

# ***Qualitative review of the accounting and auditing needs of small and medium-sized companies and their stakeholders***

**A working paper by  
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**January 2006**

## **1. Introduction**

This study focuses on the accountancy needs of private companies that fall within the size criteria for small and medium-sized companies (SMCos) given in sections 247 and 249 of the *Companies Act 1985*. The financial thresholds that differentiate companies by size have been amended a number of times, most recently by SI 2004/16, *The Companies Act 1985 (Accounts of Small and Medium-sized Enterprises and Audit Exemption) (Amendment) Regulations 2004*. The maxima for a small company are turnover £5.6 million, balance sheet total £2.8 million, and average number of employees 50. The thresholds for a medium-sized company are turnover £22.8 million, balance sheet total £11.4 million and average number of employees 250.

Differentiation on the basis of size is important in terms of financial reporting, as qualifying smaller entities are subject to a less onerous regime of regulation than large companies. Government statistics show that of the estimated 4.3 million business enterprises in the UK in 2004, just over 1 million (approximately 25%) were companies and corporations and 99% of these were small or medium (SBS, 2005). Most of these companies are likely to be eligible for the financial reporting concessions and exemptions allowed under company law in the UK. However, certain categories cannot qualify as small or medium, due to the public interest in their financial statements. These comprise public limited companies; companies that have permission under Part 4 of the *Financial Services and Markets Act 2000* to carry on one or more regulated activities; companies that carry on insurance market activity; and any company in a group containing any of the above.

It has been suggested that the increasing complexity of accounting, auditing and associated ethical standards over the past ten years has imposed disproportionate burdens on smaller entities and the effects of this on the cost and quality of their financial management and reporting are not clear from existing research. Therefore, the aim of this study is to investigate the needs of small and medium-sized companies through in-depth interviews with the directors and the providers of accountancy services. The research complements other POBA projects on issues that may have an impact on public confidence in financial reporting and corporate governance in smaller entities.

## 2. Methodology

The two main research questions addressed by the study are:

1. How do accountants and/or others help small and medium-sized companies obtain financial information for use by management?
2. How do accountants and/or others help small and medium-sized companies prepare financial information for financial reporting purposes?

The nature and purpose of the study lends itself to a qualitative rather than a quantitative analysis. Therefore, the research questions were explored through of face-to-face, semi-structured interviews across the range of small and medium-sized companies, including those employing fewer than 10 to those employing up to 250. This was achieved by interviewing the director with prime responsibility for financial matters in the participating company and, where permission was granted, conducting a separate interview with the external professional accountant or other provider of accountancy services. This matched pairs approach allowed the researchers to capture views and practices from both perspectives.

The companies were located in two diverse geographic regions to provide a mix of business environments: the relatively economically prosperous South East of England and the relatively deprived area of South Wales. Potential companies were initially identified from the FAME database, but cold canvassing was not very successful in attracting sufficient participants in the time available and personal appeals to certain alumni, colleagues and other contacts helped produce the remaining companies. Therefore, the companies studied were chosen on the basis of their location, size and willingness to participate. Part of the difficulty in locating suitable companies was that the interviews needed to be conducted over the main holiday period July to September 2005. This period is also a very busy time for accountants, many having clients with year-ends around this time.

The main issues covered in the interviews was drawn from the literature and agreed in advance with POBA. These issues can be summarised as follows:

1. Main issues in connection with how accountants and/or others help small and medium-sized companies obtain financial information for use by management:
  - Financial management
  - Accounting systems and processes
  - Sources of financial and business advice
2. Main issues in connection with how accountants and/or others help small and medium-sized companies prepare financial information for financial reporting purposes:
  - Accounts preparation
  - Financial reporting choices (shown on the statutory accounts)
  - Ethical standards for auditors

Although a small amount of factual data was collected, the majority of the findings stem from the use of open questions, which were designed to encourage the participants to offer information with the minimum of researcher bias. In addition to recording and transcribing the interviews,<sup>1</sup> verbatim notes were taken and further field notes written after each interview

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<sup>1</sup> All but one interviewee agreed to being recorded.

had been concluded. These notes and transcripts were then compared by size (both vertically and horizontally) to identify the emerging themes and/or patterns in the data.<sup>2</sup> For the purposes of this working paper 17 company directors and 17 accountants were interviewed generating over 30 hours of recorded interviews.<sup>3</sup> More than 100,000 words have been analysed using the above framework and the findings are presented in the next section.

All those taking part in the study were assured of anonymity and are referred to in this report by size band relating to the number of employees, plus a prefix indicating whether they were in the South East of England (SE) or South Wales (SW).

### **3. Findings**

The semi-structured approach to the interviews involved asking a series of broad questions such as “Can you tell me about your business?” and “Can you tell me about the relationship with your accountant?” These general questions are then supplemented with specific questions that develop the issues raised by the interviewee. From this free-flow of information the researchers have been able to identify common themes enabling a more structured analysis of the data to be presented.

#### **3.1 Company profile and management**

The first part of the interviews with the directors captured factual data and encouraged them to relax by talking about their business. The following table provides a profile of the companies studied and some details about how they are managed. The companies had their main activities in a range of different industries in the service sector, manufacturing, food production and construction. In terms of size, the companies ranged from 8 employees to approximately 250 on the payroll. Not surprisingly, none of the companies were at the smallest end of the scale, due to the understandable reluctance of owner-directors with no employees to take time off from running the business.

The figure shown for employees in the following table is the total number of employees including the directors. The numbers of directors and non-executive directors (NEDs) are shown separately in the next two columns.

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<sup>2</sup> A regional comparison is not possible at this stage.

<sup>3</sup> The accountant of one of companies in the South East declined to participate. To provide a balanced picture, an interview was held with another accountant in a similar sized practice with clients of a similar size to that of the case study company.

**Table 1 - Company profile and management**

<b>ID</b>	<b>Main activities</b>	<b>No. of employees</b>	<b>No. of directors</b>	<b>No. of NEDs</b>	<b>No. of financial decision makers</b>
SE 1-10	Training and education	8	3	3	6
SW 1-10	Electrical components supplier	8	2	0	2
SE 11-20	Video production	11	2	0	2
SW 11-20	Kitchen design and installation	11	2	0	1
SW 11-20a	Personal debt	13.5	4	0	1
SE 21-30	Electronics	22	2	0	2
SE 21-30a	Ladies fashion design	25	1	0	1
SW 21-30	Roofing contractor	25	5	0	2
SE 31-40	Wine importer and distributor	40	7	0	2
SW 31-40	Fork lift truck hire and sales	35	3	0	2
SE 41-50	Steel importer and fabrication	Approx 42	3	0	1
SW 41-50	Bakery	48	1	0	1
SE 51-100	Construction	50	3	0	1
SW 51-100	Clinical research	94	4	0	3
SW 101-150	Retail furnishings	130	3	0	3
SW 151-200	Construction	167	7	0	7
SE 201-250	Market research and consultancy	Approx 250	6	0	3

Only one company appointed NEDs. The training and education company (SE 1-10 employees) operates in a specialized industry and the appointment of a number of experienced and senior NEDs was considered very useful by the interviewee in terms of advice received and business contacts generated.

As already mentioned, the interview was held with the principal director with responsibility for financial matters in the business; the final column gives an indication of the extent to which financial decisions are shared between the directors. This reveals a variety of practices, from what might be described as an autocratic approach to a democratic approach.

The next table shows the type of any international dealings the companies may have had.

**Table 2 - International dealings**

<b>ID</b>	<b>International dealings</b>
SE 1-10	Equity finance (business angels)
SW 1-10	Customers and suppliers
SE 11-20	Customers
SW 11-20	None
SW 11-20a	None
SE 21-30	Customers and suppliers
SE 21-30a	Customers and suppliers
SW 21-30	Suppliers
SE 31-40	Suppliers
SW 31-40	None
SE 41-50	Suppliers
SW 41-50	None
SE 51-100	None
SW 51-100	Customers
SW 101-150	Suppliers
SW 151-200	Suppliers
SE 201-250	None

The extent to which the participating companies are internationalised has implications for the users of their financial statements and the IASB's current consultation on the need for International Financial Reporting Standards for SMEs. We look at accounting standards and the non-statutory users and of the annual financial statements again in subsequent sections of this paper.

## **3.2 Internal use of financial information**

### **3.2.1 Accounting information systems**

In some companies the accounting system was used simply for record-keeping and the production of management accounts was outsourced to the external accountant.

*What's the most important thing that you keep an eye on if you want to know how well the business is doing?*

We get a monthly set of management accounts that shows the balance sheet and cash flow statement for the business.

*So you get it on a monthly basis and who produces that information?*

Our accountant.

*Your external accountant?*

External firm of accountants, who are also our auditors.

*(SE 1-10 employees – director interview)*

*Do you have an internal accountant?*

No, I do that sort of thing myself.

*What sort of accounting system do you have?*

I don't. My external accountant uses Sage and I pass the invoices to him on a monthly basis. So I don't run a system here myself. He produces the management accounts and end of year statutory accounts?

*(SW 11-20a employees – director interview)*

The majority of the medium-sized companies (51-250 employees) either had a finance director or were in a position to employ an internal unqualified accountant who provided the management accounts on a regular basis.

*What sort of information do you need to control a company of this size?*

The vast majority of it I [finance director] produce internally via our management accounts.

*Are you a qualified accountant?*

No, I'm a member of the Institute of Taxation, formerly employed by a large firm of chartered accountants. I prepare the final accounts, which I then send to the auditor, who puts the statutory accounts together.

*(SW 151--200 employees – director interview)*

*Have you got anybody who's a qualified accountant employed internally?*

Not a qualified accountant.

*So that implies perhaps a non-qualified person?*

Yes. The company secretary looks after the IT and the accounts... She's not qualified, but she has a lot of experience on the IT accounting side of things.

*(SE 201-250 employees – director interview)*

However, in some of the companies the accounting software used allowed the directors to generate their own reports. This was not always a function of size; for example, the company in ladies fashion design (SE 21-30a employees) produced monthly management accounts internally. Standard commercial software was widely used, but in some cases industry-specific or bespoke packages had been adopted. In all but one case, the companies receive regular software upgrades or other support. Table 3 gives details.

**Table 3 - The accounting system**

<b>ID</b>	<b>Who recommended the accounting system</b>	<b>Software used</b>
SE 1-10	P/t bookkeeper	QuickBooks
SW 1-10	External accountant	Spreadsheet
SE 11-20	External accountant	Practys
SW 11-20	P/t book-keeper and external accountant	Spreadsheet
SW 11-20a	External accountant	Spreadsheet
SE 21-30	Customer	Pegasus
SE 21-30a	External accountant	Sage
SW 21-30	Internal	Sage
SE 31-40	Internal	Vintner
SW 31-40	Internal	Pegasus
SE 41-50	Internal	Bespoke
SW 41-50	Internal	Manual
SE 51-100	External accountant	Sage
SW 51-100	Internal	Pegasus
SW 101-150	External accountant	Bespoke
SW 151-200	Internal accountant	Bespoke
SE 201-250	Company secretary	Part manual

The influence of the external accountant on the choice of software used varied. Some companies were using software recommended by their external accounts. However, where companies were already using different software packages the accountants were happy to work with the system in place. Where the companies were using spreadsheets they had relied on templates provided by their external accountant.

*Did you get any support from your accountant in setting up your systems or is it something you did yourself?*

We did it in conjunction with the accountant. [Name removed] liaised with our accountant. We've set our system up so that it's workable for them as well so we can actually e-mail the accounts to him quarterly.

*(SW 11-20 employees – director interview)*

We're heavily into Sage and advise clients on it; that's a lot of our business. We put Sage systems in and then provide some support for them – install it, back it up, support, training. We do a lot of transactions over e-mail... We try to encourage our clients to use Sage because we consider it to be a good package.

*(SW 11-20a employees – accountant interview)*

Interviews with the accountants, suggest that the client is not under pressure from them to use a particular software package, as the following quotations show.

*Are you happy to let your clients chose their own accounting software system?*

Absolutely. They know it, they know if it works and they're happy with it. Most of them use bog standard off the shelf packages although some have more complicated systems. Sage is the most popular by and large or Pegasus or few others, but we don't favour one package over another.

*(SW 101-150 employees – accountant interview)*

On the actual accounting side of things we always say to our clients, "Nobody likes doing bookwork so you do what you are comfortable with and we'll work around you". Some use Sage, Taz and QuickBooks, others use spreadsheet. We just work around them. When we're asked for advice we usually say if you've got a computer use a spreadsheet... We make a spreadsheet template... we just change the headings to suit their day to day situation.

*(SW 11-20 employees – accountant interview)*

A wide range of packages were used, but the extent of use varied.

My accounts assistant [name removed] runs the computer-controlled accounts using Excel system and that's all done on computer at the moment.

*(SW 11-20 employees - director interview)*

The actual management accounts are generated through the Vintner system. The Vintner system is pretty much all inclusive so we don't have much need for other software. The only thing I run outside Vintner is a cash book. Vintner has a cash book but I don't use it.

*(SE 31-40 employees – director interview)*

It's basically an in-house thing which was recommended by our accountants...we were able to say what our needs were when we changed from a manual accounting system to computerised... It's an adapted system which gives us our management accounts. All our financial director does is punch in the figures and out it pops.

*(SW 101-150 employees - director interview)*

It's a specialist accounting package aimed at the construction industry which I've tweaked and adapted for our specific needs. I rely heavily of the accounting package but also perform some calculations on spreadsheets.

*(SW 151-200 employees – director interview)*

In one case, the business used a predominantly manual system. This was the family owned bakery (SW 41-50 employees) closely managed by the elderly matriarch who was reluctant to change the system she had used successfully for over 30 years.

*Have you ever thought of a computerised system?*

I don't think, probably because I'm too old, I'd be happy with that. We do use the computer a lot, orders come in via the computer and invoices are generated through the computerised sales ledger. But I'm happy with the manual system... I wasn't brought up in the computer age was I?

*(SW 51-100 employees - director interview)*

The first impression is that the small and medium-sized companies are adept at using a range of accounting systems to produce the information they need to run their business.

### **3.2.2 Key performance indicators**

In order to gain some insights into the key performance indicators used by the participating companies, the directors were asked about the most important information they use for monitoring the company's well being. Their answers revealed that management accounts were widely used and that most frequently these took the form of the profit and loss account and balance sheet and/or sales information. In most cases the information was generated monthly, but in some companies it was produced on a weekly basis.

In addition, to the management accounts, the director of the steel importing and fabrication business (SE 41-50 employees) emphasised the importance of the information he receives on customers' credit ratings, due to the high value of individual orders in that industry. Irrespective of whether the key performance indicators they were using were generated internally or externally, the directors all seemed to be of the opinion that the information was of good or excellent quality. In some cases, they had designed the management accounting system themselves or had had it tailor-made to generate the information they required.

Nearly all the companies studied appear to monitor the latest information against target or against the previous period. The directors appeared to be at ease with accounting terminology and referred appropriately to the actions they took on receipt of the latest figures as 'checking the variances' or 'variance analysis'. Indeed, setting targets and/or budgets was common practice.

For many companies, sales budgets are the most important. For example, the owner-director of the company in ladies fashion design (SE 21-30a employees) sets target sales and works out what his breakeven sales will be for different periods in the year. Despite his knowledge of the industry, he explained that it is difficult to estimate sales in a business where trends are short-lived and vagaries in the weather affect demand.

We just keep a check on the turnover. We've got quite a lot of analysis sheets on there that she [the bookkeeper] can pull up information for me when I want it. We break down the sales from each showroom centre. I've got a manager at the two other showrooms and mine so the three of us are monitored separately on sales and we know how each place is performing.

*(SW 11-20 employees – director interview)*

We compare sales against budget and last year. I suppose it's just a good guide as to our profitability on a kind of on-going monthly basis.

*(SE 31-40 employees – director interview)*

In terms of reporting we do a lot of internal analysis to keep track on the types of studies we are doing to see how profitable those individual studies are. We look at bank information in terms of cash flow and budgeting - budget comparison on a monthly basis with management accounts.

*(SW 51-100 employees – director interview)*

While information is produced, any planning and subsequent variance analysis is not so well documented. Some companies have detailed plans and formal systems of control. However, it is more typical that the owner-director will be able to maintain close control through their detailed knowledge and experience of the business, as the following examples show.

Sales figures are my constant obsession. So I will want to know, "What's the aggregate sales figure for the month so far or for the year so far compared to last year?" So I'm always comparing where we were last year with the same position this year to see how well we're doing in that respect and that allows me to estimate our profit at the end of the year and how much we can invest in programmes and so on. So that's the absolutely vital, first piece of information... It's just a figure that I ask for more or less every day really. "How many sales have we got in today?" and "What's the figure so far for the month?" And I have targets in my head.

*(SE 11-20 employees - director interview)*

The information [I require] starts with turnover and a weekly reporting system of turnover per branch per sales person. We then have the monthly management accounts which give us costs broken down between the head office and the various centres of cost. We then have our gross profit which is put into that and so we have all the figures from our generic costs such as advertising what we call head office figures. We have a budget and forecast system which we initiate at the start of every new financial year. We sometimes do two forecasts – a pessimistic forecast and one we hope to achieve. At least we have a fail safe situation where we know on a pessimistic forecast we can control the business without it getting out of hand. A lot of forecasting is made too optimistically and with the changing times we're in at the moment we need a 'what if?' situation.

*SW 101-150 employees – director interview)*

Small firms constantly face liquidity pressures and apart from information on turnover, the next most popular source of information was the current cash flow situation. The owner-director of the ladies fashion company (SE 21-30a employees) explained that he checked actual cash flow against the forecast on a weekly basis, as high levels of debtors and creditors are a key feature of his industry. Reasons for differences in actual and planned profit were examined on a monthly basis, but he considered this of less importance to the cash information.

On-line banking means that for some companies cash flow information is up to date and used on a daily basis.

There are two tools that we use... I have an on-line bank facility... so I can see what's coming in and out every day, all our balances on our accounts across the business in whichever currency. So I can see that. The other tool that I use on a daily basis is a record of our sales against our budget and last year. Because our business is quite seasonal and we compare it against both to see how we're performing... At the end of the month when the month is complete, we then just up-date that report for the full month... to see where that falls within our expectations against last year or against budget.

*(SE 31-40 employees - director interview)*

### **3.3 Relationship with the external accountant**

All the companies studied used the services of an external accountant. In most cases this was a local small or medium-sized practice (see Table 4 on p. 15). However, two of the smallest companies used ex-tax inspectors, who were not members of the accountancy profession.

My background is as an Inspector of Taxes with the Inland Revenue then I joined a small firm of accountants before moving back to this area to work for [name of big 4 accountants removed]. I always had in the back of my mind that I would like to set up on my own so that's what I did in 1994.

*(SW 1-10 employees – accountant interview)*

We run the business from home; we don't have professional premises. I used to be an Inspector of Taxes at the Inland Revenue then I went to what is now [name of big 4 accountants removed]. I was made redundant about 14 years ago... and set up my own business... which I always wanted to do.

*(SW 11-20 employees – accountant interview)*

Three of the medium-sized companies use the services of one of the top 10 accountancy firms. Two of these firms had chosen their accountant either because of the nature of the business they were in or for the perceived external credibility a 'big name' accountancy firm would bring.

*Why did you choose that particular firm of accountants?*

It was a matter of looking at the Yellow Pages and picking a big firm with good credibility because we needed that in terms of the size and type of the company we are dealing with. We had used other big firms for advice in the past, but chose our current accountant in the end.

*(SW 51-100 employees – director interview)*

*[Name of accountant removed] is quite a big size accountancy firm, does that matter?*

No, not for the service they provide us. There are those, though, that may consider that we have a recognised name on our accounts for the credibility it brings, because of who our clients are but I don't have any proof that that is the case.

*(SW 151-200 employees – director interview)*

The directors who used the non-qualified accountants were more concerned with the service provided rather than the qualifications of the person providing it.

When we were starting out, we were just looking for someone to do the books. We didn't really care too much if they were qualified as much as if they could help us on our way.

*(SW 1-10 employees - director interview)*

*Does it matter to you that he's not a qualified accountant but a tax inspector?*

It doesn't matter much. I find him more helpful than any of the qualified ones. In my experience with the more qualified ones the minute you go out of the door they forget about you. Some of them are a bunch of rogues – I know I shouldn't say that.

*(SW 11-20 employees - director interview)*

The views of the qualified accountant could be quite different, as the following quotations shows.

The problem is they've got little experience of dealing with people's tax affairs. The account prep can be suspect in some cases also. They won't have been on any structured courses to keep up to date... CPE is costly in terms of time but is necessary to do the job.

*(SW 11-20a employees – accountant interview)*

One company director was aware of the potential benefits that may be available from using a qualified accountant but did not consider the extra cost to be worthwhile. It was a conscious decision to use their chosen accountant.

We did look to whether we should go to another accountant - a bigger firm, bigger name - to see if we could get better advice... [but] we get extremely good value for money where we're at therefore it's very hard to change. To get the same service [with a qualified accountant]... we would double our accountancy fees and if you wanted to get something special on top of that, some extra advice, then you're looking at three times and therefore are you going to get that value back in tax savings.

*(SW 1-10 employees - director interview)*

The second company director using an ex-tax inspector was critical about his experience with larger firms of qualified accountants. For him it was a cost/benefit decision and was receiving the services he required for a price he was willing to pay. He does not want support in interpreting accounts, nor does he seek any more technical expertise than is available. He does not perceive any added value from using a larger firm of qualified accountants and this is based on personal experience.

*Does your accountant give you any advice about your business?*

Not a great deal, no. Other than the finance side he doesn't know much about the kitchen business. Not many accountants know about the kitchen business and if you get a specialist they charge three or four times the money. We pay him about £300 - £400 a year. You don't expect too much for that.

*Is cost the key issue or quality of service?*

The service we get – he keeps us on the ball. It's a fairly straightforward accounting process.

*(SW 11-20 employees – director interview)*

Relationships appeared to be well established and most companies chose the current firm of accountants as a result of a personal recommendation. These included family and friends, one of the other shareholders, a customer, the bank, or, the insurance broker. In some cases it was serendipity, and one director recounted how he had switched firms as a result of a chance conversation with auditor visiting a neighbouring business who had impressed him. There were one or two stories about dissatisfaction with a previous firm that had led to a change of accountants, but most of the participating companies had been with the same firm of practitioners for a considerable length of time, even though the practice may have been taken over or otherwise evolved during the period.

Once a successful relationship has been formed, companies are unlikely to replace their accountant and some have had very long-standing relationships.

We've had a working relationship with them for over 50 years or longer; it could be 90 years, I really don't know. A long, long time in various different business guises ...you know, the firm's evolved over the years. It's a long time.

*(SE 31-40 employees - director interview)*

I think we've only had three accountants since the company started in 1946.

*(SE 41-50 employees – director interview)*

We started with a company called [name of accountant removed], who I think at the time were quite a big company. Well, they must have been by the size of their bill... I think we were with them for about 10 years, so we must have been with [name of current accountants removed] for at least 15 years.

*(SE 51-100 employees – director interview)*

Our current accountant is the third we've had in 30 years. We were with a small company to start with and they couldn't handle our business. We then went with a much bigger firm. They were good accountants and we had a great relationship but because they were such a big company we were being charged fees like an international business rather than a little corner bakery. So I had to look around for someone smaller and more in touch with us.

*How long have you been with him?*

About 10 years... he was recommended to me by the bank and I took their recommendation.

*(SW 51-100 employees – director interview)*

We have an excellent relationship with our accountant who's been my accountant both from an audit point of view and a financial adviser for the last 20 to 25 years. This company in the last 80 or 90 years has only ever had three accountants; we seem to inherit long serving accountants so they have a very close understanding of the business.

*(SW 101-150 employees – director interview)*

*How long have they been the accountants?*

About 20 to 25 years. It helps if you know the people you are working with and have built up a relationship with. It's similar to the relationship you have with bankers, insurance brokers and I don't think it's a good thing to change frequently.

*(SW 151-200 employees – director interview)*

Irrespective of how successful or long-standing the relationship is, if the accountant is a sole practitioner, his or her demise heralds the end of the firm and therefore the end of the relationship for the client.

*How long have you been with your accountant?*

Only two years – our previous accountant unfortunately passed away and the new one was recommended to me by a business colleague of mine.

*SW 11-21 employees – director interview)*

### 3.3.1 Accountancy services

In most of the participating companies, a qualified accountant was responsible for preparing the statutory financial statements. The exceptions were:

- the electronic components supplier (SW 1-10 employees) and the kitchen design and installation company (SW 11-20 employees) who both employed an ex-tax inspector;
- the clinical research company (SW 51-100 employees) and one of the construction companies (SW 151-200 employees) whose financial director prepared the end of year statements;
- the furniture retailer (SW 101-150 employees) who employed a part-qualified accountant.

Table 4 summarises the size of the accountancy firm, whether or not the external accountant is a qualified member of one of the accountancy bodies and the services the case study company receives. This information is derived from the interviews with the directors.

*Table 4 - External accountant and services provided*

ID	Size of practice	External accountant	Services provided to case study company							
			Accounts preparation	Audit	Companies House returns	Credit control	Management accounts	Payroll	Tax/VAT returns	Other
SE 1-10	Small	Qualified	✓	✓	✓	✓	✓	✓	✓	
SW 1-10	Small	Unqualified	✓		✓			✓	✓	✓
SE 11-20	Medium	Qualified	✓		✓				✓	
SW 11-20	Small	Unqualified	✓		✓			✓	✓	
SW 11-20a	Small	Qualified	✓		✓				✓	
SE 21-30	Medium	Qualified	✓	✓	✓			✓	✓	✓
SE 21-30a	Small	Qualified	✓	✓	✓					✓
SW 21-30	Medium	Qualified	✓	✓	✓				✓	✓
SE 31-40	Medium	Qualified	✓	✓	✓	✓	✓	✓	✓	
SW 31-40	Medium	Qualified	✓		✓		✓		✓	
SE 41-50	Medium	Qualified	✓	✓	✓				✓	
SW 41-50	Medium	Qualified	✓		✓	✓	✓	✓	✓	
SE 51-100	Small	Qualified	✓	✓	✓				✓	✓
SW 51-100	Top 10	Qualified	✓	✓	✓			✓	✓	
SW 101-150	Top 10	Qualified		✓	✓				✓	✓
SW 151-200	Top 10	Qualified		✓	✓				✓	✓
SE 201-250	Medium	Qualified	✓	✓	✓		✓	✓	✓	

During the interviews with the directors they were asked what had been the best advice they had received from their external accountant and the accountants were asked what had been the best advice they had given to their client.

The director of the training and education company (SE 1-10 employees) told of the timely advice to send off the annual return to Companies House, which prevented the company from incurring a late penalty charge. Indeed, after that occasion, the bookkeeper supplied by the accountant was invited to regularly inspect his in-tray to ensure that nothing else was left languishing at the bottom of the pile.

He forgets to send quite a lot of things. It [annual return] sat in his in-tray for a long time and we got a summons from Companies House... Anyway, we sorted it out and... [we] changed the system because now he [the client] just has a tray that he puts anything official in and our people go through it to make sure there's nothing to be done. Because people like that get brown envelopes and they just think that's not anything to do with me, and never open the envelope. It's better than some people who just throw them away.

*(SE 1-10 employees – accountant interview)*

While it was frequently the case that the best piece of advice related to taxation, this was not always the case and issues such as company structure and succession planning were also cited.

He's also given us advice about the way in which we've structured the equity. He gave us very strong advice at the beginning, which we wouldn't possibly have been able to get to – and I don't think our non-execs would either – about different classes of shares.

*(SE 1-10 employees - director interview)*

Advice on succession planning was particularly useful. It was good to have external advice on that.

*(SW 151-200 employees – director interview)*

In another company the best piece of advice was not tax or even commercial, but concerned business ethics.

His advice to me is to play it straight. That's his advice and that's the best advice he's given me... because ducking and diving is endemic, particularly in our industry... Well, in fact probably every industry especially when you're at grass roots level and you're struggling. So ducking and diving becomes a way of life... and I know many companies who've not prospered... because they haven't played it straight and somewhere down the line they've come unstuck because eventually you do.

*(SE 51-100 employees - director interview)*

For one company audit and tax advice was valuable, as the following quotation shows, but what was more important was that the external accountant understands the business.

What we look for is being supplied with good auditing practices and [to] advise us what we are doing right and secondly with tax advice which is very important. Our accountant is the tax partner of a large company. Thirdly its understanding, the most important thing from an outside professional is that they understand the business that you are trying to run. I've seen so many cases where they don't. You have to understand that each industry or sector has its own specific needs.

*(SW 101-150 employees – director interview)*

The accountant involved with this company did not give permission for his interview to be recorded but agreed to extensive notes being taken. He regarded himself as a sounding board for the management team and felt there had to be a willingness to give and receive advice. As he put it, "It takes two to tango" and it is the level of the relationship that matters.

It was apparent that the nature of the advice given was a function of the relationship the directors had with their accountants.

He's really only good at providing information that I asked him for. He's not proactive at all... He was very good at the beginning when we were starting up and needed more business advice. Now he's there to produce the accounts and... to answer any questions and to deal with queries from the Inland Revenue and regarding VAT.

*(SW 1-10 employees – director interview)*

In some cases the relationship was more functional and advice was neither sought nor given.

I don't have many dealings with our accountants. I just don't talk to our accountant very often at all... in fact, it's probably a year since I've... talked to our accountant. I find that he's fine for the functions that he does, but I don't particularly think that he's that useful on anything wider. So, for example, I wouldn't automatically look to his advice... on any other issues to do with financial planning or tax advice or anything like that. So we don't have that sort of relationship. It's purely functional.

*(SE 11-20 employees - director interview)*

One director commented that he did not expect any advice for the £300-£400 fee he paid (SW 11-20 employees). Another could not readily bring to mind a particularly memorable piece of advice but was completely satisfied with the quality of advice provided. He gave an example of when the accountant suggested at the year end that the company should sell unsold stock at a reduced margin rather than wait too long and risk having to write it off (SE 21-30a employees).

Few of the companies regularly received accountancy services or business advice from non-accountants. The main sources of occasional financial or other business advice included solicitors (in connection with relocation and intellectual property rights) and the bank (in connection with restructuring, mortgages and lending). One director mentioned the long-standing relationship with a financial advisor who dealt with the company pension scheme (SW 101-150 employees).

### **3.4 Contact with the external accountant**

To a large extent, the frequency and purpose of contact with the external accountant reflects the range of services provided. In order to capture these aspects, the directors were invited to talk about the contact they had had with their accountants within the last three months. The frequency of contact varied from weekly, monthly and quarterly to only annual meetings. However, this must be interpreted with care because the director of the electronic components supplier who sees his accountant every week (SW 1-10 employees) explained that this was purely for social purposes (they play in the same squash league). Nevertheless, this illustrates that social as well as professional relationships may develop. The accountant of the electronics company (SE 21-30 employees) had professional meetings with his client at least four times a year. He was of the view that his relationship with his client flourished because they also had something in common at a social level and this brought them closer.

[The relationship with this client] works one of the best... It works well because they're completely confident about picking up the 'phone to me.

*(SE 21-30 employees - accountant interview)*

The quality of the relationship between these two parties was confirmed by the director (SE 21-30 employees), who particularly mentioned good communications between them. He also drew attention to his accountant's proactive stance, which included invitations to attend seminars at the practice on changes in regulations, which he (the owner-director) found very useful.

Frequency and ease of contact was also cited as a characteristic of a good relationship by the accountant of the company in ladies fashion design (SE 21-30a employees):

It's a very good and long standing relationship where he can 'phone me up and ask me anything.

*(SE 21-30a employees – accountant interview)*

Not surprisingly, the purpose of the contact for those having monthly or quarterly meetings was to discuss the periodic management accounts or matters in connection with payroll or the P11D returns. Contacts tended to be with the person with specific responsibility at the practice. Thus, in larger practices, the main partner might be contacted to discuss future borrowing needs or changes in equity shareholdings; the audit partner to discuss the forthcoming audit and annual stock-take; the tax partner to discuss taxation; and someone else to plan a software upgrade.

The more frequent the contact with the accountant, the more likely the directors were to comment positively on the way in which the accountant understood the business. The director of the training and education company (SE 1-10 employees) commented that the relationship with their accountants was improving because the new quarterly meetings that had been set up meant that the partner was starting to understand what it was that they do. Understanding the business well might also be the key to placing the accountant in a position to be proactive, and many of the directors clearly believed that this was an important aspect of the relationship. Many small companies are family-owned businesses, such as the wine importer and distributor company (SE 31-40 employees). The managing director, who was a qualified accountant himself, commented that the ability of their external accountant to galvanise the board to act was exactly what they needed, and that this was quite hard when the directors are all related.

On the other hand, one or two companies were clearly not enjoying their relationship with their accountant and this appeared to be due to personalities rather than complaints about the services provided. For example, the video production company (SE 11-20 employees) who said that he had a purely functional relationship with the accountant, which he described as being "at one removed". Indeed, he described how the accountant's manner of talking to him annoyed him so much that he made his wife (and co-director) take all telephone calls from him. When asked whether this was sufficient to make him consider changing accountants, he replied that he was so busy running the business that he did not have time to investigate alternatives or establish a new relationship with another accountant, despite the fact that he had received marketing literature from a nearby practice with a good reputation.

Nearly all the companies met with their external accountant to discuss the draft annual figures before they were finalised and this provided an opportunity for interpretation and advice. In some cases, the directors felt this was the ideal time to help the accountant to better understand the transactions and events that had taken place during the year, rather than the

reverse. For example, the director of the steel importer and fabrication company (SE 41-50 employees) told how he had to explain to the accountant that a particular bad debt written off during the year was severely reducing the draft profit because the accountant preparing the figures had overlooked the credit insurance payment that would offset this loss.

There were some complaints about the time lag between the end of the financial year and receipt of the final accounts. This did not appear to cause any problems in connection with year-end decisions, since these were taken at the draft stage. However, one company had to wait for two months after the year-end to receive confirmation of the opening balance figures from the external accountant, which reduced the usefulness of the management accounts for the first part of the current year.

Some companies received both a verbal and written report from their accountant with the year-end accounts. They were prompted to think of examples of any additional information that might have been useful in addition to the statutory accounts and detailed financial statements they received from the accountant at the year-end. However, they all appeared to be satisfied with the information they received. Some directors said they had no qualms about asking for what they wanted when the need arose and others pointed out that they did their own detailed analysis and therefore had all the detail they required.

Where explanations and advice were provided at the year-end, it was considered to be useful, but few directors felt advice was needed. This may reflect the relative maturity of the businesses participating in the study.

I don't come back to them [external accountant] that often... If I think he can help I may... contact him. It just depends on what the issues are. You see, I can go months and months without actually contacting him.

*(SE 31-40 employees – director interview)*

It would appear that for most of the companies the year-end accounts served solely to confirm what they already knew. However, some directors mentioned the link between receiving confirmation of the final figures and planning capital requirements or making remuneration/dividend decisions.

*You seem to be saying that you use the accounts to give you confirmation.*

That's true because once you know what the figures are you're in a better position from a tax point of view to have to take larger remuneration, bonus, dividends – however you want to distribute profits.

*(SE 51-100 employees – director interview)*

However, some of the accountants expressed frustration at their clients' lack of interest in the feedback available.

Others just want a set of accounts and a tax return and tend not to ask any questions... They don't want to know. They are more concerned with paying the least amount of tax... They just seem to have blinkers on.

*(SW 1-10 employees – accountant interview)*

You can provide them with all sorts of figures and reports, but the number of times I've found my envelopes not even opened and certainly the letters never read. They might squint at the back page to see how much profit they've made, how much they owe me and how much tax they have to pay and put it back in the envelope. I write quite detailed letters, 2 or 3 pages, on comparing one year to the other, areas they need to look at and consider, perhaps other ways of approaching things. I'm certain half of them never get read.

*(SW 11-20a employees – accountant interview)*

### 3.5 Auditing and financial reporting

#### 3.5.1 Audit choice

Most of the companies studied had had an external audit of their last set of annual accounts. The directors were asked whether this was a statutory requirement or a voluntary choice. Table 5 summarises their replies and the main reasons for their choice.

**Table 5 - External audit**

ID	Audit	Main reasons
SE 1-10	Voluntary	For business angel investors and future sale
SW 1-10	None	Once in the past following a tax investigation
SE 11-20	None	Cost (saves the company £500)
SW 11-20	None	
SW 11-20a	None	
SE 21-30	Voluntary	For customers (eg tendering for MOD contracts)
SE 21-30a	Statutory	But would have one in any case for check
SW 21-30	Statutory	Also checks internal processes and deters fraud
SE 31-40	Statutory	
SW 31-40	None	
SE 41-50	Statutory	Needed for credit insurers in any case
SW 41-50	None	
SE 51-100	Voluntary	Likely to exceed exemption threshold next year
SW 51-100	Statutory	
SW 101-150	Statutory	
SW 151-200	Statutory	
SE 201-250	Voluntary	For future sale of company

The value of the audit to outside investors, either current or potential, was apparent and was one reason for voluntary compliance. Another reason given was linked to the possible future sale of the company.

[Name of partner at accountants removed] asked us about that [voluntary audit] quite early on and said, "You don't have to have this, but if we do it, it won't cost you that much because we already know the systems and everything... You may want to ask the board, but I wonder, given the nature of the investors that you have [syndicate of business angels] and the fact that at some point you might want to sell the company, doing this kind of thing might be a good practice to get into?" We spent about 5 seconds thinking about it and thought – yes!

*(SE 1-10 employees - director interview)*

I suppose the unspoken rationale [for the voluntary audit] is that if we come to sell the company it's a lot easier to sell a company with audited financial statements.

*(SE 201-250 employees – director interview)*

There was evidence to suggest that the value of the audit is linked to the relative prosperity of the company. Two companies regarded themselves as 'cash rich' and had not seen any detrimental impacts following their decision to take advantage of the audit exemption threshold.

When we were advised that the threshold had been raised in terms of turnover... I think it was two or three years ago maybe... that it was no longer necessary to have the audit, which was extra expense. So we thought, "Well, why bother?" ... We're luckily cash positive and we have no problems with credit.

*(SE 11-20 employees - director interview)*

I don't see there's any need to have [an audit]. We're a cash rich business and don't owe any money to anybody.

*(SW 11-20a employees - director interview)*

For some companies the audit of the final accounts was seen as part of the tax system.

We still have it [the accounts] audited and accounts are still prepared mainly I suppose for tax – you know, Inland Revenue purposes.

*What, the Revenue like audited accounts?*

Yeah, of course they do! So yes, so that would be an example where we have an audit and accounts are prepared when legally we wouldn't be required.

*(SE 31-40 employees - director interview)*

It was also felt that the business would benefit from a better credit rating if audited accounts were filed, but there were no other business benefits.

*How would you feel if the business didn't have to have the accounts audited? What do you think you would decide to do? Would you go on with the audit or would you decide to drop it?*

Purely for financial terms I would probably drop it, but you still need the set of accounts produced. The audit itself really is just checking what we're doing basically... They come in here and ask stupid questions. There again that's what they've got to do.

*Do any of your suppliers or anybody else say to you, "Oh it's good you've got audited accounts - we'd like to see audited accounts"?*

Most of my suppliers of any note... use credit insurance depending on who it is. There's quite a few who use that. They can get credit insurance on us and they would need probably audited accounts to get that information.

*(SE 41-50 employees - director interview)*

Some directors thought it essential to have an independent verification of the accounts. This was not restricted to the larger companies; the director of the company in ladies fashion design (SE 21-30a employees) was certain he would continue to have the accounts audited on a voluntary basis if he dropped under the threshold.

*If you didn't need a statutory audit would you still have one?*

Yes, for reasons of external control. As I'm [Finance Director] the only person preparing the accounts it gives external assurance of the work I've undertaken to the other directors and for external shareholders if we did have them.

*(SW 151-200 employees – director interview)*

One director was not interested in whether or not the company accounts were audited.

*Do you have an audit?*

Can you explain that a bit more to me?

*You're at a level where the new audit threshold of £5.6m means that you do not have to be audited?*

I don't really understand that side of the business. That's why I have an accountant. I can't give it to you any straighter than that.

*(SW 51-100 employees – director interview)*

There was no support for a compilation report or any other lesser form of assurance from any the accountants interviewed in the South East. Most of those asked simply said that they were not in favour and it would not be useful, but one accountant, who is also the case study company's auditor, gave a number of different reasons.

*What are your views on the value of an alternative/lesser form of assurance for SMEs?*

It's a bit wishy-washy. The audit is useful, but we think users are very confused about what an audit is. It's about the true and fair view – how can you have a 'slightly true' and a 'slightly fair' view? It wouldn't produce an objective set of accounts... It's also about going concern – it would be dangerous to have something as a half-way house. Someone who didn't want the checks on stock, for example, would be trying to pull the wool over the eyes of the readers of the accounts... [without the full range of checks] there'd be more company failures or manipulation of profit to reduce the tax bill.

*(SE 21-30a employees – accountant interview)*

### **3.5.2 Separation of the preparation and audit functions**

It was apparent that amongst the companies having the accounts audited the external accountant was also the auditor. Therefore, the directors were asked what difference it would make to the company if they had to have the accounts audited by a separate firm. Not surprisingly, the likelihood of increased costs in terms of time and money, and generally having to establish and maintain a new relationship did not make this a popular suggestion.

If it was the law of the land, then no problem - I guess there could be an increase in cost so I would only support it if I had to.

*(SW 10-20 employees – director interview)*

I should think it'd be a bit more expensive doing it that way because they'd be going over the same ground at times. They must go over the same ground... I wouldn't be happy to pay more, no. That would be crazy.

*(SE 41-50 employees - director interview)*

This perceived increase in costs of separating the preparation and audit functions was confirmed by some of the accountants interviewed.

The difference between [the cost of] a set of statutory accounts with an audit certificate and a set of statutory accounts without an audit certificate is... not a great deal... because we're doing the work.

*If you hadn't prepared them as well and were only auditing them the amount of work would be extra?*

That's right... [recently] the figure of £4,000 was being used... but I think that's wildly overstated... In my case it would be around a £1,000.

*(SE 51-100 employees – accountant interview)*

The director of the training and education company (SE 1-10 employees) indicated that a situation might arise where he ended up having to referee the two professional firms, since the auditor would be auditing the work of the firm of accountants to whom he outsourced the management accounting system from which the financial accounts are drawn.

I think the other thing that would irritate me is that I don't want to end up refereeing. I've never had this with accountants, but I've had it with lawyers where two lawyers are involved with the same thing and it irritates me enormously the stupid point scoring that goes on about little items of law that the other one might have got wrong... But it's so pathetic, and so the idea of two firms of accountants sitting there and saying "Of course, that's not really the right treatment for XYZ"... I just think I'm not interested in that. I can't see how it could possibly help.

*(SE 1-10 employees - director interview)*

When the issues surrounding the costs of compliance and audit thresholds were discussed further, one owner-director took a cost-benefit approach to the fees charged, whilst others considered the audit fee to be insignificant compared to the costs of other services and the bureaucratic burdens placed on the company by regulation.

Well, if you're going to do it [separate the preparation and audit functions] I think you should do it properly. I suppose it would come down to cost. That would be it because, you know, you'd weigh it up. "What are the disadvantages of not having it done?" and "Is it a lot cheaper?" Well, if it's that much cheaper and... and you're still getting... most of what you want, then perhaps you would go for it, but I think... it would come down to cost.

*(SE 51-100 employees - director interview)*

Our insurance brokers are separate and their fees are actually more than the audit fee. Their service is so specialist we need their services for the business we're in.

(SW 151-200 employees – director interview)

I can understand that the government would like to assist SMEs... by cutting their costs and everything else, but if you look at the red tape and the bureaucracy that we're going through in every other area, you could pay for an audit 50 times over if they cut some of that out.

(SE 51-100 employees - director interview)

An increase in fees was not always anticipated. One company felt that the fee structure was based on ability to pay and that the introduction of a separation of functions would be cost neutral.

Would it affect the costs? No, probably not. I'll tell you why, because even if they charged, you can see supposedly what the auditors have charged for their audit so say it was for example £5,000 – now, you know, another firm of auditors comes in and sees that it's £5,000, but if they looked at our books and it costed at four, they'd still charge us five, wouldn't they? That's the reality of the world. So no, I don't think it will make any difference at all.

(SE 31-40 employees - director interview)

Apart from the one quotation above, there was no real support for the separation of function proposal and again issues such as cost and cooperation were apparent.

The separation of function issue was not seen as adding value to the company and so any additional costs of complying with the ethical standards could not be passed on to clients.

*You mentioned the ethical standards. Are they causing you some problems?*

Lots of problems. Specifically with the tax department as previously they worked along side the audit department and within our audit file there was a section for tax review. Now they have to say that they are working as a separate team and the audit department has to audit our own tax people, which is increasing the workload.

*Is that increasing the workload and fees?*

Our workload has increased but complying with ethical standards is something that we can't pass on to our clients. They don't see any benefit from the ethical standards and so would be unwilling to bear the additional cost. They don't see the division between audit and tax as they get the same tax figure whatever system is adopted.

(SW 151-200 – accountant interview)

The potential alliances between two separate accountancy firms, one preparing the accounts and the other auditing them, was seen as counter productive by some company directors.

I think that we've got a clear enough understanding of our accounting system ourselves. I think that [name of accountants removed] has a clear enough understanding... of the way we do things, particularly since [name of internal bookkeeper removed] doing it. I don't really need an external auditor to confirm that. I suppose if we were a more disjointed company and I wasn't so on top of it... perhaps then I would need the satisfaction or confidence of an external auditor.

The firms of accountants will form alliances the same way as solicitors do. So you'll have one doing the audit for that one and that one will do the audit for that one and you won't have actually achieved a thing because all the professional bodies whenever they've got this arms length arrangements or whatever they are, they just form alliances, so you're actually not getting anywhere!

*(SE 51-100 employees - director interview)*

However, these alliances can already be seen with non-qualified accountants who have clients above the audit threshold or clients who are below the audit threshold but need an audit for another purpose.

*What happens when your clients exceed the audit threshold?*

I have a chartered firm of accountants in [neighbouring town] who are happy to do as much work as I can give them.

*Do you think the firm in [neighbouring town] are happy with your work?*

They redid the work on their own paper, but the figures were identical so they must have been happy with my work.

*(SW 11-20 employees – accountant interview)*

Some directors see the accounts preparation and audit as intertwined. For example, the director of the company in ladies fashion design (SE 21-30a employees) found it difficult to separate the notion of accounts preparation and the audit services provided by his accountant. For him, the confirmation of the annual results as a result of the external audit was very important, and he was of the opinion that there was little value in the financial statements unless they were audited. He was particularly concerned about the valuation of assets (stock, being one of the most important) and was planning to introduce quarterly internal audits. The following quotation illustrates the views of a larger company.

I suppose I've never seen the two as separate in the sense that... the preparation of the financial statement is really... an inevitable product of the audit, but I suppose you can see that someone could prepare the financial statements and then someone else audit it... I don't feel a need for it. From my point of view... the purpose of the audit... is two-fold... It's to pick up on anything we might have been doing wrong in terms of... taxation or anything of that nature... and the other part of it I suppose is to make sure that the accounts reconcile.

*(SE 201-250 employees - director interview)*

The accountants' views on continuing to prepare and audit the same set of financial reports were different. Some were aware of the ethical issues involved, but were satisfied with their current arrangements.

Well, we've had two different sets of advice and one said "You can do it" and one said "Be careful about it." So we're sticking with that for the time being, but it may be there may be a point in time when my conscience gets the better of me... But up until now and while the ethical situation is as it is, we have been able to convince ourselves that there are sufficient controls within our organisation and sufficient differences of personnel that actually it isn't affecting it.

*(SE 1-10 employees – accountant interview)*

*Do you think there's a perception that accountants preparing and auditing the same figures could be problematical?*

Yes, putting a set of accounts together doesn't mean that you've checked the systems. Auditing does and I'm able to put the auditing hat on and qualify the accounts if necessary.

*(SW 11-20a employees – accountant interview)*

One accountant was concerned that there was a lack of awareness amongst accountants of the new ethical standards due to lack of publicity.

I sense that many accountants are totally unaware of the new ethical standards. I don't think the publicity about them and the implications are very well known in accounting circles... I've discussed this with lots of accountants and they look blank-faced and say, "What? What are you talking about?" And it worries me that accountants might for some time yet carry on doing what they've always done without really recognising the ... implications.

*(SE 31-40 employees – accountant interview)*

### **3.5.3 Financial Reporting Standard for Smaller Entities (FRSSE)**

There was very limited awareness of whether or not the company's statutory accounts had been prepared using the FRSSE. This is not surprising, since the final accounts preparation in all the companies studied was outsourced and accounting standards are intended to provide technical guidelines for accountants rather than the lay population. Even a director who was a qualified accountant was unaware of the use of the FRSSE.

*Would you know if your accounts are prepared in accordance with the FRSSE?*

I don't really know how he does it.

He's put something on the top of the accounts – hang on a minute. Yes, it says here.

*(SW 11-20 employees – director interview)*

*As I know I am talking to an accountant I can ask you this next question. Does [name of external accountant removed] use the FRSSE to prepare your accounts?*

I don't know.

*(SE 31-40 employees – director interview)*

Nearly all the external accountants took advantage of the provisions of the FRSSE for qualifying clients.

*Do you prepare the accounts according to the FRSSE?*

Yes. Wonderful software keeps me up to date.

*(SW 11-20a employees – director interview)*

*Are the client's accounts prepared using the FRSSE?*

As a matter of routine, yes – we use it for all our clients [95% are SMEs].

*(SE 21-30 employees – accountant interview)*

However, there was one exception:

*Are the client's accounts prepared using the FRSSE?*

No – it's on our software, but we don't use it for any SME client [100% are SMEs].

*(SE 21-30a employees – accountant interview)*

Not surprisingly, some accountants thought that their clients did not really understand this particular choice.

*Do your SME clients understand when you say you are going to use the FRSSE?*

No, most of them don't really understand. It just means... less disclosure or fewer complications... but most of them don't really know what you're talking about. It's not of interest. They've got a business to run and the accountant is there to do just what they have to do from a legal disclosure point of view.

*(SE 31-40 employees – accountant interview)*

### **3.5.4 Filing choice**

When the issue of the formal filing of accounts at Companies House was discussed there was a degree of ignorance and disinterest in the views expressed. Some owner-directors thought they were filing full accounts, but their accountant confirmed they had filed abbreviated accounts. This may have been due to the decision being guided by the accountant's advice.

*Do you file full accounts or abbreviated accounts?*

Full accounts

*(SW 11-20 employees - director interview)*

*If you prepare accounts for companies, do you advise them to file abbreviated or full accounts?*

I tell them that we file abridged accounts to Companies House.

*(SW 11-20 employees – accountant interview)*

*Do you file full accounts with Companies House?*

Yes

*Why have you decided to do that, because you can file abbreviated accounts of course?*

Well, in that case by answering yes it might be abbreviated accounts; I know we file accounts at Companies House. I just think it's a good thing to do; we're successful and not ashamed of anything. We're constantly looking for new sources of income and I know that people seem to use Companies House to check companies out. If we can look as good as we are, we have nothing to hide.

*(SW 11-20a employees - director interview)*

*When you file accounts to Companies House are they full or abbreviated accounts?*

Abbreviated because the clients want as little information going to Companies House as possible. From competitors, creditors and customers seeing it so they want the minimum amount of information as possible.

*(SW 11-20a employees - accountant interview)*

One accountant routinely advised his clients to file abbreviated accounts:

*Does this client file full or abbreviated accounts at Companies House?*

We always file abbreviated accounts for all clients [100% are SMEs]... because they hide the strengths and weakness and the profit margins from competitors.

*(SE 21-30a employees - accountant interview)*

It was sometimes seen as a badge of a well managed business that full accounts were filed at Companies House. The expression 'nothing to hide' or 'something to hide' was used a number of times by interviewees.

[Names of business directors removed] are all very capable of thinking "I'm talking to this company and so I'll check their accounts out and pull them off Companies House." ...I think we have a kind of 'this is kosher, this isn't kosher' and we just think, "No, I wouldn't touch that with a barge pole!" So there'd be a kind of instinctive reaction against abbreviated accounts that would mean we didn't really bother discussing it because we'd all think, "We wouldn't want to be the sort of company that looked like... they had something to hide".

*(SE 1-10 employees - director interview)*

The above situation is contrasted with companies wanting to withhold information from competitors.

*Do you know whether you're filing full accounts with your return to Companies House or whether you file abbreviated accounts?*

I think it's just abbreviated accounts...I think the assumption was that you give as little information in terms of detail about your costs and income as possible just on the basis of competitors maybe could look it up. So why give more information than you need to give?

*(SE 11-20 employees - director interview)*

In one company, the filing decision was based on what the accounts contained. If the information was flattering then full accounts were filed, otherwise only abbreviated. There appeared to be an implication for a company's credit rating, but this disadvantage was not enough to influence the decision. This may give support to the views of the director above who had nothing to hide.

*So do you decide whether to file full or abbreviated accounts on a year by year basis?*

Yes, I make the decision on a yearly basis, and this year it's going to be abbreviated.

*Because you want reduced disclosure?*

Yes, I want reduced disclosure because I didn't want people to know that I'm moving out of one building and into another and everything else at this moment and spending hundreds of thousands moving premises. I'd rather hit them with it all next year when hopefully there's a healthy profit in there and I can say, "Well there's the reasons I've done that." ... I'm using it for our advantage. The disadvantages are the credit insurers, but I can give them full information when they want it. Two have asked and two have got it, but for every Tom, Dick and Harry it's not available, unless I decide to disclose it to them.

*Who in particular would you like not to see the full information then?*

Competitors and certain suppliers, because certain suppliers are competitors as well.

*(SE 41-50 employees - director interview)*

### **3.6 Users of the annual report and accounts**

The directors are required to file a copy of the annual report and accounts at Companies House and also receive a number of copies of the full financial statements from the accountant for themselves and their co-shareholders. Table 6 summarises the range of non-statutory recipients of the annual accounts.

**Table 6 - Non-statutory recipients of the annual accounts**

ID	Bank/lenders	HM Revenue & Customs	Potential/existing customers	Suppliers	Employees	Other
SE 1-10 SW 1-10	✓ ✓	✓ ✓	✓		✓	✓
SE 11-20 SW 11-20 SW 11-20a	✓ ✓					✓
SE 21-30 SE 21-30a SW 21-30	✓ ✓ ✓	✓ ✓	✓			✓
SE 31-40 SW 31-40	✓ ✓	✓ ✓	✓ ✓			
SE 41-50 SW 41-50	✓ ✓	✓		✓		✓
SE 51-100 SW 51-100	✓ ✓	✓	✓			
SW 101-150	✓	✓				
SW 151-200	✓	✓	✓	✓		✓
SE 201-250	✓		✓			

The table shows that all but one of the companies gave their accounts to the bank and many of them gave them to potential or existing customers. Where the accounts were given to HM Revenue and Customs in support of tax returns (corporation tax and/or VAT), it tended to be the accountant who provided them, rather than the directors. The following quotations illustrate typical responses from the interviews with the directors.

*Who do you give copies of those accounts to? Anybody?*

Only the bank when we wanted a loan, but, as I say, that's been paid off. Nobody else only Companies House.

*Do you think they might give them to the tax authorities when they deal with the taxation side for you?*

Well, I presume our accounts are open to the tax people in one form or another. I don't know who gives it to them... but I think the accountant does. He sends the return and we send the cheque and if they've got a problem or a query, then they'll talk to us I suppose.

*You and the other director don't share the accounts amongst your employees or anything like that?*

No.

*And do you ever have any suppliers or anybody else who might want to see your accounts?*

No.

*(SE 11-20 employees - director interview)*

The training and education company (SE 1-10 employees) was the only business to provide copies of the financial statements to employees. The desire of this company to report the annual results to employees can be sharply contrasted with the electrical components supplier.

We keep the accounts side on the directors side so the girl who looks after the accounts in the office doesn't see the overall financial position. We limit the amount of information that goes into the office.

*(SW 1-10 employees - director interview)*

The provision of financial reports to banks was discussed in the interviews with the accountants. Some felt that audited reports were unnecessary and that banks preferred more regular information that was independently verified in some other way; for example, a compilation report might be sufficient for their needs.

The bank, to be quite honest, doesn't seem to appreciate what an audit is or isn't... [and] more recently they are asking for management information - monthly or quarterly accounts that sort of thing - as a basis to support the funding they have provided to the company. The movement on the [bank] account doesn't always show the full picture of course, but they will have an idea from the [bank] account. I think that's one of the reasons why banks don't insist on audited accounts. Having said that many of the banks know the accountants who have prepared the accounts and will have an idea of the quality of the work coming from them... A set of audited accounts are out of date anyway for the bank.

*(SW 31-40 – accountant interview)*

*You mentioned that the banks like an audit report, but do the banks just want an independent report and not an audit? What do you think of that?*

That's an issue that we are coming across a lot. A lot of companies have loan covenants which say 'audited accounts are to be produced'. We are asking our clients to offer a compilation report to the bank instead of an audited set of accounts but we haven't had much experience of this yet. Maybe over time the banks will change.

I think what the banks need is information on whether the company is a going concern, do they have enough money to repay the loans, is the profit figure about right, are they complying with standards and the Companies Act. They don't need to know whether invoices, for example, have been signed off in triplicate. For these reasons a compilation report should be adequate.

*(SW 151-200 – accountant interview)*

The ladies fashion design company (SE 21-30a employees) that files abbreviated accounts provides copies of the full accounts to six credit rating companies that represent overseas suppliers. Voluntary provision of full information for credit rating purposes was also important to the steel importer and fabrication company (SE 41-50 employees), where the owner-director regularly gives the annual financial statements to certain suppliers, as credit insurance is a particular feature of the industry. However, he was careful to explain that he is reluctant to do this when the supplier is also a competitor, which is sometimes the case. One of the construction companies needs to send the annual financial statements to a vetting company as they are involved in work for the government and the Ministry of Defence.

#### 4. Conclusions

This aims of this study were to answer two research questions:

1. How do accountants and/or others help small and medium-sized companies obtain financial information for use by management?
2. How do accountants and/or others help small and medium-sized companies prepare financial information for financial reporting purposes?

This research has investigated a wide range of companies in terms of size (from as few as 8 employees to 250 employees) and in terms of the diversity of their business activities.

With regard to the first question we find SMCos are content with their accounting and auditing services no matter how they have been provided. The accounting systems used appear to be 'fit for purpose'. Where internal accounting expertise exists it is able to provide the financial information needed by management in a form that is readily understandable to the user which is invariably the directors. This could be relatively simple information regarding key performance indicators such as cash flow and turnover or more complex industry specific reports. Companies lacking internal accounting expertise either sub-contract to a third party or ask their external accountant to provide the necessary information.

Each company studied has a unique relationship with its external accountant, but a common thread is that the directors have been able to obtain the financial information they require. Their external accountants have also shown flexibility to work with the accounting system preferred by the company even if it is not their recommended choice. Most companies reported good long standing relationships with their external accountants who were able to meet their needs. In some cases external accountants provided valuable business advice and this could be on a regular basis or on a contingency basis, and as a result of either party being proactive. More advice and help was available, but was not always taken up by the directors.

With reference to the second question, financial reporting on the other hand is seen as fulfilling a compliance need. None of the companies prepared their final accounts for filing with Companies House without the assistance of an external accountant. Not all the accountants were professionally qualified but this was not an issue for those using their services. There is confusion about which form of accounts are filed and how they have been prepared.

For some firms the value of the audit in its current form is questionable and for others where it is voluntarily or statutorily required, it is indistinguishable from the accounting and tax services they obtain from the same provider. Nearly half (4 out of 9) of the companies who were eligible for the audit exemption chose to have a voluntary audit. There is no support for a separation of accounting and auditing functions to two providers as this is seen as costly and unnecessarily burdensome, with no advantages perceived.

We conclude that the accounting and auditing needs of small and medium-sized companies are diverse but are being adequately met with their current internal arrangements and the external relationships that exist with their providers of accountancy and auditing services.

## **References**

SBS (2005) *Small and Medium Enterprise (SME) Statistics for the UK 2004 (URN 05/92)*