed profit and loss account and, possibly, additional management information. Building on these findings, Carsberg et al (1985) found that 80% of the directors of the 50 small companies that took part in their interview survey reported that their annual accounts were prepared by the firm's auditors.

The availability and communication of management information can be facilitated through the use of computer-based information and communication technology (ICT) and research shows that increasing numbers of small firms now use computers (Chen and Williams, 1993; Fitchew and Blackburn, 1998; Poutziouris, Chittenden and Michaelas, 1998b). A study consisting of interviews with 15 owner-managers of small firms by Marriott and Marriott (1999) found that all but one used a computerised accounting package, although in some cases erroneous or incomplete figures were produced. In general, they found that greater use was made of computers by owner-managers who considered that their financial skills were good.

Since the Bolton Committee reported in 1971 that financial management skills were generally poor in small businesses, subsequent studies have provided empirical evidence which appears to support their view (for example, Lang, 1973; Robson Rhodes, 1984; Lewis and Toon, 1986; Storey, Keasey Watson and Wynarczyk, 1987; Holmes and Nicholls, 1989; Nayak and Greenfield, 1994). However, Jarvis, Kitching, Curran and Lightfoot (1996) argue that previous researchers have adopted questionable research methods by using practices in large firms as the template against which to measure financial management in small businesses. They conducted interviews with 20 owner-managers of small firms and contend that the motivations of small business owners and the cost structures of small firms differ from those of large firms. They concluded that performance measures employed in large firms are often totally inappropriate to small firms. 'Accounting systems introduced for control purposes are influenced by the relationship between the owner and the business. In the case of small businesses, the owner-manager and the business are often inseparable and a different emphasis is given to control reflected through the accounting system' (ibid., p. iii).

Evidence from case study research by Perren, Berry and Partridge (1999) addresses these apparent contradictions in the findings of previous studies. They found that the owner-managers in the case study firms employed informal mechanisms of information acquisition during the early development of their businesses, relying on tacit routines. However, they concluded that this should not be interpreted as indicating that information and control were poor, but that they were appropriate for a small business. As the business grows and the number of transactions increases, 'informal personal control by the owner-manger becomes stretched and needs to give way to more formal delegated processes of control' (ibid., p. 351). This is consistent with a contingent view of systems development, which suggests that accounting systems (and the information they provide) develop in sophistication according to the size and age of the organisation (Pugh, Hickson, Hinings and Turner, 1969) and level of uncertainty (Chapman, 1997). 'Uncertainty is caused not only by the interaction of a number of external contextual factors, but critically also by factors such as the level of organizational knowledge and understanding of how these impact on internal processes' (Chapman, 1997, p. 201).

2.6 Conclusions

Financial reporting is based on the needs of investors, who are identified as the defining group of users of large company accounts. However, whilst investors in large companies require financial statements that will allow them to assess the stewardship of management, the investors in small companies are in most cases both owner and manager. Therefore, the agency relationship that exists between the shareholders and directors of large companies is not replicated in small companies. Nevertheless, previous research shows that there is a demand for audited accounts by the owner-managers of many small companies, who are identified as the main users of the statutory financial statements. This suggests the possibility that other agency relationships exist in small companies or that the audited accounts of small companies have different uses from those of large companies.

There has been little previous research into the needs of owner-managers in relation to the utility of the annual accounts and the adoption of different definitions of the small businesses studied makes comparisons difficult. The majority of previous research has been small in scale or designed to collect qualitative data and there has been a lapse of at least 15 years since the last generalisable study of the directors of small companies in the UK. During that period the financial reporting environment and the economic environment within which businesses operate has changed. In addition, there have been dramatic developments in information technology, which have affected the ease of recording, generating and communicating management information.

Previous research shows that the main use of small company accounts is to provide information to management. It indicates that as well as meeting external financial reporting needs, the information contained in the annual accounts of small companies is being used for management purposes and this may be contingent upon size. None of the previous studies have investigated whether there were any specific items in the accounts that are being used by the owner-manager, or given much detail on how they are used in the management of the business. The rationale for the current deregulatory trend is based on reducing the cost burdens of financial reporting which, it is argued, fall disproportionately on smaller entities. However, this has not been tested empirically and little attention has been given to the perceived benefits provided by the statutory audited accounts.

The theories and gaps in the literature presented in this chapter form the theoretical foundations for the present study. In the next chapter we examine the aims and objectives of the study and the way in which the research was designed.

Chapter 3 The study

3.1 Introduction

The purpose of the study was to investigate the use of the statutory accounts by the owner-managers of small companies within the context of the Big GAAP/Little GAAP debate. As already discussed, the literature provides no universal definition of a small firm. However, as the study was set in the context of the current deregulatory trend, it was decided to adopt the maximum size criteria for a small company relating to turnover, total assets and number of employees under EU law. This definition permitted data to be collected from companies that are likely to qualify as 'small' under current UK company legislation, as well as those that would become eligible if the ceilings were to be raised to EU levels.

The main research questions addressed by the study were as follows:

1. What are the benefits and costs to small companies of meeting financial reporting requirements?
2. What are the reasons for the financial reporting choices made by small companies?
3. How useful is the audit report to management on their own and other companies' accounts?
4. What factors influence the usefulness of the statutory accounts to management?
5. How useful are the statutory accounts to management in the context of other sources of information for managing the company?
6. How are the statutory accounts used in small companies?

3.2 Methodology

As it was considered desirable to be able to generalise from the results, the study took the form of a large postal questionnaire survey of a randomly selected sample of companies. In the first instance a literature search was conducted to identify the areas in which the deregulation of financial reporting by small companies has taken place (see Chapter 1). In addition, it was necessary to critically assess previous research into the uses and users of the statutory financial statements of small and medium-sized private companies. This included an exploratory study (Dugdale, Hussey and Jarvis, 1998), which was the precursor to the present research (see Chapter 2).

In order to clarify the main issues interviews were held with practitioners from both large and small firms of accountants and the principal directors of small companies. A draft questionnaire was designed, containing a combination of closed and open questions and was piloted by sending it to the directors of 22 small companies. Replies were received from 12 companies and after a number of minor amendments, the questionnaire was finalised (see Appendix A).

3.3 Sample selection

One of key problems in designing a study of small businesses is the lack of a comprehensive and economical sampling frame. It was decided to use FAME, a computerised database that contains information on 270,000 British companies taken from the returns made to the Registrar of Companies. One limitation of this choice of sampling frame is that FAME does not include companies with a turnover of under £0.5m. However, the information is detailed, up to date and easy to access.

A search of the database was conducted at the beginning of March 1999 to identify all active, independent,[13] private limited companies that met the following size criteria[14] in the most recent year for which accounts were filed:

- turnover of up to £4.2m (information available for 46% of companies on FAME);
- balance sheet total of up to £2.1m (information available for 100% of companies on FAME);
- number of employees of up to 50 (information available for 32% of companies on FAME).

These search criteria provided a list of 11,648 companies filing full, audited accounts (£350,000 turnover being the audit exemption level at the time of selection). The list was sorted alphabetically and a systematic random sample taken by selecting every fifth company. This gave an initial sample of 2,327 companies. At the end of March 1999 the questionnaire was posted to the principal (named) director with an accompanying letter and prepaid envelope. This resulted in 198 usable replies.

In order to improve the response rate, two follow-ups were sent to non-respondents at fortnightly intervals (Kervin, 1992). The covering letter accompanying the second copy of the questionnaire was marked 'Private and Confidential' in an attempt to ensure that it was opened by the director to whom it was addressed, rather than a subordinate or professional intermediary who might discard it. This resulted in a further 187 usable replies.

A total of 39 questionnaires were discarded for the reasons given in Table 3.1 and this reduced the effective number of companies surveyed to 2,288.

[13] Subsidiary companies were excluded.
[14] These are the maximum levels under EU law at the time the companies were selected.

Table 3.1
Companies excluded from the study

Reason	No. of companies
Not trading/in liquidation	21
Owner overseas/unavailable	7
Subsidiary	4
Sold/taken over/no longer a company	3
Questionnaire returned by intermediary at registered office	3
Questionnaire returned 'Gone away'	1
Total	**39**

The total of 385 usable responses is considered to be sufficient to allow the results to be generalised from the sample companies to the population[15] and gives a response rate of 17%. Although higher than the 11% achieved by a postal survey of small and medium-sized businesses without reminders (ICAEW, 1996), this is not as high as the typical rates of between 30% and 70% suggested by Kervin (1992).

Two factors may have affected the response rate of the present study. First, the sampling frame consisted of data drawn from Companies House, where the filing rules mean that the records are historical. Under section 244(1) of the Companies Act 1985 the usual period allowed to private companies for filing financial statements is 10 months after the end of the accounting reference period. During that time the name of the principal director or the trading address and other details may have altered from those on record. Secondly, many small companies do not provide a trading address, but instead give a registered office address (often that of their accountants or other professional adviser). There was some evidence that in some cases the first mailing of the questionnaire had not been forwarded to the addressee, but intercepted and rejected by an intermediary.

In any large survey the problem of questionnaire non-response bias must be addressed, since it is not likely that all those surveyed will respond. Previous research (Morgan, 1974; Wallace and Mellor, 1988) suggests that non-respondents behave like late respondents. Therefore, one method for testing for non-response bias is to compare the characteristics of the respondents to the first mailing with those who reply to the second request. This was done by conducting an independent samples *t* test to look for differences in the mean age, turnover, total assets, number of employees and number of shareholders of the two batches of respondents. The results were non-significant in each case, confirming that there was no difference between early and later respondents and that the findings of the study can be generalised to the wider population of companies with similar characteristics.

[15] According to Krejcie and Morgan (1970, p. 608), for populations of 1m or more, the minimum acceptable sample size is 384.

The methodological triangulation (Easterby-Smith, Thorpe and Lowe, 1991) incorporated in the research design resulted in the collection and analysis of both qualitative and quantitative data. The qualitative data from the interviews and the open questions in the questionnaire were analysed using general analytical procedures (Miles and Huberman, 1994) which group the data into thematic categories. The quantitative data was analysed using a specialist statistical package, SPSS for Windows.

3.4 Profile of the sample companies

In this section we present a profile of the 385 sample companies by analysing data taken from their accounts for the most recent year filed at Companies House and available on FAME. The analysis takes the form of a breakdown by size, age, region and industry.

We commence by looking at the demographics relating to size. Table 3.2 provides a breakdown of the sample companies by turnover.

Table 3.2
Companies by turnover

Turnover	**No. of companies**	**% of companies**
Under £1m	238	61.8
£1.0m – £1.49m	46	11.9
£1.5m – £1.99m	26	6.8
£2.0m – £2.49m	21	5.5
£2.5m – £2.99m	17	4.4
£3.0m – £3.49m	18	4.7
£3.5m – £3.99m	14	3.6
£4m and above	5	1.3
Total	**385**	**100.0**

Source: FAME

Just under two-thirds of the companies have a turnover of under £1m, illustrating that even though the sample excluded companies with sales of less than £0.5m, the majority of small companies are concentrated at the lower end of the spectrum. A total of 88% of the companies fall within the present turnover threshold for a small company (not exceeding £2.8m). As the upper size limit of the sample was £4.2m, and the companies are representative of the wider population, this implies that if thresholds were to be raised to £4.2m, approximately 12% of companies would be reclassified as 'small' according to this measure.

Table 3.3 continues the analysis of the sample companies by size and provides a breakdown by balance sheet total (total gross assets).

Table 3.3
Companies by balance sheet total

Total assets	No. of companies	% of companies
Under £0.5m	187	48.6
£0.5m – £0.99m	93	24.2
£1.0m – £1.49m	59	15.3
£1.5m – £1.99m	37	9.6
£2.0m – £2.1m	9	2.3
Total	**385**	**100.0**

Source: FAME

As with the figures for turnover, this table shows that the majority of companies are at the lower end of the size scale. Indeed, 85% of the sample have a balance sheet total of up to £1.4m, thus falling within the present Companies Act threshold for 'small'. If thresholds were increased to £2.1m, approximately 15% would be reclassified as 'small' according to this measure.

Table 3.4 provides a breakdown of the sample companies by a third measure of size: the annual average number of employees.

Table 3.4
Companies by number of employees

Employees	No. of companies	% of companies
Up to 10	199	51.7
11 – 20	94	24.4
21 – 30	41	10.6
31 – 40	30	7.8
41 – 50	21	5.5
Total	**385**	**100.0**

Source: FAME

Just over half the sample companies (52%) have an annual average of up to 10 employees and a little more than three-quarters (76%) have as many as 20 employees. This measure of size follows a similar pattern to that shown for turnover and total assets, with the majority of companies clustered at the lower end of the scale. Currently there are no proposals to raise the employee threshold for a small company to beyond 50.

As expected, further analysis showed an association between number of employees and turnover. Companies with a turnover of under £1m are more likely to have 10 or fewer employees, whilst companies in the £1m to £4.2m band are more likely to have between 11 and 50 employees (chi-square 74.012; degrees of freedom 1; p <0.01).

The age of the sample companies was calculated by deducting the year of incorporation, from the year in which the data was collected and analysed (1999). Table 3.5 shows the results.

Table 3.5
Companies by age

Age*	**No. of companies**	**% of companies**
Up to 5	25	6.5
6 – 10	93	24.2
11 – 15	67	17.4
16 – 20	62	16.1
More than 20	138	35.8
Total	**385**	**100.0**

* Calculated by subtracting 1999 from year of incorporation
Year of incorporation source: FAME

The vast majority of the companies (94%) have survived beyond the crucial first five years, during which previous research shows that small firms are most vulnerable to failure (Milne and Thomson, 1986; Storey, 1994). Almost two-thirds of the sample (64%) are up to 20 years old, and just over a third (36%) have been making a contribution to the economy for more than 20 years. However, it must be borne in mind that this analysis can only be a guide to the age of the business, as some companies may have existed in some other form (such as a sole proprietorship or partnership) prior to incorporation.

An analysis of research in the UK and the USA by Storey (1994) shows that young firms grow more rapidly than older firms. Therefore, exploratory tests were conducted to look for an association between age and increased turnover or number of employees. However, the results were inconclusive.

Table 3.6 provides regional demographics by analysing the sample companies by the postal region of their registered office or trading address.

Table 3.6
Companies by region

Region	**No. of companies**	**% of companies**
Inner London	63	16.3
South	60	15.6
Outer London	41	10.6
Scotland	32	8.3
South West	29	7.5
East	28	7.3
North West	28	7.3
South East	26	6.8
West Midlands	23	6.0
Yorkshire & Humberside	21	5.5
East Midlands	15	3.9
Wales	13	3.4
North	6	1.6
Total	**385**	**100.0**

Source: FAME

The sample companies were spread across a wide range of regions, with the majority (43%) concentrated in London and the South. Tests showed no significant association between region and number of employees.

Table 3.7 shows the industrial demographics of the sample companies through an analysis of the standard industrial classification (SIC) of their primary activities (see Appendix B). It should be borne in mind that these classifications are very broad and it is possible that companies have ancillary activities in other categories.

Table 3.7
Companies by standard industrial classification

Standard industrial classification	No. of companies	% of companies
0 Agriculture, forestries and fishing	16	4.2
1 Energy and water supply industries	12	3.1
2 Extraction of minerals and ores; manufacture of metals, mineral products and chemicals	35	9.1
3 Metal goods, engineering and vehicles industries	23	6.0
4 Other manufacturing industries	42	10.9
5 Construction	83	21.6
6 Distribution, hotels and catering; repairs	41	10.6
7 Transport and communication	97	25.2
8 Banking, finance, insurance, business services and leasing	4	1.0
9 Other services	32	8.3
Total	**385**	**100.0**

Source: FAME

Just under half the sample companies (48%) have primary activities in services industries (energy and water supply industries; distribution, hotels, catering and repairs; transport and communication; banking, finance, insurance, business services and leasing; other services). The remaining 52% are in non-service sectors. The largest proportion (25%) are in the transport and communication sector, followed by construction (22%). Only 1% of the total are in the banking, finance, insurance, business services and leasing sector, some of whom would not qualify as 'small' on the grounds of public interest. The low number of companies in this category may be due to the sector containing a larger proportion of subsidiary companies (which were excluded in the selection criteria) or unincorporated businesses, such as independent financial advisors. Not surprisingly, a significant association was found between industry and number of employees (chi-square 19.351; degrees of freedom 9; p 0.02).

The highest proportion of companies in transport and communication are located in London (35%) and the lowest (1%) in the East Midlands. There was a similar pattern in the construction industry, with the largest proportion (34%) in London and the lowest (2%) in the East Midlands.

3.5 Conclusions

The study took the form of a postal questionnaire survey of a systematically selected random sample of 2,288 companies meeting the EC definition of 'small' in the most recent year for which their accounts were available. A total of 385 usable replies were received, giving a response rate of 17%. The data was analysed statistically using SPSS. Tests showed no evidence of non-response bias to the survey and this, together with the level of response, suggests that the survey results can be generalised to the population of companies with similar characteristics.

The majority of the companies were at the smaller end of the scale; 62% had a turnover of under £1m; 49% had total assets of under £0.5m; and 52% had up to 10 employees. Analysis by age shows that approximately one-third were up to 10 years old, one-third between 11 and 20 years old and the remainder between 21 and 90 years old. Sectoral analysis shows that they were spread across all regions of Great Britain, with the majority in London and the South (43%). The companies were distributed across a wide range of industries, with 48% in service industries and 52% in non-service industries. In the service sector the majority (25%) were in the transport and communication industry (25%) and in the non-service sector the majority (22%) were in the construction industry.

This chapter has described the research design and has provided a profile of the sample companies. The next chapter looks at the results of the survey that relate to the ownership and management of the companies surveyed.

Chapter 4 Company ownership and management

4.1 Introduction

In this chapter we examine the relationship between ownership and management, and the level of financial sophistication in the sample companies. In large companies there is information asymmetry between those who own the company and those who manage it. The statutory accounts provide the means by which the directors report the financial results to the shareholders and the relationship between the two parties can be described as an agency relationship (Jensen and Meckling, 1976). In small companies, however, management is rarely divorced from ownership and this has implications for financial reporting by small firms.

The first section looks at ownership in terms of the number of shareholders and the level of family-ownership. This is followed by an examination of the composition of the board of directors and the way in which the company is managed. The third section provides an analysis of the respondents according to their position in the company and qualifications. The final section investigates the level of accounting expertise within the company and the extent to which the accounting system makes use of information technology.

4.2 Ownership

The Companies (Single Member Private Limited Companies) Regulations 1992 allows private companies limited by shares or guarantee to be formed with a single shareholder, but the definition of a small company in the Companies Act 1985 does not include any measure of size in terms of ownership. As the number of owners may have some bearing on agency relationships within the company, the respondents were asked how many shareholders the company has. The results are shown in Table 4.1.

Table 4.1
Number of shareholders

Shareholders	No. of companies	% of companies
1	43	11.2
2	170	44.2
3	53	13.8
4	49	12.7
5 or more	69	17.8
No response	1	0.3
Total	**385**	**100.0**

The vast majority of companies (82%) have between one and four shareholders and the mode was two. Most companies with one or two shareholders are in the construction or transport and communications industries. Most of those with three or four shareholders are in the construction industry. No significant association was found between the number of owners and the age of the company.

The results of previous studies (Bolton, 1971; Poutziouris, Chittenden and Michaelas, 1998) suggest that a significant proportion of small firms are family controlled. In order to see whether this is also true of small companies, the respondents were asked whether they would describe the company as a family-owned business. Table 4.2 shows their responses.

Table 4.2
Level of family ownership

Level of family ownership	**No. of companies**	**% of companies**
Family-owned, first generation	179	46.5
Family-owned, second generation	73	19.0
Owners not related	98	25.5
Partly family-owned	34	8.7
No response	1	0.3
Total	**385**	**100.0**

Three-quarters of the companies are wholly or partly family-owned and nearly half (47%) are owned by the first generation of the founding family. The owners are unrelated in a quarter of the sample. Further analysis shows that companies that are wholly family-owned are likely to have a turnover of less than £1m., whilst those where all or some of the owners are unrelated are likely to have a turnover of £1m or above (chi-square 7.265; degrees of freedom 1; p <0.01). A significant difference was found in relation to the age of the company and family ownership. Wholly family-owned businesses have with an average age of 23 years, whereas those where all or some of the owners are unrelated have an average age of 16 years (t 4.630; degrees of freedom 376; p <0.01).

4.3 The directors

The respondents were asked how many executive directors are involved in the day-to-day activities of the business. Table 4.3 shows the results.

Table 4.3
Number of executive directors

Executive directors	No. of companies	% of companies
1	81	21.0
2	173	44.9
3	73	19.0
4	34	8.8
5 or more	18	4.7
No response	6	1.6
Total	**385**	**100.0**

The majority of companies (66%) have either one or two executive directors and this substantiates the findings of the pilot study (Dugdale, Hussey and Jarvis, 1998). There was a strong correlation between the number of executive directors and the number of owners (p <0.01), which confirms that small companies are owner-managed. This finding shows that there is no scope in small companies for the major agency relationship that exists between the owners and management in large companies. Therefore, the role of financial reporting in providing information to shareholders for assessing the stewardship of management is redundant in small companies. This raises important questions in connection with financial accounting theory and the relevance of the SoP to small companies, since the conceptual framework is based on the needs of investors, who are identified as the defining class of users (ASB, 1999a).

The Cadbury Report (Cadbury, 1992) recommends the appointment of non-executive directors (NEDs). A NED can be defined as ‘a director of a company who is not involved in the day-to-day management of the business but who is appointed to bring independent judgment on issues of strategy, performance, resources and standards of conduct’ (Hussey, 1995, p. 237). The pilot study revealed some confusion over the term, and therefore the questionnaire for the present study provided a simple description, defining non-executive directors as those not involved in the day-to-day activities of the business. Table 4.4 shows the results.

Table 4.4
Number of non-executive directors

Non-executive directors	No. of companies	% of companies
1	68	17.7
2	34	8.8
3	15	3.9
4	5	1.3
5 or more	9	2.3
None/no response	254	66.0
Total	**385**	**100.0**

Just over one-third of the sample companies (34%) claimed to have one or more NED, similar to the findings of the pilot study. One company claimed to have 10 NEDs and two others as many as 12, but it is likely that these extreme cases are examples of honorary titles conferred on retired founders, family and other associates. A more detailed description of the role of a NED, as used by Berry and Perren (1999) might have elicited more valid results. Their survey found that only 20% of small companies had a NED.

Further analysis shows that companies where all or some of the owners are unrelated were more likely to have a NED than those that are wholly family-owned (chi-square 4.860; degrees of freedom 1; p 0.03). The size of the company, as measured by turnover, did not appear to be associated with the appointment of a NED.

The questionnaire was sent to the principal director, as previous research shows that in the majority of cases this is the person in charge of the financial function in a small company (Page, 1981 and 1984; Carsberg, et al, 1985). In order to check that the views collected were indeed those of the chief directors, the respondents were asked to indicate their position in the company. Table 4.5 shows the results.

Table 4.5
Position of respondents

Position	**No. of companies**	**% of companies**
Managing director or chief executive	239	62.0
Finance director or company secretary	73	19.0
Other director	26	6.8
Accountant or financial manager	20	5.2
Other manager	7	1.8
No response	20	5.2
Total	**385**	**100.0**

Confirming the findings of earlier studies, the results show that 81% of the respondents were the principal directors (either the managing director, chief executive, finance director or company secretary). A further 7% indicated that they were directors, but did not provide a more specific title.

The validity of the responses to the questionnaire depends to some extent on the ability of the respondent to understand the questions. This was particularly important since it was impossible to avoid using a certain amount of accounting terminology and one of the purposes of piloting the questionnaire (see Chapter 3) was to test this aspect. In addition, running a business requires a wide range of knowledge and experience, and the usefulness of financial information to management depends on the ability of owner-managers to understand it.

Previous research (Foster, 1975; Watts and Zimmerman, 1986) suggests that the financially unsophisticated users of corporate reports are less able to interpret the information in the financial statements than users with an educational background in accounting. Although an investigation of the respondents' understanding of the financial statements is beyond the scope of this study, their post-school qualifications and training were used as a proxy for financial sophistication. Moreover, this is a convenient measure to use in a questionnaire survey. Table 4.6 gives a breakdown of the educational background of the respondents.

Table 4.6
Qualifications and training of respondents

Qualifications and training	No. of respondents	% of respondents
Studied/trained in business or management subjects and/or subjects related to the company's activities	266	66.6
Professional or vocational qualification	218	56.6
First degree	102	26.5
Postgraduate degree	38	9.9
None of these	62	16.1
No response	1	0.3

Note: More than one response was possible; n = 385

Two-thirds of the respondents had studied or received training in business or management subjects and/or subjects related to the company's activities and more than half had a professional or vocational qualification. More than a third of the participants hold a degree (37%) and 10% have a postgraduate degree. Further analysis shows that those holding a professional or vocational qualification were likely to have studied or received training in business or management subjects and/or subjects related to the company's activities (chi-square 39.444; degrees of freedom 1; p <0.01). Similarly, those with a degree are likely to have studied or received training in business or management subjects and/or subjects related to the company's activities (chi-square 4.412; degrees of freedom 1; p 0.03).

A small proportion of the respondents did not have the benefit of this high level of education or training (16%). Nevertheless, it should be borne in mind that lack of formal qualifications does not imply that they do not have the ability or experience to understand accounting information. Therefore, although most of the respondents were not in the same league of financial sophistication as qualified accountants or analysts, for example, it can be argued that the majority were not entirely naïve users of accounting information.

4.4 Management style

Management plays a vital role in planning, controlling and decision-making in any business. Therefore, the respondents were asked how the company is currently managed. Table 4.7 shows the results.

Table 4.7
Management style

Management style	**No. of companies**	**% of companies**
Mainly by one director with advice/consultation from other directors	136	35.3
Solely by one director	87	22.6
By all directors equally	85	22.1
By directors with some senior managers	74	19.2
No response	3	0.8
Total	**385**	**100.0**

Since 66% of the sample had only one or two executive directors, it comes as no surprise that the majority (58%) were managed mainly or solely by one director. There was a significant association between the number of shareholders and the way in which the company was managed (chi-square 19.443; degrees of freedom 4; p <0.01). This evidence supports the picture painted by the Bolton Committee that 'an essential characteristic of a small firm is that it is managed by its owners or part-owners in a personalised way, and not through the medium of a formalised management structure' (Bolton, 1971, p. 1). It also confirms that as ownership and management are held in the same hands, the agency relationship that exists between the two parties in larger firms is absent in small companies.

4.5 The accounting function

In order to gauge the level of accounting expertise within the company, the respondents were asked to indicate whether they had an accountant or other employee responsible for financial matters on the staff. Table 4.8 gives details.

Table 4.8
Staff responsible for financial matters

Staff	**No. of companies**	**% of companies**
Bookkeeper	224	58.2
Credit controller	130	33.8
Qualified accountant (employee)	66	17.1
Qualified accountant (director)	55	14.3
Director	55	14.3
General manager/administrator	22	5.7
Non-qualified accountant	6	1.6
Other	8	2.1

Note: More than one response was possible; n = 385

Nearly 60% of the companies have at least one bookkeeper and 34% have one or more credit controllers. A significant number (31%) have a qualified accountant either on the staff or on the board of directors. This evidence, together with the educational background of the respondents shown in Table 4.6, shows that many small companies have considerable financial expertise available internally to aid the collection, analysis and reporting of financial information. Further analysis shows that companies with a turnover of £1m or more are likely to have qualified accountant in-house whilst those with a turnover under £1m tend not to have a qualified accountant on the staff (chi-square 6.949; degrees of freedom 1; p <0.01).

Related to the level of accounting expertise available internally is the relative sophistication of the accounting system. A computerised accounting system gives greater access to financial information which management can use for planning, controlling and decision making. Previous research shows that the majority of small firms have a computer (Chen and Williams, 1993) and there is evidence to suggest that some firms use it for bookkeeping or accounting purposes (Fitchew and Blackburn, 1998; Marriott and Marriott, 1999). Therefore, the respondents were specifically asked about the level of computerisation of their accounting system. Table 4.9 gives details of their replies.

Table 4.9
Type of accounting system

Accounting system	**No. of companies**	**% of companies**
Computerised	219	56.9
Partly computerised	96	24.9
Manual	67	17.4
No response	3	0.8
Total	**385**	**100.0**

The results show that 82% of small companies use a computerised or partly computerised accounting system and this indicates that the use of computers is now widespread in small businesses. This corroborates recent research by Chittenden, Poutziouris and Michaelas (1998).

4.6 Conclusions

The analysis in this chapter has presented a picture of the ownership and management of the small companies that took part in the study. More than 80% of the sample have between one and four owners (the mode was 2) and 75% are wholly or partly family-owned. Older companies were more likely to be wholly family-owned. Although there are already a number of different measures for defining ‘small’ in company legislation, these results suggest that the number of owners or family ownership might also be relevant criteria by which to differentiate small entities from their larger counterparts.

Two-thirds of small companies have either one or two directors and the majority (58%) are managed mainly or solely by one director. There was a strong correlation between ownership and the number of executive directors, confirming that small companies are owner-managed. From a theoretical perspective this demonstrates that there is little scope for an agency relationship between owners and management in small companies. This has important implications for the relevance of the SoP to small companies, since the conceptual framework is based on the stewardship role of the financial statements and the needs of investors (ASB, 1999a). This is discussed further in later chapters.

Just over a third (34%) have a NED and these tended to be companies that are not wholly family-owned. Just over 80% of the respondents are the principal directors of the company, which previous research indicates are those in charge of the financial function. They were well qualified to answer what was, of necessity, a fairly technical questionnaire: 67% have studied or received training in business or management subjects or subject related to the company's activities; 57% have professional or vocational qualifications; and 36% have a degree.

A total of 31% of the companies have a qualified accountant on the staff or on the board of directors and these companies tended to be those with a turnover of £1m or more. More than half (58%) have at least one bookkeeper and 34% have one or more credit controllers. The vast majority (82%) have a computerised or partly computerised accounting system. These results suggest that many small companies have considerable financial expertise available internally and the means by which to record and analyse financial and other management information.

Using the survey results, this chapter has presented up-to-date information on the ownership and management of small companies. It has also provided insights into the educational background of the principal director and the level of financial sophistication within the company. In the next chapter the results relating to the financial reporting choices made by sample companies are examined.

Chapter 5 Financial reporting choices

5.1 Introduction

In Chapter 1 it was noted that the principal aim of those responsible for the regulation of financial reporting by small companies is to relieve the burden of compliance that falls disproportionately on small businesses compared to their larger counterparts. However, the current deregulatory trend has been taking place with little empirical evidence of the needs of small companies. This chapter focuses on the financial reporting choices exercised by the owner-managers of the sample companies, which provides some insight into the extent to which small companies' needs are met by changes designed for their benefit.

The first section analyses the type of accounts the companies have filed with the Registrar of Companies and the reasons given by the respondents for their choice. This is followed by an examination of the likely adoption levels of the FRSSE, the most recent option to be offered to smaller entities. The final section explores the respondents' views on the overall costs and benefits of financial reporting.

5.2 Filing options

The filing options set out in the Companies Act 1985 allow companies that qualify as 'small' and 'medium-sized' to prepare and file either full or abbreviated financial statements with the Registrar of Companies. It is relevant to mention medium-sized companies at this point, as approximately 20% of the sample currently fall into this classification.

Small companies filing abbreviated financial statements are not required to file a profit and loss account or a directors' report and may file either an abbreviated or a shorter-form balance sheet (see Chapter 1). Medium-sized companies are permitted to file financial statements with the Registrar in an abbreviated format, but this differs from that available to small companies. In the abbreviated accounts of a medium-sized company, certain profit and loss account items can be combined and shown as one item under the heading 'gross profit or loss'. In addition, the notes to the accounts may omit the segmental analysis of turnover that would otherwise be required. The requirements for the full directors' report, balance sheet and notes to the accounts are fundamentally the same as those for large companies.

All abbreviated financial statements must be accompanied by a special auditors' report, unless the company qualifies for audit exemption. This report must state that, in the auditors' opinion, the company is entitled to deliver abbreviated financial statements and the statements are properly prepared in accordance with the relevant sections of the Companies Act.

Whether the financial statements filed with the Registrar are full or abbreviated, the balance sheet must be signed on behalf of the board by a director. Therefore, it would be reasonable to assume that the owner-managers of the sample companies would know what type of accounts the company had filed the previous year. Table 5.1 provides a breakdown of their responses.

Table 5.1

Filing choice last year by size of company

Filing choice	No. of companies	% of companies
Full accounts	252	65.5
Abbreviated accounts	114	29.6
Uncertain/no response	19	4.9
Total	**385**	**100.0**

It should be borne in mind that the sample was selected on the basis of the availability of three size measurement criteria: turnover, balance sheet total and number of employees (see Chapter 1). As a figure for turnover would not have been available if the company had filed abbreviated accounts, at the time of selection all the companies had filed full accounts. However, the table shows that 30% of the respondent stated that they had filed abbreviated accounts last year.[16]

Private companies can file their accounts with the Registrar up to 10 months after the end of their accounting reference period. Therefore, it is quite possible that some directors had opted to file abbreviated accounts in their last accounting period, but that these latest returns had yet to be updated on the FAME database from which the sample was selected. Thus, it seems likely that would appear that some companies had only recently exercised the choice to file abbreviated accounts or had become eligible to do so.[17] Indeed, some respondents volunteered information to this effect.

Further analysis found an association between type of accounts filed and size of company. Those filing abbreviated accounts are more likely to be companies with a turnover of under £1m and those filing full accounts tend to be larger with a turnover of £1m or more (chi-square 6.766; degrees of freedom 1; p <0.01).

The respondents were asked to state the main reason for their filing choice. This was designed as an open question and the results have been derived from an analysis and classification of the replies. Table 5.2 shows the reasons given by the 207 respondents answering this question who had filed full accounts with the Registrar in their most recent financial year.

[16] Using the size thresholds in the Companies Act 1985, 31% of small companies and 22% of medium-sized companies in the sample had filed abbreviated accounts.

[17] Four of the sample companies had primary activities in the banking, finance, insurance, business services and leasing sector and may not have qualified for the exemptions and concessions available on the grounds of public interest.

Table 5.2
Reason for filing full accounts

Reason	No. of companies	% of companies
Statutory requirement	62	30.0
Accountant's advice	56	27.1
Tradition	30	14.5
Full disclosure	25	12.1
Cost benefits	13	6.3
Other	21	10.0
Total	**207**	**100.0**

The most commonly cited reason, reported by 30% of respondents, is that the directors are merely complying with statutory requirements. Without further investigation it is difficult to know whether some companies are unaware that they might have filed abbreviated accounts or that they were not eligible to file abbreviated financial statements in that period.

More than a quarter of those filing full accounts stated that they did so because they were following their accountant's advice. It seems likely that the directors of small companies would rely on professional advice when it comes to meeting their obligations in such a complex and heavily regulated area as financial reporting. It was noted in Chapter 4 that 31% of the sample companies had a qualified accountant on the board of directors or on the staff, so accountancy advice would have been readily available for these firms.

There may have been a number of reasons for advising full disclosure, the most important of which hinge on the question of the company's eligibility to file abbreviated accounts. The application of the criteria for defining small and medium-sized companies can be complex. In addition to satisfying the basic size tests, companies must also satisfy other qualification criteria, which may be difficult to interpret. It could be that some accountants are erring on the safe side in advising full disclosure. However, it seems more likely that, if there is no need to protect commercial confidentiality, filing full accounts avoids the additional cost of preparing abbreviated accounts.

In other cases the advice to file full accounts may be connected to commercial benefits of full disclosure; for example, if the company were preparing for flotation. Other reasons may be related to management's desire to use the statutory accounts to encourage investment (Olsson, 1980) or to enhance their corporate image, which previous research suggests is of increasing importance (Korn Ferry, 1986; Martin, 1989). Indeed, one respondent mentioned that his company filed full accounts because in his opinion, "It looks more professional".

The table shows that 15% of the sample companies had filed full accounts because it was a tradition and they had always done so. A further 12% referred specifically to the desire to make full disclosure. As one executive chairman wrote, "We want to show the growth and performance of the company and show that we've got nothing to hide". Another managing director stated that the company wanted to make full disclosure because the board was preparing for flotation, whilst three in the 'other' category simply stated that full accounts are of more use to the company. The cost benefits of filing full accounts were reported by fewer than 10% of respondents and several owner-managers specifically stated that it was more cost effective to prepare only one type of accounts that would fulfil their statutory obligations both to the Registrar and to their shareholders.

Table 5.3 shows the reasons given by the respondents of the 102 companies that had filed abbreviated financial statements in the previous financial year.

Table 5.3
Reason for filing abbreviated accounts

Reason	**No. of companies**	**% of companies**
Legal minimum/confidentiality	43	42.2
Accountant's advice	22	21.6
Cost benefits	18	17.6
Statutory requirement	17	16.7
Other	2	2.0
Total	**102**	**100.0**

Filing abbreviated accounts with the Registrar of Companies results in additional cost, as they must be prepared in addition to the full financial statements for shareholders. Consequently, it is likely that the company will only decide to take this option where it is deemed to be worthwhile on grounds of preserving commercial confidentiality. This was reflected in reasons shown in Table 5.6 for filing abbreviated accounts. The most common reason is that they want to disclose the legal minimum and thus reduce the amount of information available to competitors. As one respondent stated, "We've got something to hide!" It is widely acknowledged that, regardless of size, one of the aims of management is to comply with regulatory requirements and maintain the financial status of the entity, with the minimum disclosure of information that would be of advantage to a competitor (Mace, 1977; Hussey and Everitt, 1991).

Acting on their accountant's advice was given as a reason by just under a quarter (22%) of those filing abbreviated accounts. This is slightly lower than the proportion of those filing full accounts. Cost benefits were also cited as reasons for filing both types of accounts. For those filing abbreviated accounts, this might be interpreted as indicating that some directors consider that there are cost advantages in preserving commercial confidentiality.

5.3 The FRSSE

The FRSSE represents the most recent development in the deregulatory trend for small companies, but it is worth noting that if abbreviated accounts are filed, adoption of the FRSSE will make little difference to the amount of information disclosed to external parties. In order to gain some insights into the views of owner-managers on the standard, the respondents were asked whether the company would be preparing its statutory annual accounts in accordance with the FRSSE. Although this was a somewhat technical question to expect the respondents to answer, it was considered likely that their accountants would have discussed the options with them. Table 5.4 shows their responses.

Table 5.4
Adoption of the FRSSE

Adopt the FRSSE	No. of companies	% of companies
Will take professional advice	240	62.3
Undecided	44	11.4
No	43	11.2
Yes	38	9.9
No response	20	5.2
Total	**385**	**100.0**

The results show that the majority of owner-managers will take professional advice before deciding whether to prepare their accounts in accordance with the FRSSE, whilst a further 10% simply indicated that they were undecided. Nevertheless, nearly a quarter of respondents had made up their minds, with 11% deciding against adoption and 10% stating that they would be following the standard.

Of the 32 respondents who gave reasons for not adopting the FRSSE, the main reason (given by 12 respondents) can be summed up by the managing director who wrote, "We have no wish to change". The remainder gave a range of different reasons and eight respondents who stated that they would not be adopting the FRSSE acknowledged that they did not know what it was. The role of the accountant in the decision was not apparent in the answers given to this question, although one respondent stated that his accountant had advised against it and another noted that he would look into the advantages. This contrasts with the main rationale for adopting the standard given by nine of the 26 respondents who gave reasons for preparing their accounts in accordance with the new standard, which was that they were following their accountant's advice.

There was no significant association between size of company or the presence of a qualified accountant in the company and the respondents' views on adopting the FRSSE.

5.4 Advantages and disadvantages of financial reporting

As a precursor to the examination of company practice, this section reports on the results relating to opinions on the advantages or benefits of financial reporting and the costs or disadvantages. The questionnaire contained four questions on this topic, each of which was designed as an open-ended question in order to elicit the widest range of undirected answers. This type of question can be successful if respondents identify fairly strongly with the objectives of the research or have strong feelings on the topic (Kervin, 1992).

Table 5.5 shows the result of categorising the responses relating to the main advantage of having to produce the statutory annual accounts.

Table 5.5
Main advantage of financial reporting

Main advantage	No. of companies	% of companies
Confirmation/verification	122	31.7
Annual update/overview	59	15.3
Discipline/good practice	44	11.4
Other	75	19.5
None/minimal	43	11.2
No response	42	10.9
Total	**385**	**100.0**

A total of 78% of the sample consider that there is some advantage to be gained from having to produce the statutory annual accounts. Supporting the findings of previous research (Carsberg et al, 1985; Dugdale, Hussey and Jarvis, 1998), the principal benefit appears to lie in having the financial results confirmed or verified, with nearly one-third of respondents holding this view. Related to this is the benefit of having an annual update or overview of the financial position. ‘Directors seem to have a rough idea of the results of the business over a period, but find the annual accounts useful in dispelling the uncertainty about profitability’ (Carsberg et al, 1985, p. 31).

The terms ‘confirmation’ and ‘verification’ imply that the owner-manager keeps some financial records or has some informal knowledge of the financial results of the company. At the very least, the company will receive regular bank statements showing the cash balance of the business, which subsequently can be confirmed by the figure for cash in the balance sheet of the statutory accounts. These two terms also imply that the accountants who prepare the annual accounts are perceived as experts and this gives more credibility to the results reported.

Just over 11% of owner-managers consider that the main advantage of financial reporting lies in the discipline of the exercise or that it is simply good practice. However, a similar proportion specifically stated that for them there was no advantage or minimal benefits from financial reporting.

A significant association was found between size of company and the perceived advantages of having to produce the statutory accounts. Companies with a turnover of £1m or more are likely to consider that the main benefit is the confirmation/verification of the results. The directors of companies with a turnover of under £1m tended to see the main benefit as the annual update/overview, the discipline/good practice that statutory reporting provides, or consider that there are few or no benefits to producing the annual accounts (chi-square 11.688; degrees of freedom 4; *p* 0.02).

Table 5.6 shows the results of categorising the views of the respondents on the main disadvantage of having to produce the statutory annual accounts. It must be borne in mind that the results shown in Tables 5.5 and 5.6 are not mutually exclusive.

Table 5.6
Main disadvantage of financial reporting

Main disadvantage	No. of companies	% of companies
Cost/time/inconvenience	249	64.7
Other	29	7.5
None/minimal	46	11.9
No response	61	15.8
Total	**385**	**100.0**

A total of 72% of respondents consider that there is some disadvantage in having to produce the statutory annual accounts. As can be seen, owner-managers perceive the main disadvantage of financial reporting to be the cost, in monetary terms or in terms of time and inconvenience. However, 12% specifically stated that they do not consider there is much or any disadvantage in producing the statutory annual accounts. Overall, the findings in the preceding two tables show that over 70% of owner-managers identify both costs and benefits to their companies of financial reporting, with only 11% reporting neither.

As in the previous table, a significant association was found between size of company and the perceived disadvantages of financial reporting. Companies with a turnover of under £1m tended to consider that the main disadvantage was the cost and inconvenience, whilst those with a turnover £1m or more were more likely to hold other views or be of the opinion that there were few or no disadvantages to producing the statutory accounts (chi-square 7.987; degrees of freedom 2; p 0.02).

The disclosure of information that may be useful to competitors does not feature as a perceived disadvantage of financial reporting. This may be an indication that current reporting options offer sufficient protection to those who do not wish to provide full information. Previous research (Carsberg et al, 1985), which was conducted prior to the introduction of the option to file modified accounts (and, subsequently, abbreviated accounts), also found that in general the directors of small companies do not see the disclosure of commercial information as a burden.

In order to gain some understanding of the extent to which current financial reporting requirements meet the needs of the owner-directors of small companies, the respondents were asked to specify any information they would find useful that is not currently shown in the statutory accounts. Table 5.7 summarises their responses.

Table 5.7
Useful information not currently disclosed in the statutory accounts

Information desired	Own accounts	Others' accounts
	% of companies	**% of companies**
More detail	6.3	9.3
Other	2.1	4.5
None	24.9	10.9
No response	66.7	75.3
Total	**100.0**	**100.0**

n = 385

There was a low response rate to this open-ended question which may be due to a number of reasons. It is possible that the majority of respondents do not have strong feelings on the subject. Alternatively, they may have required more time to think about the question or may have lack sufficient knowledge to give a detailed answer. In addition, the respondents may have been suffering from question fatigue, as the open-ended questions were grouped together towards the end of the questionnaire. However, it is clear that a considerable number of respondents wanted to register that they are satisfied with the amount of information in their own company's accounts (25%) and the accounts of other companies (11%).

The main theme identified in the answers of those who expressed a view was the need for more detailed financial information and this supports the findings of previous research (Carsberg et al, 1985). Some respondents referred to the need for more detail relating to turnover or costs; others wanted details such as margins or ratios in general. It would appear that the information desired but not currently disclosed was more likely to be in the accounts of other companies (14%), rather than in their own accounts (8%). It would be valuable to discuss these findings with the owner-managers themselves and their accountants in order to obtain further insights into the information needs of small companies.

In a separate open-ended question the respondents were asked if there was any information that they considered should not be disclosed in the statutory annual accounts filed with the Registrar of Companies. A total of 19% volunteered that they were satisfied with disclosure levels and only 15% gave details of the type of information they considered should not be made publicly available in their own company's accounts. Analysis reveals that the directors of 8% of small companies object to disclosing financial information relating to their emoluments and other personal information.

This can be compared Page's (1984) study, which was conducted prior to the introduction of 'modified' accounts. He found that 52% of respondents wanted less disclosure and specifically mentioned were directors' emoluments. In addition, 22% thought the accounts for private companies were intrusive into the owner's private affairs. The present study's finding that fewer than 10% object to disclosing information relating to the directors may be attributed to the current deregulatory trend that has seen changes to the Companies Act that permit small companies to file abbreviated accounts (SI 1997/220). In addition, they may omit certain information relating to directors' emoluments from the notes to the accounts (SI 1997/220 as amended by SI 1997/570).

As in Table 5.6, there was no significant mention of the desire to protect commercially sensitive information.

5.5 Conclusions

This chapter has provided up-to-date evidence of company practice and disclosure preferences as well as owner-managers' views on the costs and benefits of financial reporting in 1999. At the time of selection for inclusion in the sample, all the companies had filed full accounts, but the survey reveals that in the most recent financial year 30% had opted to file abbreviated accounts. Those filing abbreviated accounts are more likely to be companies with a turnover of under £1m, whilst those filing full accounts tend to have a turnover of £1m or more.

The main reasons given for filing full accounts were because it is a statutory requirement or because the directors are following the advice of their accountants. The main reasons given for filing abbreviated accounts were because they wished to disclose the legal minimum and/or preserve commercial confidentiality. Whether they choose to file full or abbreviated accounts, a significant proportion of owner-managers do so on their accountant's advice.

This is not surprising since practitioners are in the best position to offer guidance in such a highly regulated environment. A key factor in the filing decision is the company's eligibility to file abbreviated accounts. In addition to satisfying the basic size tests, companies must also satisfy other qualification criteria, which may be difficult to interpret and therefore require professional advice. A second important factor is that the accountant knows the client's business and can therefore discuss with the owner-manager the pros and cons of filing abbreviated accounts which protect commercial confidentiality but incur higher costs since they must be prepared in addition to the full accounts for shareholders. Cost benefits were cited as reasons for filing both full accounts and abbreviated accounts, but the cost benefits of filing full accounts were reported by only 6% of respondents. This is a surprising result, since the deregulatory debate is strongly focused on relieving cost burdens.

It would appear that the accountant has an important role to play, not only in advising on the type of accounts that should be filed, but also in whether the accounts will be prepared according to the FRSSE. Although nearly 10% of respondents had decided to adopt the standard and 11% had decided against it, most were undecided (74%) with 62% stating that they would be taking professional advice.

More than 70% of owner-managers believe that there are both costs and benefits to financial reporting. The main advantage is seen as the confirmation/verification of the financial results, and this opinion tended to be held by the owner-managers of companies with a turnover of £1m or more. The main disadvantage was seen as the cost and inconvenience and this view was more likely to be held by the directors of companies with a turnover of less than £1m. Contrary to the findings of previous research (Keasey and Short, 1990) this indicates that size does influence the perception of the relative burden of financial reporting requirements.

Only a small minority of the respondents offered views on current levels of disclosure in the statutory accounts. The main themes were that more detailed financial information should be given in the accounts, but that financial and personal information relating to the directors should be confidential. The desire for more detailed information implies that commercial confidentiality is of less importance to some companies than the needs of management. Management's needs are discussed in more detail in Chapter 7.

This chapter has presented the results of the survey relating to the financial reporting choices made by the sample companies. The next chapter builds on these findings and provides insights into the views of the respondents on the role of the auditors' report and the utility of this component of the statutory accounts.

Chapter 6 Role of the auditors' report

6.1 Introduction

In the UK, qualifying small companies have been permitted to dispense with the requirement for an external audit since 1994, but the current regulations stem from 1997 (SI 1997/936) when the turnover threshold for exemption was revised to £350,000 and the balance sheet total amended to £1.4m. In June 1999, the DTI created considerable debate by announcing proposals to increase the turnover threshold to a possible maximum of £4.2m (DTI, 1999b).

In this chapter the owner-managers' views on the role of the audit report and the value of having an external audit are analysed. The first section examines the type of accounts of other businesses read by the respondents, before going on to look at the usefulness of the auditors' report on their own and other companies' accounts. This is followed by an analysis of their perceptions of the function and purpose of the audit report. Anticipating further developments in the deregulation of small companies, the final section explores the respondents' views on the value of having an audit should this become non-mandatory.

6.2 Usefulness of the auditors' report

Once filed with the Registrar, the accounts of all companies become public documents and can be inspected on payment of a small fee. Before asking the respondents for their views on the usefulness of the auditors' report on their own and other companies' accounts, they were asked whether they ever read the statutory annual accounts of other businesses. The intention was to provide some measure of the breadth of their experience as well as which accounts were of interest to them. Table 6.1 gives details.

Table 6.1
Accounts of other business read

Accounts read	**No. of companies**	**% of companies**
Major competitors	126	32.7
Major customers	93	24.2
Major suppliers/creditors	57	14.8
Other	43	11.2

Note: No. of companies = 385; more than one response was possible

Although not directly comparable, a small study by Pratten (1998) found that 62% of small and medium-sized companies had used the accounts of other companies for a number of different purposes. However, in the present study, just over half the respondents (52%) claimed to read the accounts of other companies. Between a quarter and a third of owner-managers read the accounts of their major competitors and/or their major customers. In addition, nearly 15% read those of their major suppliers and creditors. The 'other' category included various types of personal or business investment (cited by 7% of respondents) and the accounts of potential acquisitions (2% of respondents). Companies with a turnover of above £2.8m were more likely to read the accounts of their major competitors, customers and suppliers/creditors than their smaller counterparts (chi-square 13.893, degrees of freedom 1, p <0.01).

The figures in Table 6.1 are lower that those found in the pilot study (Dugdale, Hussey and Jarvis, 1998), although the ordering is similar. This is probably due to sampling differences.

The next question asked the respondents to indicate how useful they find the auditors' report on their own accounts and those of other businesses, using a rating scale where 1 = of no use and 5 = very useful. The mid-point of the scale (3) is considered to be neutral. Table 6.2 shows the results.

Table 6.2
Usefulness of the auditors' report
(% of companies)

The auditors' report	**Very useful**		**Of no use**			**No**	**Total**
	5	**4**	**3**	**2**	**1**	**response**	
On own company's accounts	18.7	23.1	26.2	16.4	14.5	1.1	100.0
On the accounts of other businesses	4.2	13.0	18.7	15.1	23.6	25.4	100.0

No. of companies = 385

The table shows that 42% of the directors of small companies find the auditors' report on their own accounts useful, whereas 17% consider it to be useful on the statutory accounts of other businesses. There was a significant association between the usefulness of the audit report on other companies' accounts and readership of other companies' accounts (chi-square 20.144; degrees of freedom 1; p <0.01). Not surprisingly, those who indicated that they do not read the accounts of other businesses are likely to consider the audit report of no use. Of those who do read the accounts of other businesses, 28% find the audit report useful whilst 38% who do not. Exploratory analysis found no significant association between the responses to this question and size of company.

With regard to their own accounts, it must be borne in mind that the sample was selected from a database that excluded companies with a turnover less than £500,000. Since the current turnover threshold for small company audit exemption is £350,000, in principle, all the participating companies would have been required to have an audit. However, as mentioned in earlier chapters, private companies can file their accounts up to 10 months after the end of their financial year, which means that the records are historical. It is possible that in their last accounting period some companies may have become eligible for exemption. Indeed, three respondents volunteered that their company's accounts were not audited at present.

6.3 Perceptions of the auditors' report

In order to probe the question of usefulness further, the respondents were asked to indicate whether they agreed or disagreed with a number of statements relating to possible functions or purposes of the audit, using a rating scale where 1 = disagree and 5 = agree. The mid-point on the scale (3) is considered to be neutral. Table 6.3 shows the results.

Table 6.3
Perceptions of the auditors' report
(% of companies)

Perceptions of the auditors' report	Agree 5	4	3	2	Disagree 1	No response	Total
Shows compliance with legislation	51.7	30.9	11.7	0.5	0.8	4.4	100.0
Provides check on internal records	48.1	26.0	13.0	3.6	4.4	4.9	100.0
Improves credibility of the information	28.6	33.8	20.2	6.8	4.2	6.4	100.0
Improves quality of the information	14.8	20.0	33.0	17.7	9.1	5.4	100.0
Helps protect against fraud	11.9	22.3	30.9	15.3	11.7	7.9	100.0
Shifts responsibility from the auditors to the directors	14.0	15.8	28.1	15.3	17.9	8.9	100.0

No. of companies = 385

It comes as no surprise that the overwhelming majority (83%) agreed with the statement that the audit shows compliance with the legislation. Nevertheless, 13% of the respondents appear to be uncertain or disagreed with this statement, but perhaps they were exempt or were reading more into it than was intended. Apart from assurance that they are meeting regulatory obligations, the main value of the audit appears to be its confirmatory role in checking internal systems and records (74% agreed with this statement). Related to this is the belief that the audit improves the credibility of the information (62% agreed), but there was less certainty among owner-managers that the audit improves the quality of the information.

The presence of an independent check on the information should increase the extent to which users can rely on the financial statements. However, the auditors do not owe a duty of care to all groups who might place reliance on the auditors' report. *Caparo Industries plc* v *Dickman* [1990] All ER 568, which, in general, subsequent decisions of the courts have upheld, laid down tight limits on when a professional owes a duty of care and can be sued by a person other than his client.

However, there are limitations on the auditor's responsibility, particularly in relation to fraud. The view held by 34% of the respondents that the audit helps to protect against fraud is a misconception, although the blame for fraud is often placed on those who audit the accounts (Kaplan, 1987; Mitchell, Puxty, Sikka and Willmott, 1991; Humphrey, Moizer and Turley, 1993). Although searching for fraudulent practices is not the duty of the auditors, there is some justification for this view, since any material fraud is likely to affect the true and fair view.

There was some evidence of an audit expectation gap in the views expressed about the responsibilities of the directors regarding the preparation of the financial statements on which the auditors report. A third of the sample disagreed with the statement that the audit shifts responsibility from the auditors to the directors and a further 28% were uncertain, despite the fact that the auditors' report clearly states that the company's directors are responsible for the preparation of the financial statements.

6.4 Audit exemption

Anticipating further developments in the deregulation of small companies, the respondents were asked if they would continue to have their company's accounts audited if they were not legally required to do so. There was a very high response rate to this open-ended question (98%) and only 8% expressed any uncertainty in their views. Table 6.4 gives details.

Table 6.4
Views on a non-mandatory audit

View	No. of companies	% of companies
Would continue to have accounts audited	241	62.6
Would not have accounts audited	111	28.8
Would take professional advice	21	5.5
Undecided	11	2.8
No response	1	0.3
Total	**385**	**100.0**

The majority of owner-managers (63%) would continue to have their accounts audited if they became exempt. The main reasons they gave related to the value of having an independent check on the figures and/or confirmation of the financial position. This ratification was not only for the benefit of external users of the accounts, but also for the directors themselves. For example, one respondent wrote, "It avoids disputes between brothers!" (three owners, managed mainly by one). Another noted, "It's essential with two people each with 50%" (two owners, managed by both equally). It was also important in companies where the owners were not related: "We think an outside assessment is valuable" (two owners, managed by both equally). This supports the findings of previous research (Freedman and Goodwin, 1993).

Not surprisingly, there was a strong positive association between respondents who would continue to have their accounts audited voluntarily and those that find the auditors' report on their own accounts useful (chi-square 39.417, degrees of freedom 1, p <0.01). A similar correlation was also found in respect of the auditors' report on the accounts of other businesses (chi-square 5.833, degrees of freedom 1, p 0.02). Those in favour of a non-mandatory audit were more likely to file full accounts than abbreviated accounts (chi-square 4.318, degrees of freedom 1, p 0.04).

The minority of respondents (29%) stated that they would discontinue the audit if it were not mandatory. The main reasons for giving up the practice were the savings in time and/or expense and the view that there was little or no benefit in having the accounts audited. As the managing director of a partly family-owned business noted, "We do not take part in fraud or lying to each other. We know each week exactly the Company's situation to the last pound" (three owners, managed by two directors equally). Another wrote, "As a small family concern we keep very tight controls and find that the auditors simply feed back information we have already prepared" (six related owners, managed mainly by one director).

Further analysis of the data found a significant difference in terms of size between the companies whose directors were in favour of continuing with a non-mandatory audit and those who would discontinue the practice (t 3.663; degrees of freedom 350; $p < 0.01$). Those who would have their accounts audited voluntarily had an average turnover of £1.3m, whilst those who would stop doing so had an average turnover of £0.8m. This size difference is supported by other statistics which show that companies with a turnover exceeding £1m are more likely to opt for a voluntary audit than their smaller counterparts (chi-square 12.115, degrees of freedom 1, p 0.01).

Although the recent MORI survey (ACCA, 1998) found that more than 80% of SMEs consider that the information provided in the statutory audit is useful to the bank, there was no widespread mention of this in the present study. One possible reason for this may be due to sampling differences. Details of the size and selection methods employed by the MORI survey have not been published, whereas the sample for the present study was specifically selected to be representative. Another reason may be connected to the way in which the data was collected. Again, details of the MORI survey are not available, but the present study collected the information by asking an open question, rather than a forced answer question that lists potential answers. Therefore, the validity of the significant association (chi-square 5.364, degrees of freedom 1, p 0.02) found between companies that would continue to have their accounts audited on a voluntary basis and those that send a copy of their statutory accounts to the bank and other providers of finance is likely to be greatly enhanced.

This further supports the notion of an agency relationship between lenders and owner-managers. The need for audited accounts by the bank has been identified in earlier studies. For example, Berry, Citron and Jarvis (1987) found that, irrespective of the size of the company, bankers considered the full (audited) statutory accounts the most important source of documentary information. They concluded that the statutory accounts are perceived as more reliable than other sources of information, such as management accounts, which do not exist in all cases.

No significant association was found between the respondents' views on a non-mandatory audit and the presence of a qualified accountant in the company or external shareholders (defined as shareholders who are not executive directors).

6.5 Conclusions

The findings in this chapter reveal that up to a third of the directors of the small companies that took part in the survey read the statutory accounts of other companies. In the main these were the accounts of their major competitors (33%), major customers (24%) or major suppliers and creditors (15%). A total of 42% of respondents consider that the auditors' report on their own company's accounts is useful and, of those who read the accounts of other businesses, 28% consider that it is useful.

Apart from showing compliance with the legislation, the auditor's report is perceived as improving the credibility and quality of the information, and providing a check on internal books and records. Further analysis suggests that the auditors' report increases the reliability of the information contained in the accounts. However, there are limitations on the auditors' responsibility, particularly in relation to fraud, and it is also recognised that responsibility for the information contained in the financial statements rests with the directors.

The majority of the owner-managers of the sample companies do not see the external audit as a burden. On the contrary, 63% perceive sufficient benefits that they would opt for a voluntary audit should their company become exempt from the statutory audit. These companies had an average turnover of £1.3m. However, 29% stated that they would discontinue the practice if it were not mandatory and these were found to be companies in the sample with an average turnover of £0.8m. Thus, the larger the business, the more likely it was that the directors would not take advantage of audit exemption should the company become eligible. In Chapter 5 it was noted that the vast majority of owner-managers perceive both costs and benefits to financial reporting and it would appear that for companies with an average turnover of £1.3m the cost of the audit is outweighed by the benefits.

This chapter and the last have examined the survey results relating to value of the statutory accounts to the owners/directors of small companies. In the next chapter the usefulness of the annual accounts is considered as a potential source of management information in the context of other sources of accounting and general information that may be available internally.

Chapter 7 Uses and sources of management information

7.1 Introduction

Although previous research indicates that the directors themselves are the principal users of the annual financial statements of small companies, little is known about the relative importance of the statutory accounts as a source of financial information to the company. This chapter presents the survey results that are concerned with the utility of the annual accounts in the context of other sources of information available to management. This provides further insights into the role of the statutory accounts and financial management practices in small companies and moves away from the external financial reporting perspective adopted in Chapters 5 and 6.

The first section looks at who is responsible for the preparation of the statutory accounts and the timeliness of the statutory accounts and any additional annual financial information prepared. This is followed by an analysis of the findings relating to the use of the annual financial statements and the sources and relative utility of more frequently available management information.

7.2 Annual accounting information

Before looking at the annual accounting information itself, it is helpful to consider the source of the information. Therefore, the respondents were asked who normally prepares the company's statutory accounts. Table 7.1 gives details.

Table 7.1
Who prepares the statutory accounts

Preparer	**No. of companies**	**% of companies**
External accountant (local firm)	226	58.7
External accountant (national firm)	90	23.4
Qualified accountant (employee)	28	7.3
Qualified accountant (director)	23	6.0
Other	10	2.6
No response	8	2.0
Total	**385**	**100.0**

Supporting the findings of earlier studies (Page, 1981 and 1984; Carsberg et al, 1985), the results show that the vast majority (82%) of small companies' statutory accounts are prepared by an external accountant. More than half the sample use a local firm and nearly a quarter use a national firm. There was no significant association between size of company and whether the annual accounts are prepared internally or externally.

Only 6% of respondents stated that their accounts are prepared by a qualified director, although it was noted in Chapter 4 that 14% of the companies have one or more directors who is a qualified accountant. Similarly, 7% are prepared by a qualified employee, yet 17% of respondents stated that they have a qualified accountant on the staff. One explanation for this may be connected to the fact that the annual financial statements must be prepared within a highly complex regulatory framework (see Chapter 1). Therefore, owner-managers may prefer to use an external firm of accountants to both prepare and audit the annual accounts, and employ an internal accountant to provide regular management accounting information.

In many cases the statutory accounts form part of a package of annual information the directors receive. Therefore, they were asked whether they received any additional information from the company's accountants at the same time as the statutory accounts. Table 7.2 shows the results.

Table 7.2
Other annual information provided

Information	No. of companies	% of companies
Verbal explanation/analysis of the accounts	230	59.7
Management advice/recommendations	158	41.0
Additional detailed profit and loss account	148	38.4
Advice/recommendations on record keeping	112	29.1
Additional detailed balance sheet	101	26.2
Written explanation/analysis of the accounts	99	25.7
Cash flow statement	51	13.2
Other	11	2.9

Note: More than one response was possible

The great majority of companies (82%) receive some form of additional annual information from their accountant. Most commonly this was a verbal explanation or analysis of the accounts (60%), management advice (41%) and/or a detailed profit and loss account (38%). These findings uphold those of previous studies (Page, 1981 and 1984; Carsberg et al, 1985), which show that the auditors provide the company with the statutory accounts 'supplemented by a detailed profit and loss account and, possibly, additional management information' (Carsberg et al, 1985, p. 24).

The SoP (ASB, 1999a) suggests that timeliness is one of the factors that limits the relevance and reliability of the financial statements. Therefore, the respondents were asked to provide details of how long after the end of the financial year the company received the statutory accounts and any additional detailed accounts. Their responses were grouped into 10-week time bands and the results are shown in Table 7.3.

Table 7.3
Time lag from year-end to receipt of annual accounts
(% of companies)

No. of weeks	Statutory accounts	Additional accounts
1 – 10	24.4	29.8
11 – 20	48.1	47.2
21 – 30	17.7	16.8
More than 30	7.5	6.2
No response	2.3	-
Total	**100.0**	**100.0**
	(n = 385)	(n = 161)

The table shows that there was very little difference in the number of weeks management had to wait before receiving either the statutory accounts or any additional detailed accounts and the majority of companies receive them within 20 weeks. The mean time lag was slightly longer for the statutory accounts (17 weeks) than for the additional accounts (15 weeks).

7.3 Uses of the annual accounts

In order to explore the uses of the annual accounts the respondents were asked who normally receives a copy of the annual accounts, apart from the Registrar of Companies and the shareholders. They were also asked to indicate whether these were the abbreviated accounts or the full accounts. Table 7.4 shows their responses.

Table 7.4
Non-statutory recipients of the statutory accounts

Recipient	No. of companies	% of companies
Bank/other providers of finance	266	69.1
Inland Revenue	174	45.2
Directors*	73	19.0
Senior managers	44	11.5
Major suppliers/creditors	36	9.3
Major customers	24	6.3
All employees	10	2.6
Other	34	8.8

Note: More than one response was possible
* Defined as directors who are not shareholders

The main non-statutory recipients of small companies' annual accounts are the bank and other providers of finance, the Inland Revenue and members of the management team who are not shareholders. These three main uses of the statutory accounts support the evidence of previous studies (Page, 1984; Carsberg et al, 1985; Barker and Noonan, 1996; Dugdale, Hussey and Jarvis, 1998, Pratten, 1998).

It comes as no surprise that the majority of companies (69%) send a copy of their statutory accounts to the bank (and other providers of finance), since banks represent the main source of finance for smaller entities (Cosh and Hughes, 1998). The importance of the bank in this respect also confirms previous research into bank lending (Berry, Citron and Jarvis, 1987; Berry et al, 1993; Berry, Crum and Waring, 1993; Berry and Waring, 1995).

Companies that send their accounts to the bank were likely to have a turnover of £1m or above, whilst the turnover of those that do not send their accounts to the bank tended to under this level (chi-square 10.854, degrees of freedom 1, p <0.01). In addition, companies that send their accounts to the bank were more likely to be in non-service industries, whilst those who do not tend to be in the service sector (chi-square 12.399, degrees of freedom 1, p <0.01). The reasons for these findings may be due to the fact that smaller companies, and those in service industries, are less likely to have fixed assets to use as collateral to support borrowing.

A significant association was also found between those who send the statutory accounts to the bank and those who rate the statutory accounts as useful for management purposes, and vice versa (chi-square 5.358, degrees of freedom 1, p 0.02). This finding lends further support to the notion of an agency relationship between the directors of small companies and the bank. In addition, there was a significant association between those who send the accounts to the bank and the decision to continue to have the accounts audited, even if this became non-mandatory and vice versa (chi-square 5.364, degrees of freedom 1, p 0.02).

Companies have always been required to send their statutory accounts to the Inland Revenue. One reason for the relatively low proportion of respondents reporting that they do so (45%) is that in some cases this may be done by the firm's tax advisors.

Only a small proportion of the sample companies (19%) give a copy of their statutory accounts to directors who are not shareholders. Further analysis indicates that these are businesses where a non-executive director is employed (chi-square 12.499, degrees of freedom 1, p <0.01). Similarly, 12% of companies distribute the statutory financial statements to senior managers and tend to be businesses that are managed by directors in conjunction with senior managers (chi-square 14.674, degrees of freedom 1, p <0.01).

A small minority of directors send a copy of the statutory accounts to their major suppliers and creditors (9%), major customers (6%) or employees (3%). The pilot study (Dugdale, Hussey and Jarvis, 1998) found that the main reason for providing creditors and customers with the accounts was to reassure them and enable them to carry out their own financial health checks.

Further analysis confirms the findings of the pilot study that those who send their statutory accounts to their major suppliers and creditors read the accounts of these business contacts (chi-square 13.613, degrees of freedom 1, p <0.01) and the accounts of their major customers (chi-square 16.918, degrees of freedom 1, p <0.01). Similarly, those who send their statutory accounts to their major customers are those who read the accounts of these customers (chi-square 10.417; degrees of freedom 1, p < 0.01) and the accounts of their major suppliers/creditors (chi-square 7.647, degrees of freedom 1, p <0.01).

Previous research shows that the directors of small companies see the statutory accounts as 'a primary aid to the management of the business' (Carsberg et al, 1985, p. 88). The results in Table 7.4 indicate that one important aspect of the utility of the accounts lies in their use by management as a means of communicating with external stakeholders in the company, particularly the bank and other major lenders.

In order to probe the question of uses and usefulness of the statutory accounts further, the respondents were asked whether they use the company's annual accounts for a number of listed purposes. If so, they were asked to indicate how useful they find them, using a rating scale where 1 = of no use and 5 = very useful. In order to aid comparison of the relative usefulness of the different purposes, the responses have been ranked according to their mean scores and the results are shown in Table 7.5.

Table 7.5
Usefulness of uses of the annual accounts

Use	Mean Score	Rank
Deciding directors' pay/bonuses/dividends	3.62	1
Comparing performance with previous periods	3.39	2
In connection with loans/finance	3.38	3
Long-term planning	3.34	4
Deciding employees' pay/bonuses/dividends	3.20	5
Confirming management information	3.15	6
Capital expenditure	3.12	7
Borrowing decisions	3.10	8
Comparing performance with targets	2.88	9
Short-term planning	2.84	10
Reassuring customers and suppliers	2.83	11
Marketing/pricing decisions	2.43	12
Comparing performance with other companies	2.08	13

None of the mean scores shown in the table reached 4 or above, thus indicating a relatively low level of usefulness for the purposes listed. At the top of the list is deciding directors' remuneration in the form of pay, bonuses and dividends and this finding supports the results of previous research (Lee and Tweedie, 1975; Carsberg et al, 1985). Those who rate the annual accounts as useful for deciding directors' emoluments tend to be those who find the statutory accounts useful for management purposes (chi-square 9.7699, degrees of freedom 1, $p < 0.01$) and to be companies with more than one executive director (chi-square 11.037, degrees of freedom 4, $p < 0.03$). No significant association was found with this result and size of company.

Second in the ranking is the use of the accounts for comparing performance with previous periods (although making inter-firm comparisons was the least useful purpose). This demonstrates that to some extent the comparability of the accounting information in the statutory accounts adds to their utility. This is relevant to the application of the conceptual framework for financial reporting to small companies, since one of the secondary characteristics of the quality of useful accounting information is comparability (ASB, 1999a).

The usefulness of the statutory accounts in connection with loans and finance comes a very close third and supports the view that an agency relationship exists with the bank (and other lenders). In contrast with previous research (Carsberg et al, 1985), the use of the accounts in connection with making capital expenditure decisions does not appear to be particularly useful. This may reflect changes in the composition of the small business sector over the last 15 years, which has seen a decline in capital hungry manufacturing industries and an increase in service sector businesses.

The published profit and loss account and balance sheet and the financial statements generated by the management accounts are key sources of information for managing the company. In an attempt to gain some further insights, the respondents were asked whether they use any items in the profit and loss account or balance sheet for managing the company and, if so, which items they find particularly useful. This was an open question to which only approximately 25% responded with specific items. These centred mainly on overheads, costs and expenses, or other profit and loss account items in the statutory accounts and/or the additional accounts.

There are a number of possible reasons for the low response rate to this question and some of the other open-ended questions. These include question fatigue (as the open-ended questions were grouped together towards the end of the questionnaire) and lack of time or knowledge to provide a detailed answer. However, it can also be interpreted as indicating that owner-managers do not pick out and use specific items from the accounts, but instead use the information provided in a more general manner. Indeed, 5% of respondents answered the question by recording that they use all or most items in the statutory accounts and 4% use all or most items in the additional accounts. This finding requires further investigation.

7.4 General sources of management information

A second question asked whether the respondents use certain general sources of information for managing the company. If so, they were asked to indicate how useful they find them, using the same rating scale where 1 = of no use and 5 = very useful. As in the previous analysis, the answers have been ranked according to their mean scores and the results are shown in Table 7.6.

Table 7.6
Usefulness of general sources of management information

Information	Mean Score	Rank
Monthly/quarterly management accounts	4.24	1
Cash flow information	4.06	2
Bank statements	3.97	3
Budgets	3.53	4
State of order book	3.49	5
Additional accounts for management	3.38	6
VAT records	2.91	7
Statutory accounts for shareholders	2.61	8=
Statutory accounts for the Registrar	2.61	8=
Credit rating agency data	2.32	10
Published industry data	2.20	11

The three most useful sources of information for management purposes are the periodic management accounts, cash flow information and bank statements. Published industry data, credit rating data and the statutory accounts are considered to be the least useful of the items the respondents were asked to rate. The results indicate that the usefulness of the statutory accounts to management rests more with their role in connection with loans and finance, and less with internal financial management practices. They also show that owner-managers of small companies place considerable importance on controlling cash, which previous research (Jarvis et al, 1996) shows is critical to the survival of a small business.

With regard to the utility of the annual accounts in the context of other information for managing the company, the table shows that the additional accounts for management are considered to be useful, but the statutory accounts for the Registrar and for shareholders were not. By specifying separately what are potentially three different forms of annual accounts, this clarifies one of the findings of the pilot study (Dugdale, Hussey and Jarvis, 1998), which gave some indication that the annual accounts are a useful source of management information. Further analysis of the present data shows that the utility of the statutory accounts is not associated with the size of the company. However, tests show that owner-managers who find their statutory accounts useful are likely to be those that do not use periodic management accounts (chi-square 9.019, degrees of freedom 1, $p < .01$). This result requires further investigation.

Previous research in both large and small companies suggests that improving the timeliness of annual accounting information increases its usefulness to users (Lunt, 1982, Carsberg et al, 1985). However, a t test found no significant difference between the utility of the statutory accounts and the time lag from year-end to receipt by management. In Chapter 5 it was noted that some owner-managers feel there is a need for more detailed information to be given in the statutory accounts. It seems likely, therefore, that the lack of detail in the statutory accounts compared with the additional management accounts provided at the same time and the more frequently produced management accounts detracts from their usefulness.

In order to gain further insights into the type of management accounting information available in small companies, the directors were asked whether they use certain specific sources of information for management purposes. If so, they were requested to indicate how frequently they used them. Table 7.7 shows their responses.

Table 7.7
Frequency of use of specific sources of management information (% of companies)

Source	Monthly	Quarterly	Annually	Total
Bank reconciliation statement	63.9	5.5	3.6	73.0
Profit and loss account	48.1	18.7	20.0	86.8
Cash flow statement	39.5	14.0	5.2	58.7
Balance sheet	38.2	14.3	25.7	78.2
Budget variance analysis	36.1	13.2	2.1	51.4
Cash flow forecast	34.3	13.5	8.3	56.1
Budgeted profit and loss account	32.2	16.1	9.4	57.7
Budget plans	21.0	13.5	8.3	42.8
Costing reports	18.7	5.2	3.1	27.0
Break-even analysis	9.6	5.7	6.0	21.3
Standard costing and variance analysis	9.1	2.3	2.3	13.7
Ratio analysis	8.6	7.0	10.6	26.2
Industry trends	6.0	7.0	9.4	22.4
Inter-firm comparison	2.9	4.2	8.8	15.9

The table shows that most frequently used sources of management information are the bank reconciliation statement, profit and loss account, cash flow statement and balance sheet, all of which are drawn up at least quarterly by more than half the companies. These results confirm the importance of cash flow information and bank statements as sources of information in small companies, which was noted in connection with Table 7.6. Reconciling cash flow information with bank statements is a means by which the relationship with the bank can be managed, as well as providing a check on internal records.

Nearly half the respondents use a cash flow forecast and budget variance analysis at least quarterly to aid management, yet only around one in five were conducting any break-even analysis and this requires further investigation. Confirming the results shown in Table 7.6, which show that published industry data is not considered to be useful by small companies, inter-firm comparisons were conducted by fewer than 16% of the sample. This may be an indication that small companies experience problems in gaining access to industry benchmarks or that competitors are filing abbreviated accounts, which reduce the amount of information available for calculating ratios and making comparisons.

A small number of respondents volunteered that some of their management accounting information was drawn up on a weekly basis. As might be expected, there was a positive association between the monthly use of information and the presence of a computerised accounting system (chi-square 45.001; degrees of freedom 1; $p < 0.01$).

7.5 Conclusions

This chapter has examined the survey results relating to the internal use made of the annual accounts and other sources of management information. The statutory accounts of the majority of the companies in the sample (82%) are prepared externally and 82% receive some form of additional information at the same time. Most commonly this is a verbal explanation or analysis of the accounts (received by 60% of the sample companies), management advice (received by 41%) and/or a detailed profit and loss account (received by 38%). The average time lag from year-end to receipt of the accounts is 17 weeks for the statutory accounts and 15 weeks for those receiving additional detailed accounts. In contrast with large companies, there was no indication that improvements in the timeliness of the statutory accounts would improve its usefulness to owner-managers.

Supporting the findings of the pilot study and other previous research, the results show that the main non-statutory recipients of the statutory accounts are the bank and other providers of finance (69%), the Inland Revenue (45%) and management itself (31%). As in the pilot study, a positive association found between those respondents who distribute their statutory accounts to their major suppliers/creditors and customers and those who read the accounts of these business contacts.

The most useful purpose to which the annual accounts are put is in deciding directors' pay, bonuses and dividends, and this has some parallels with the use of large company accounts. The owner-managers of small companies also find the statutory accounts useful for comparing performance with previous periods and in connection with loans and/or finance. However, when compared with other sources of management information available, the statutory accounts are not considered to be useful. This is probably due to the lack of detail and the historic nature of the statutory accounts vis à vis regular management accounts, which can be, generated internally using computerised accounting systems. Tests shows that the utility of the statutory accounts is not associated with the size, but owner-managers who find their statutory accounts useful are likely to be those who do not use periodic management accounts.

The most useful general sources of information are the periodic management accounts, cash flow information and bank statements. With regard to specific sources of management accounting information, the profit and loss account, balance sheet and bank reconciliation statement were the most widely used items and were drawn up at least quarterly by more than 50% of the sample companies. In addition, up to 50% of the respondents use cash flow forecasts and budgets at least quarterly. Not surprisingly, there was a significant association between the frequency of availability of financial information and the presence of a computerised accounting system.

This chapter concludes the analysis of the survey results. The final chapter draws together the findings of the study and discusses the implications for policy makers and the accountancy profession.

Chapter 8 Conclusions and recommendations

8.1 Introduction

Of the 3.7m active businesses in the UK, 99% are small firms with fewer than 50 employees (DTI, 1999c). Thus, small businesses play a significant role in the economy. This study focuses on incorporated small businesses and took the form of a survey using a postal questionnaire. The research examines the use of the statutory financial statements by the chief directors of a representative sample of 385 small companies in a wide range of industries across the UK.

Previous studies (Page, 1981, Carsberg, Page, Sindall and Waring, 1985; Barker and Noonan, 1996; Dugdale, Hussey and Jarvis, 1998) identify management as the main users of small company accounts. However, there is little generalisable evidence of the specific uses or the factors that affect the utility of the accounts to the directors of small companies (Jarvis, 1996). Moreover, the present research is the first major investigation of their views in the UK for at least 15 years. Although the sampling frame did not permit the inclusion of businesses with a turnover of less than £0.5m, in other respects the sample was representative of companies that fall within the current EU definition of 'small'.

The research is set in the context of a number of debates that reflect the dynamic, and sometimes controversial, financial reporting environment of the 1990s. One issue concerns financial accounting theory and the debate over the need for a set of coherent underlying principles. This led to the development of a conceptual framework for financial reporting in the UK, but this appears to be based on the needs of large, public companies, despite the fact that 99% of companies are small and unlisted. This is most apparent in the so-called 'objectives' of financial reporting, which are to provide information for assessing the stewardship of management and for economic decision-making, and identifies investors as the defining class of user.

In contrast to large companies, the majority of small companies are owned and controlled by the same individuals (Bolton, 1971; Carsberg et al, 1985; Poutziouris, Chittenden and Michaelas, 1998). Therefore, the agency relationship (Jensen and Meckling, 1976) between management and shareholders that is present in large companies is seldom significant in small companies. Another major difference between large and small companies lies in the financial strategies they pursue. Whereas profit-maximisation and growth are likely to be the main aims of both shareholders and directors of large companies, small companies are more likely to pursue satisficing (Simon, 1960) or 'lifestyle' strategies in pursuit of survival and stability (Jarvis, Kitching, Curran and Lightfoot, 1996). This raises questions about the utility to small companies of financial statements prepared in accordance with a large company template.

A second important issue is the increased volume and complexity of financial reporting requirements since the ASB was established in 1990. This has led to an escalation of the Big GAAP/Little GAAP debate and, as a result, there has been a gradual relaxation in the regulation of small company reporting. The main changes allow small and medium-sized companies (as defined under the Companies Act 1985) to adopt various options that simplify, abbreviate or otherwise reduce the amount of information disclosed. In addition, most of the smallest companies are exempt from the requirement to have their accounts audited. These developments have implications for the 'relevance' and 'reliability' of the financial statements, which the SoP identifies as the primary characteristics of accounting information that is useful to users.

Periodically, the government has made adjustments to the size thresholds in company legislation to allow for indexation and to meet European harmonisation objectives. In 1999 the DTI put forward a proposal to increase the turnover threshold that permits small companies to file abbreviated accounts and adopt the FRSSE from £2.8m to £4.2m, and increase the balance sheet total from £1.4m to £2.1m. In addition, it was announced that the turnover threshold for audit exemption could be raised from £350,000 to a possible maximum of £4.2m.[18] The rationale for these changes is that they will reduce the burden of financial reporting for an increased number of small companies, although this has not been tested empirically. In addition, these developments are taking place without detailed knowledge of the information needs of the owner-managers of small companies or of the perceived benefits attached to financial reporting by smaller entities.

8.2 Discussion and implications

In this section we draw together the main findings of the study and the implications arising from them. The six interrelated research questions posed at the outset of the study are used to structure the discussion.

1. What are the benefits and costs to small companies of meeting financial reporting requirements?

The directors of small companies see the main benefit of financial reporting as being the confirmation and verification of the annual financial results and this view is held by those in companies with a turnover of £1m and above. The main disadvantage of financial reporting is seen as the cost, in monetary terms as well as in terms of time and inconvenience, and this view is associated with those in companies with a turnover of under £1m. The disclosure of information that may be useful to competitors does not feature as a perceived disadvantage of financial reporting. This may be an indication that current reporting options offer sufficient protection to those who do not wish to provide full information.

Contrary to the findings of previous research (Keasey and Short, 1990), these results indicate that size of the company is significant factor in the cost/benefit debate. However, the situation is complex, as the survey shows that the majority of directors identify both costs and benefits to financial reporting. These findings are discussed further in subsequent sections.

[18] Since this study commenced these thresholds have been extended further (see Chapter 1).

2. What are the reasons for the financial reporting choices made by small companies?

The main reasons given for filing full accounts is that the directors are meeting statutory requirements or following their accountant's advice. A small number stated that they have always done so or that they actively want to make full disclosure. This was because they wanted to demonstrate how well the company is performing or show that they have nothing to hide. The main reason given for filing abbreviated accounts is that the directors wish to disclose the legal minimum, thus preserving commercial confidentiality.

Whether they choose to file full or abbreviated accounts, a significant proportion of directors do so on their accountant's advice. This is not surprising since practitioners are in the best position to offer guidance in such a highly regulated environment. A key factor in the filing decision is the company's eligibility to file abbreviated accounts. In addition to satisfying the basic size tests, companies must also satisfy other qualification criteria, which may be difficult to interpret and therefore require professional advice.

A second important factor is that the accountant knows the client's business and can therefore discuss the pros and cons of filing abbreviated accounts, since this option helps protect commercial confidentiality, but incur higher costs as they must be produced in addition to the full accounts prepared for shareholders. Cost benefits were cited as reasons for filing both full accounts and abbreviated accounts, but only by a minority of respondents. This seems surprising, since the deregulatory debate is strongly focused on relieving cost burdens. However, the research shows that cost is not a major factor in the filing choices of small companies.

Apart from filing choices, small companies can choose whether to adopt the FRSSE or continue to produce their accounts in accordance with the full range of accounting standards. The research found that the importance of the role of the accountant in advising on financial reporting options is also critical in connection with this aspect of financial reporting, which is the most recent development in the simplification of financial reporting by small businesses. The majority of directors intend to seek their accountant's advice before deciding on this option and at the time of the survey only a small minority had decided to adopt the FRSSE. Although it is too early to draw conclusions about the perceived benefits or otherwise of this particular development of 'Little GAAP', the results show that size of company or presence of a qualified accountant in the company does not appear to have any appreciable bearing on take-up rates.

It is clear that whether the financial reporting choices stem from companies legislation (as in the case of filing options) or from accounting standards (as in the case of the FRSSE), the directors rely on the professional advice. It would appear that the accountant's detailed knowledge of the complex regulatory framework, and the implications of the various choices for the client's business, place practitioners in a unique position to offer guidance to small companies.

It was hypothesised that companies wishing to minimise disclosure or would choose to adopt the FRSSE. However, initial tests found no significant results. Nor was there any association between the intention to adopt the FRSSE and choosing to discontinue the audit if permitted to do so, although the regulators have presented both as relieving the cost burdens. This may be due to a lack of understanding on the part of the directors of small companies regarding the implications of these various financial reporting choices.

3. How useful is the audit report to management on their own and other companies' accounts?

At the time of selection, all the companies surveyed had a turnover level above the audit exemption threshold of £350,000. Therefore, all were obliged to have their accounts audited. This study reveals that the utility of the auditors' report to the directors of small companies is in relation to their own company's accounts rather than to the accounts of other businesses. Approximately half of the directors of small companies read the accounts of other businesses. In the main, these are the accounts of major competitors, major customers and/or major suppliers/creditors.

The auditors' report is mainly perceived as improving the credibility and quality of the information, and providing a check on internal books and records. Thus, the role of the audit report can be described as increasing the extent to which users can rely on the information contained in the accounts. However, the benefits attached to the statutory audit receive little attention in the current deregulatory debate, which focuses mainly on saving costs.

An important finding of this study is that the majority of small companies do not see the statutory audit as a burden. On the contrary, 63% of owner-managers perceive sufficient benefits that they would opt for a voluntary audit should they become exempt. These companies had an average turnover of £1.3m. Only 29% of respondents stated that they would discontinue with the audit if it were not mandatory and these companies had an average turnover of £0.8m. Therefore, it would appear that the government's proposal to raise the audit threshold from £350,000 to a possible maximum of £4.2m would only be seen as a benefit by the very smallest companies.

The government's prime aim in raising the audit threshold is to relieve small companies of 'unduly burdensome regulations' (Wills, 1999, p. 73). In addition, it would increase the consistency of the definition of 'small' in UK company law, as well as meeting EU harmonisation objectives. In the public debate surrounding the deregulation of small company financial reporting, it is important that the opinions of owner-managers (and other stakeholders) are sought, as well as the views of regulators and the profession. This means careful research and analysis, as suggested by Masters (1999, p. 108). This view is echoed by the Better Regulation Task Force in relation to deregulation in general: 'We think that thoroughly researched policies and good information are the best ways to ensure that small firms do not bear unnecessary regulatory burdens' (ibid, 2000, p. 9).

4. What factors influence the usefulness of the statutory accounts to management?

From the preceding discussion it is apparent that financial reporting is seen by management as serving a mainly confirmatory role and that the auditors' report increases the reliability of the information contained in the accounts. Since the majority of small companies would continue to have their accounts audited if they became eligible for exemption, one of the main factors that influences the utility of the financial statements would appear to be these regulatory requirements.

Only a small number of respondents offered opinions on the utility of current levels of disclosure in the statutory accounts. The most commonly cited view was that more detailed financial information should be given in the accounts of their own and other businesses. This requires further investigation, as the desire for more detailed information in their own accounts implies that commercial confidentiality is of less importance in some companies than the needs of management.

A small number of respondents expressed the view that financial and personal information relating to the directors should not be disclosed. This may indicate that that some companies are not aware of recent changes to the Companies Act that permit small companies to file abbreviated accounts and omit certain information relating to directors' emoluments from the notes to the accounts (SI 1997/220 as amended by SI 1997/570). It would be valuable to discuss these findings with the owner-managers themselves, and their accountants, in order to obtain further insights into the information needs of small companies.

Another factor that influences the usefulness of the statutory accounts to management is timeliness. The study identifies an average time lag from year-end to receipt of the accounts of 17 weeks for the statutory accounts and 15 weeks for the additional detailed accounts. In contrast with large companies, there was no significant indication that improvements in the timeliness of the statutory accounts would improve its usefulness to owner-managers. This seems surprising in view of the confirmatory role played by the statutory accounts since it was hypothesised that the sooner the accounts are available, the more useful they will be for decision making. However, this result may be connected to the purposes for which the accounts are used, which are discussed further in a subsequent section.

5. How useful are the statutory accounts to management in the context of other sources of information for managing the company?

In addition to examining the utility of the statutory accounts in their own right, where their importance lies in the confirmatory role they play, the research investigated their relative utility compared with other sources of information that might be available for managing the company. The results show that the statutory accounts are not considered to be useful in this context. This is not surprising, since financial reports are designed to provide information 'that is useful to a wide range of users' (ASB, 1999a, p. 23) and have been developed from a large company perspective where investors' needs are paramount. In small companies the statutory accounts are received as part of a package of annual information. The vast majority of owner-managers receive management advice or further analysis at the same time as the statutory accounts and more than a third receive additional detailed financial statements from their accountant.

General sources of information that is useful for managing the company are considered to be the periodic management accounts, cash flow information, bank statements and budgets. The majority of the directors of small companies use management accounts and bank reconciliation statements on a monthly basis; in addition, up to half use cash flow forecasts and budgets at least quarterly.

Monitoring cash is clearly seen as important to the management of the business. There is no requirement for small companies to report cash flow information in their statutory financial statements, but since liquidity is a key characteristic of a going concern, such information is likely to be of interest to other stakeholders, such as lenders, trade creditors, customers and employees. The vast majority of companies have a computerised or partly computerised accounting system and this was positively associated with the frequency of availability of management information.

6. How are the statutory accounts used in managing the company?

Owner-managers consider the most useful purpose of the annual accounts is deciding the level of directors' pay, bonuses and dividends. This view is held by directors who find the statutory accounts useful for management purposes and associated with companies where there is more than one executive director. Research in large companies shows that directors' remuneration and shareholders' dividends are also of considerable importance to investors (Lee and Tweedie, 1975).

Whilst economic rationality explains the behaviour of shareholders of large companies, previous research shows that the owner-managers of small companies are more likely to be seeking survival and stability than profit maximisation and growth (Jarvis et al, 1996). Thus, in small companies, owner-managers are more likely to be following satisficing strategies (Simon, 1960) when making decisions relating to directors' emoluments, and this aspect requires further investigation.

The second most useful purpose of the statutory accounts is comparing the company's performance with previous periods. This supports the inclusion of comparability in the conceptual framework for financial reporting, as this is clearly an important factor in the utility of the accounts of small companies. This is closely followed by use of the accounts in connection with loans and/or finance.

Apart from the Registrar of Companies and shareholders, owner-managers send the statutory accounts to a number of external parties. The study identifies the main non-statutory recipients of the statutory financial statements as major lenders, the Inland Revenue and management. The fact that the majority of small companies (69%) use the statutory accounts to supply information to the bank and other providers of finance is not unexpected, as previous research shows that banks represent the main source of finance for small businesses (Cosh and Hughes, 1998). The importance of the role of the statutory accounts in relations with the bank also confirms previous studies into the bank lending (Berry, Citron and Jarvis, 1987; Berry et al, 1993; Berry, Crum and Waring, 1993; Berry and Waring, 1995).

The present study shows that companies whose directors send their accounts to the bank and other lenders are those with a turnover of £1m or above and primary activities in non-service industries. One reason for this may be that smaller companies, and those in service industries, are less likely to have fixed assets to use as collateral to support borrowing. Directors who send their accounts to the bank and other lenders are those who consider the statutory accounts are useful for management purposes and would continue to have their accounts audited if this became optional.

Previous research (Carsberg et al, 1985) shows that the directors of small companies see the statutory accounts as a primary aid to the management of the business. The above results provide evidence of a positive association between the utility of the accounts to management and borrowing. This supports the notion of an agency relationship between the directors of small companies and the bank and other lenders.

It is somewhat surprising that fewer than half of small companies reported that they send a copy of their statutory accounts to the Inland Revenue, since companies are required to send their accounts in support of tax computations. However, it is probable that in most small companies this is done by the firm's accountant on behalf of the directors and hence this unlikely result.

Just under a third of directors use the statutory accounts to inform members of the management team who are not shareholders, and a small proportion send them to their main business contacts, such as major suppliers/creditors and major customers. Directors who send their statutory accounts to their major business contacts are those who read the accounts of these business contacts.

8.3 Conclusions and recommendations

Although there are some limitations relating to the study, as the sampling frame did not include companies with a turnover of less than £0.5m, nonetheless the findings both update and extend the literature on financial reporting by small companies. It can be argued that whilst the reliability of data collected via a postal questionnaire tends to be high, the validity is relatively low. Therefore, there is scope for further research of a qualitative nature. However, in support of the research design, it does allow the results to be generalised to the wider population of similar companies.

The main focus of the current deregulatory trend is on relieving burdens for small companies and cost is the main argument put forward for increasing the threshold under which smaller entities become eligible for concessions. The results of this study demonstrate that this step would be advantageous for companies at the smaller end of the scale. However, the regulators seem to have overlooked the perceived benefits in their search to unpack what they see as the regulatory burden. The emphasis seems to be placed on the importance of regulation as a safeguard to the public, rather than on its usefulness to internal and external parties in business decision making, planning and reviewing activities.

Previous studies identify the directors of small companies as an important beneficiary of the production of the statutory accounts. The results of the present research reveal new insights into the reasons why this is the case. Whilst the main objective of financial reporting by large companies is to assess the stewardship of management, this is not the case in small companies. This study demonstrates that the stewardship function is largely absent in small companies, since ownership and management are seldom separated. Instead, the accounts appear to play an agency role between the owner-manager and the bank and other lenders. Whilst the statutory accounts of large companies are prepared with the needs of investors in mind, the main benefit of financial reporting by small companies is confirmation and verification of the results. This, in turn, relates to the main uses of the accounts of small companies, which are in connection with directors' emoluments, comparison with previous periods and to support borrowing.

One of the fundamental guidelines followed by the ASB in conducting its affairs is 'to determine what should be incorporated in accounting standards based on research, public consultation and careful deliberation about the usefulness of the resulting information' (ASB, 1995, p. 129). The results of this study should ensure that the development of the conceptual framework for financial reporting is not influenced by past or future armchair empiricism. The study also contributes to the Big GAAP/Little GAAP debate by providing empirical evidence of the needs of the directors of small companies. The findings will be of interest to those involved in policy formation and the regulation of financial reporting, practitioners and their small business clients, as well as academics in the fields of accounting and small business. This is reflected in the following recommendations:

- Further changes in the regulation of financial reporting by small companies should take account of the fact that there are both costs and benefits to the directors of small companies, who are the main users of the accounts.

- The present Companies Act threshold of £2.8m already captures 80% of companies under £4.2m and this should guide future changes to size thresholds that are not related to indexation.

- Those responsible for regulation should be wary of using a large company template to examine the needs of small companies. It may be more appropriate to examine the process of how owner-managers use the statutory accounts and this could result in a conceptual framework for small company reporting.

- In the complex, rapidly-changing environment of 'Little GAAP', it is important that accountants keep up to date with developments, as the directors of small companies rely on them for advice on the various financial reporting options available to them.

- Because the directors of small companies rely on professional guidance from their accountants regarding financial reporting options, further research should be conducted with practitioners regarding the relevance of current and future concessions.

- If the audit exemption threshold is raised, it should be recognised that companies with a turnover of more than £1.3m would wish to have their accounts audited on a voluntary basis.

- Small companies should be encouraged to establish computerised accounting systems to generate periodic management accounts, cash flow information and bank reconciliation statements.

- Further empirical evidence is required from members of the accountancy profession, as they are in a strong position to provide feedback on how well ‘Little GAAP’ is working for small companies.

- Further qualitative research should be conducted with the directors themselves and their accountants to gain further insights into how, when and precisely what information in the statutory accounts is used and details of any further information they would find useful in the statutory financial statements. In addition, a qualitative approach could investigate more effectively any disclosures that are currently required which the directors would prefer not to make.

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Appendices

Appendix A

Questionnaire

The Use of Financial Information in Private Companies

A survey by Kingston University

This study has been commissioned by
the Institute of Chartered Accountants in England & Wales
with the aim of finding out the views of the owners and managers
of small companies

Questionnaire No. [ ] 1-4

Your participation in this research is greatly appreciated.
Neither your name, nor that of your company will be associated with any of your responses.

Q1. How many years has the company been trading? 5-8

Q2. How many shareholders (owners) does the company have? 9-10

Q3. How many directors does the company have?

Executive directors (involved in day-to-day activities of the business)		11-12
Non-executive directors (not involved in day-to-day management)		13-14

Q4. How many of the following staff does the company employ?

Qualified accountant who is also a director		15
Qualified accountant who is not a director		16
Credit controller		17
Bookkeeper		18
Other employee responsible for financial matters *(please state)*		19-21

....

Q5. Would you describe the company as a family-owned business? *(Tick one box only)*

Family-owned (first generation)		22(1)
Family-owned (subsequent generation)		(2)
Partly family owned		(3)
Owners are not related		(4)

Q6. How is the company currently managed? *(Tick one box only)*

Solely by one director		23(1)
Mainly by one director with advice/consultation from other directors		(2)
By all directors equally		(3)
By directors with some senior managers		(4)
Other *(please state)*		24

....

Q7. What type of statutory annual accounts did the company prepare last year?

	25 a) For the Registrar	26 b) For shareholders	
Abbreviated financial statements			(1)
Full financial statements			(2)
Uncertain			(3)
Other (*please state*)			(4)

....

Q8. What was the main reason for choosing to file this type of accounts with the Registrar of Companies? 27-28

....

....

Q9. Do you ever read the statutory annual accounts of other businesses? *(Tick as many boxes as apply)*

No	☐	29
Yes, major competitors	☐	30
Yes, major customers	☐	31
Yes, major suppliers/creditors	☐	32
Yes, other *(please state)*	☐	33-35

....

Q10. How useful is the auditors' report to you? *(Circle the number closest to your view)*

	Very useful				Of no use	
On your company's statutory accounts	5	4	3	2	1	36
On statutory accounts of other businesses	5	4	3	2	1	37

Q11. What is your view on the following statements regarding the audit? *(Circle the number closest to your view)*

	Agree				Disagree	
Provides a check on internal books/records	5	4	3	2	1	38
Shifts responsibility from the auditors to the directors	5	4	3	2	1	39
Helps protect against fraud	5	4	3	2	1	40
Improves quality of the information	5	4	3	2	1	41
Improves credibility of the information	5	4	3	2	1	42
Shows compliance with legislation	5	4	3	2	1	43
Other *(please state)*	5	4	3	2	1	44-46

....

Q12. Would you continue to have your company's accounts audited even if not legally required to do so?
(Tick one box only)

Yes *(please give your reasons)* ☐ 47

....

No *(please give your reasons)* ☐ 48

....

Undecided	☐	49 (1)
Would take professional advice	☐	(2)

Q13. Who normally prepares your company's statutory accounts for the Registrar and shareholders?
(Tick one box only) 50

A qualified accountant who is a director of the company	☐	(1)
A qualified accountant who is an employee of the company but not a director	☐	(2)
An external accountant/auditor from a local firm	☐	(3)
An external accountant/auditor from a national firm	☐	(4)

Other *(please state)* 51

....

Q14. Apart from the statutory annual accounts, is any additional information made available by the accountant to management at that time? *(Tick as many boxes as apply)*

No additional information	☐	52
Verbal explanation/analysis of the accounts	☐	53
Written explanation/analysis of the accounts	☐	54
Management advice/recommendations	☐	55
Advice/recommendations on record keeping	☐	56
Additional detailed profit and loss account	☐	57
Additional detailed balance sheet	☐	58
Cash flow statement	☐	59
Other *(please state)*	☐	60

....

Q15. How many weeks after the end of the financial year does the company receive the annual accounts?

	No. of weeks	
Statutory annual accounts	☐	61-62
Additional detailed accounts	☐	63-64

Q16. Apart from the Registrar of Companies, who normally receives a copy of the annual accounts?

	(1) Abbreviated statutory accounts	(2) Full statutory accounts	(3) Additional detailed accounts	
All employees				65
Directors who are shareholders				66
Directors who are <u>not</u> shareholders				67
Senior managers				68
Bank/other providers of finance				69
Major suppliers/creditors				70
Major customers				71
Inland Revenue				72
Anyone else? *(please state)*				73-75

....

Q17. Do you use any of the following general sources of information for managing the company? If so, please indicate how useful you find them. *(Circle the number closest to your view)*

	Very useful			Of no use		
Statutory accounts for the Registrar	5	4	3	2	1	76
Statutory accounts for shareholders	5	4	3	2	1	77
Additional accounts for management	5	4	3	2	1	78
Monthly/Quarterly management accounts	5	4	3	2	1	79
VAT records	5	4	3	2	1	80
Cash flow information	5	4	3	2	1	81
Bank statements	5	4	3	2	1	82
State of order book	5	4	3	2	1	83
Budgets	5	4	3	2	1	84
Credit rating agency data	5	4	3	2	1	85
Published industry data	5	4	3	2	1	86

Other *(please state)*	5	4	3	2	1	87-91

....

Q18. What type of accounting system do you have? *(Tick one box only)*

Manual accounting system	☐	92(1)
Computerised accounting system	☐	(2)
A combination of computerised and manual accounting systems	☐	(3)
Other *(please state)*	☐	93

....

Q19. Do you use any of the following specific sources of information for managing the company? If so, please indicate approximately how frequently you use them.

	(3) Monthly	(2) Quarterly	(1) Annually	
Profit and loss account				94
Budgeted profit and loss account				95
Balance sheet				96
Cash flow statement				97
Cash flow forecast				98
Bank reconciliation statement				99
Ratio analysis				100
Inter-firm comparison				101
Industry trends				102
Break-even analysis				103
Budget plans				104
Comparison of budgets with actual				105
Production reports				106
Manufacturing statement				107
Costing reports				108
Standard costing and variance analysis				109
Other *(please state)*				110-14

....

Q20. Do you use your company's annual accounts for any of the following purposes? If so, please indicate how useful you find them. *(Circle the number closest to your view)*

	Very useful				Of no use	
Short-term planning	5	4	3	2	1	115
Long-term planning	5	4	3	2	1	116
Deciding directors' pay/bonuses/dividends	5	4	3	2	1	117
Deciding employees' pay/bonuses/dividends	5	4	3	2	1	118
Marketing/pricing decisions	5	4	3	2	1	119
Borrowing decisions	5	4	3	2	1	120
Capital expenditure	5	4	3	2	1	121
Comparing performance with targets	5	4	3	2	1	122
Comparing performance with previous periods	5	4	3	2	1	123
Comparing performance with other companies	5	4	3	2	1	124
Confirming management information	5	4	3	2	1	125
In connection with loans/finance	5	4	3	2	1	126
Reassuring customers and suppliers	5	4	3	2	1	127
Other *(please state)*	5	4	3	2	1	128-32

....

Q21. Do you use any items in the profit and loss account or balance sheet for managing the company? If so, which items do you find particularly useful?
From the statutory accounts: 133-37

....

....

From the additional detailed annual accounts: 138-42

....

....

Q22. What do you consider are the main advantages of having to produce the statutory annual accounts? 143-47

....

....

Q23. What do you consider are the main disadvantages of having to produce the statutory annual accounts? 148-52

....

....

Q24. What information would you find useful that is not currently shown in the statutory accounts?
In your company's statutory accounts: 153-57

....

....

In the statutory accounts of other companies: 158-62

....

....

Q25. What information do you consider should not be disclosed in the statutory annual accounts you send to the Registrar of Companies? 163-67

....

....

Q26. Will your company be preparing statutory annual accounts in accordance with the new Financial Reporting Standard for Smaller Entities (FRSSE)? *(Tick one box only)*

Yes *(please give your reasons)* ☐ 169-71

....

No *(please give your reasons)* ☐ 172-74

....

Undecided	☐	175(1)
Will take professional advice	☐	(2)

Q27. What was company's turnover for the last financial year? *(Tick one box only)*

Under £1m	☐	176(1)
£1m - £1.49m	☐	(2)
£1.5m - £1.99m	☐	(3)
£2m - £2.49m	☐	(4)
£2.5m - £2.99m	☐	(5)
£3m - £3.49m	☐	(6)
£3.5m - £3.99m	☐	(7)
£4m and above	☐	(8)

Q28. What is your position in the company? *(Tick one box only)*

Managing director/Chief executive	☐	177(1)
Finance director	☐	(2)
Other *(please state)*	☐	178

....

Q29. What is your highest educational qualification? *(Tick one box only)*

First degree	☐	179(1)
Postgraduate degree	☐	(2)
None of these	☐	(3)

Q30. Do you hold a professional or a vocational qualification?

Yes	☐	180(1)
No	☐	(2)

Q31. Have you studied or received training in business or management subjects, or subjects related to the company's activities? *(Tick one box only)*

Business/management subjects	☐	181(1)
Subjects related to company's activities	☐	(2)
None of these	☐	(3)

Q32. Would you be willing to be interviewed?	☐	182
Q33. Would you like a summary of the findings?	☐	183

If you have answered 'yes' to Q32 or Q33, please print your details below:

Name: ....

Address: ....

....

....

Tel: .... Email: ....

Thank you very much for taking part in this survey.
please return your completed questionnaire in the envelope provided to:

Kingston University Survey
Silverhill

Rudgeway
Bristol BS35 3YA

Appendix B

First level analysis of standard industrial classification codes

0 Agriculture, forestry and fishing	0.1 Agriculture and horticulture 0.2 Forestry 0.3 Fishing
1 Energy and water supply industries	1.1 Coal extraction and manufacture of solid fuels 1.2 Coke ovens 1.3 Extraction of mineral oil and natural gas 1.4 Mineral oil processing 1.5 Nuclear fuel production 1.6 Production and distribution of electricity, gas and other forms of energy 1.7 Water supply industry
2 Extraction of minerals and ores other than fuels; manufacture of metals, mineral products and chemicals	2.1 Extraction and preparation of metalliferous ores 2.2 Metal manufacturing 2.3 Extraction of minerals, not elsewhere specified 2.4 Manufacture of non-metallic mineral products 2.5 Chemical industry 2.6 Production of man-made fibres
3 Metal goods, engineering and vehicles industries	3.1 Manufacture of metal goods not elsewhere specified 3.2 Mechanical engineering 3.3 Manufacture of office machinery and data processing equipment 3.4 Electrical and electronic engineering 3.5 Manufacture of motor vehicles and parts thereof 3.6 Manufacture of other transport equipment 3.7 Instrument engineering
4 Other manufacturing industries	4.1 Food, drink and tobacco manufacturing (a) 4.2 Food, drink and tobacco manufacturing (b) 4.3 Textile industry 4.4 Manufacture of leather and leather goods 4.5 Footwear and clothing industries 4.6 Timber and wooden furniture industries 4.7 Manufacture of paper and paper products; printing and publishing 4.8 Processing of rubber and plastics 4.9 Other manufacturing industries
5 Construction	5.0 General construction and demolition work 5.1 Construction and repairs of buildings 5.2 Civil engineering 5.3 Installation of fixtures and fittings 5.4 Building completion work

6 Distribution, hotels and catering; repairs	6.1 Wholesale distribution 6.2 Dealing in scrap and waste materials 6.3 Commission agents 6.4 Retail distribution (a) 6.5 Retail distribution (b) 6.6 Hotels and catering 6.7 Repair of consumer goods and vehicles

7 Transport and communication	7.1 Railways 7.2 Other inland transport 7.3 Not in use 7.4 Sea transport 7.5 Air transport 7.6 Supporting services to transport 7.7 Miscellaneous transport services and storage not elsewhere specified 7.8 Not in use 7.9 Postal services and telecommunications
8 Banking, finance, insurance, business services and leasing	8.1 Banking and finance 8.2 Insurance, expect for compulsory social security 8.3 Business services 8.4 Renting of movable 8.5 Owning and dealing in real estate
9 Other services	9.1 Public administration, national defence, and compulsory social security 9.2 Sanitary services 9.3 Education 9.4 Research and development 9.5 Medical and other health services; veterinary services 9.6 Other services provided to the general public 9.7 Recreational services and other cultural services 9.8 Personal services 9.9 Domestic services

Source: FAME

Appendix C

Regional classifications

Region	Post code and postal town			
1. South Western	BA	Bath	PL	Plymouth
	BS	Bristol	SN	Swindon
	DT	Dorchester	TA	Taunton
	EX	Exeter	TQ	Torquay
	GL	Gloucester	TR	Truro
2. Southern	AL	St Albans	OX	Oxford
	BH	Bournemouth	PO	Portsmouth
	GU	Guildford	RG	Reading
	HP	Hemel Hempstead	SL	Slough
	LU	Luton	SO	Southampton
	MK	Milton Keynes	SP	Salisbury
3. Eastern	CB	Cambridge	NR	Norwich
	CN	Chelmsford	PE	Peterborough
	CO	Colchester	SG	Stevenage
	IP	Ipswich	SS	Southend-on-Sea
4. South Eastern	BN	Brighton	RH	Redhill
	CT	Canterbury	TN	Tonbridge
	ME	Medway		
5. Outer London	BR	Bromley	KT	Kingston-upon-Thames
	CR	Croydon	RM	Romford
	AD	Dartford	SM	Sutton
	EN	Enfield	TW	Twickenham
	HA	Harrow	UB	Southall
	IG	Ilford	WD	Watford
6. Inner London	E	London E	SE	London SE
	EC	London EC	SW	London SW
	N	London N	W	London W
	NW	London NW	WC	London WC

Source: FAME