Views of the directors of SMEs in the UK on financial reporting requirements in a changing regulatory environment

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Abstract

This empirical study focuses on the views of the directors of small and medium-sized private companies in the UK on the accounting and auditing options since the size thresholds were raised to the EU maxima. It also examines their opinions on the draft simplification proposals made by the European Commission in 2007 and gauges the potential demand for an International Financial Reporting Standard for Private Entities. The directors' views are important because they must weigh up the costs and benefits of the financial reporting options available to them and choose a strategy that best meets their needs.

The data was collected via a postal questionnaire survey of active, independent, private companies with a balance sheet total in their 2006 accounts not exceeding the EU April 2008 maxima for a medium company. Useable responses were received from 1,294 companies, representing a response rate of 14%, but the sample was not representative of the very smallest companies.

The results show that significant numbers see benefits in registering full accounts on a voluntary basis and/or voluntary audit. Consistency with previous years and/or usefulness to users were major factors for many, whereas cost was a major factor for only a minority. More than half dropping the audit since 2003 reported no decrease in external accountancy fees. Small companies whose 2006 accounts had not been audited were more likely to be interested in a less rigorous, cheaper alternative to audit, whilst medium companies were more likely to be interested in an IFRS for PEs. Widest support for the Commission's draft proposals was for exemption for micro entities from the requirement to register accounts, and least support was for increasing the transition period for crossing the size thresholds to 5 years. Opinion was divided on extending audit exemption to medium companies. These results contribute to the debate on better regulation and reducing administrative burdens on SMEs.

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1. Introduction

This paper presents key findings from a UK survey[1] of the directors of small and medium-sized entities (SMEs) on accounting and auditing requirements in company law. The research is set in the context of a changing regulatory environment due to several changes in the size thresholds in UK company law to bring them to the EU maxima. This is an empirical study that also examines the directors' views on the draft simplification proposals made by the European Commission (EC, 2007a) and potential demand for an International Financial Reporting Standard for Private Entities (IFRS for PEs)[2] (IASB, 2007).

Under company law, the directors are responsible for filing accounts and distributing them to shareholders and must, therefore, evaluate the costs and benefits of the options available and select those that meet the company's needs. The directors' views are vital since they are both preparers and users of the statutory accounts (Page, 1984; Carsberg, Page, Sindall and Waring, 1985; Barker and Noonan, 1996). Previous research shows they use them for a range of internal and external purposes (Collis and Jarvis, 2000 and 2002).

The next section provides an overview of developments in the deregulation of financial reporting by SMEs in the UK since the 1980s. This is followed by a description of the methodology and the sample companies, and the results. The paper concludes with comments on the contribution and limitations of the study.

2. Developments in the deregulation of financial reporting by SMEs

The rationale for simplifying the financial reporting requirements for SMEs is the need to reduce regulatory burdens that fall disproportionately on smaller entities. SMEs are considered to be 'the backbone of the European economy, acknowledged as a constant source of ideas, innovation and entrepreneurial skills, the principal providers of existing jobs and the main source of new employment' (EC, 2006, p. 1).

The move towards a less onerous regime for SMEs in Europe is related to the increased importance of smaller entities since the 1980s. For example, between 1980 and 2005 in the UK, the total number of business enterprises grew by nearly 80% to 4.3m. This was mainly due to more micro-businesses (1 to 9 employees) and one-person companies (SBS, 2002). By the start of 2006, there were an estimated 4.5m businesses, of which 1.1m (26%) were companies[3]. The vast majority of companies (97%) were small (0 to 49 employees) and 2% were medium (50 to 249 employees); together these SMEs accounted for 46% of turnover and 44% of jobs in the UK (BERR, 2007).

[1] The survey was commissioned by the Department for Business, Enterprise and Regulatory Reform (BERR) to contribute to strategic priorities relating to better regulation and reducing administrative burdens, and demonstrates the evidence-based approach to policymaking (Cabinet Office, 1999).
[2] The original was issued as the ED IFRS for SMEs.
[3] This category includes public corporations and nationalised bodies.

This classification of size by employees is the one used by the UK's Office for National Statistics, but size is a more complex and dynamic concept in company law. The Fourth Company Law Directive (78/660/EEC) provides qualitative and quantitative tests for defining a small or medium-sized company and the maxima in the size tests are subject to revision approximately every five years to take account of monetary and economic trends. However, national governments can set lower thresholds if they wish.

When the financial reporting options for SMEs were first introduced in the UK, the thresholds were set at a lower level than the EU maxima, and the turnover threshold for audit exemption was lower than for the accounting options. Subsequently, the UK raised the thresholds in a series of steps, until in 2004 they were standardised for all financial reporting options and harmonised with the EU maxima. In April 2008, the UK thresholds were raised again to align them with the revised EU maxima.

In general, unless excluded for reasons of public interest, an entity qualifies as small or medium in relation to a financial year if it meets two or more of three size criteria relating to turnover, balance sheet total and average number of employees in its first year. In a subsequent financial year, it must qualify or satisfy the size tests in that year and the preceding year. The conditions for exemption from audit are that the entity qualifies as small in relation to that year and meets both the turnover and balance sheet criteria for that year.[4] Table 1 summarises the thresholds for reporting entities in the UK with accounting periods starting on or after 6 April 2008.

Table 1 UK thresholds for small and medium entities from April 2008

Criteria	**Small company**	**Medium company**
Turnover	£6.5m (€8.8m)	£25.9m (€35.0m)
Balance sheet total	£3.26m (€4.4m)	£12.9m (€17.5m)
Average employees	50	250
Aggregate criteria	**Small group**	**Medium group**
Turnover	£6.5m net or £7.8m gross	£25.9m net or £31.1m gross
Balance sheet total	£3.26m net or £3.9m gross	£12.9m or £15.5m gross
Average employees	50	250

2.1 Statutory accounts

The Fourth Directive (78/660/EEC) requires all EU companies to make their accounts available at a registry on the basis that anyone dealing with a limited liability entity should be able to see the accounts. However, the Directive recognises that it could disadvantage smaller entities if too much detail were published. Therefore, national governments can provide an option allowing non-publicly accountable SMEs to register abridged accounts.

[4] The detailed rules can be found in the Companies Act 2006, c. 45, Parts 15 and 16. See Appendix 1 for a summary of the thresholds for companies with accounting periods starting on or after 6 April 2008.

In the UK, the option to file abridged accounts for qualifying small and medium-sized entities was introduced in 1981 and the financial thresholds were raised by approximately 40% in 1992.[5] This option gives exemption from the requirement to file a profit and loss account or directors' report, and requires the company to publish an abbreviated balance sheet only. Abbreviated accounts are drawn from the full accounts that all companies are required to prepare for shareholders, but because they exclude information on financial performance, they are not capable of giving a true and fair view (PricewaterhouseCoopers, 1999).

Table 2 summarise the changes in the UK size thresholds for small and medium-sized entities filing abbreviated accounts since 1981.

Table 2 UK thresholds for abbreviated accounts 1981 - 2008

	1981	1992	2004	2008
Small				
Turnover	£1.4m	£2.8m	£5.6m	£6.5m
Balance sheet total	£0.7m	£1.4m	£2.8m	£3.26m
Average employees	50	50	50	50
Medium				
Turnover	£5.75m	£11.2m	£22.8m	£25.9m
Balance sheet total	£2.8m	£5.6m	£11.4m	£12.9m
Average employees	250	250	250	250

2.2 Financial Reporting Standard for Smaller Entities

In the UK, the Accounting Standards Board (ASB) is responsible for setting Financial Reporting Standards (FRS). These are authoritative statements of 'how particular types of transaction and other events should be reflected in financial statements. Accounting standards have a major influence on financial reporting, since 'compliance with accounting standards will normally be necessary for financial statements to give a true and fair view' (CIMA, 1996, p. 6), as required under UK company law.

In 1997, the ASB issued the *Financial Reporting Standard for Smaller Entities* (FRSSE). Their aim was to reduce burdens on small companies, whilst ensuring that financial statements intended to give a true and fair view provide information that is useful to users. 'The FRSSE is designed to provide smaller entities with a single accounting standard that is focused on their particular circumstances' (ASB, 2005, p. 169). Qualifying small companies or groups can adopt the FRSSE in place of the full range of accounting standards[6] and fallback to full standards is permitted if a particular transaction or event is not covered in the FRSSE.

[5] The Companies Act 1981 referred to 'modified' accounts. Since the Companies Act 1989, the term 'abbreviated' accounts has been used in UK company law.
[6] A small group adopting the FRSSE also needs to apply certain other standards.

If the FRSSE is adopted, the financial statements must state that they have been prepared ‘in accordance with the Financial Reporting Standard for Smaller Entities (effective January 2005)’ (ASB, 2005, p. 16). This can be included in the note on accounting policies or, if abbreviated accounts are also prepared, in the statement required by company law to be given on the balance sheet.

The FRSSE is subject to periodic revision to reflect developments in the full range of accounting standards and revised versions came into effect in 1998, 2000 and 2005. The 2005 version turned the FRSSE into a ‘one-stop shop’ by incorporating the relevant requirements from company law.

2.3 International Financial Reporting Standard for SMEs

The International Accounting Standards Board (IASB) sets International Financial Reporting Standards (IFRS), which can be adopted by any country. Since 2005, group companies with a listing on an EU stock exchange have been required to follow IFRS in their consolidated financial statements, and national governments may extend the requirement to single entities and unlisted companies. In the UK, the use of IFRS is a requirement for all listed groups and a choice for single companies and unlisted entities.

In 2007, the IASB issued an exposure draft of the IFRS for SMEs (now known as the IFRS for private entities):

- to provide high quality, understandable and enforceable accounting standards suitable for SMEs globally
- to reduce the financial reporting burden on SMEs that want to use global standards
- to meet the needs of the users of SMEs' financial statements.

The IFRS for SMEs is a simplified, self-contained set of accounting principles that are appropriate for smaller, unlisted companies and is based on the full range of IFRSs. In due course, national governments will be able to decide whether to adopt it and which companies will be permitted to use it. The exposure draft defines an SME as an entity that does not have public accountability and publishes general-purpose financial statements for external users. A non-publicly accountable entity is defined as an entity:

- whose shares are not publicly traded
- that is not a financial institution or an essential public service
- that is not economically significant in its own country.

2.4 Statutory audit

In addition to the requirement to file accounts with the registrar, the Fourth Directive requires the accounts of all non-dormant limited liability entities to be audited. However, national governments are permitted to provide an option giving exemption to non-publicly accountable small entities within their jurisdictions. The statutory audit is an external audit that involves ‘an independent examination of, and the subsequent expression of opinion on, the financial statements of an organization’ (Oxford Dictionary of Accounting, 2005, p. 34).

In the UK, audit exemption was introduced in 1994 (SI 1994/1935). The option applies to a company that qualifies as small for filing abbreviated accounts, but not if audit is required by shareholders holding at least 10% of issued share capital. Initially the turnover threshold set at £90,000, which was lower than the level for filing abbreviated accounts (which itself was lower than the EU maximum). A company with a turnover between £90,000 and £350,000 was given the option of filing an accountant’s compilation report, but this was dropped in 1997 when the threshold was raised to £350,000 (SI 1997/936). Over the years, the thresholds were raised in steps until in 2004 the EU maxima were adopted (SI 2004/16). Table 3 summarises this and shows the UK thresholds from April 2008, which reflect the revised EU maxima.

Table 3 UK thresholds for total audit exemption 1981 - 2008

Criteria	1994	1997	2000	2004	2008
Turnover	£0.09m	£0.35m	£1.0m	£5.6m	£6.5m
Balance sheet total	£1.4m	£1.4m	£1.4m	£2.8m	£3.26m
Average employees	50	50	50	50	50

A further change in 2004 was the requirement that an exempt company with a turnover between £1m and £5.6m must file an audit exemption report (AER) stating that, in the opinion of the accountant, the accounts are in agreement with the company’s accounting records and have been drawn up in a manner consistent with the Companies Act. The AER must also state that based on the information contained in the accounting records, the company is entitled to audit exemption on the grounds of size.

Revised guidelines from the UK’s Auditing Practices Board (APB, 2006) require auditors of entities submitting abbreviated accounts to make a special report that the entity is entitled to deliver abbreviated accounts and that they have been prepared properly. If the auditor’s report on the full accounts is qualified, company law requires the special report on the abbreviated accounts to set this out. If the auditor’s report on the full accounts is unqualified but contains an emphasis of matter paragraph, this and any further materials needed to understand it must be included in the special report.

2.5 Draft simplification proposals

In July 2007, the European Commission invited comment on draft proposals for a simplified business environment in the areas of company law, accounting and auditing (EC, 2007a). The main suggestions for SMEs were:

- to introduce a new category of micro entities using size tests based on turnover below €1m (£0.74m), balance sheet total below €0.5m (£0.37m) and fewer than 10 employees[7]
- to exempt micro entities from the scope of the Fourth Directive (the accounting directive)
- to extend the transition period for SMEs crossing the size thresholds from two year to five years
- to exempt small entities from the requirement to publish their accounts
- to permit owner-managed medium-sized entities and unlimited companies to use rules currently available to small entities only.

By mid October 2007, the Commission had received responses from 23 countries, including 22 member states and published an analysis in December 2007 (EC, 2007b). The responses relating to the suggestions for SMEs can be summarised as follows:

- Approximately 80% supported the notion of exempting micro entities from the scope of the accounting directive.
- A small majority was against increasing the transition period for SMEs crossing the size thresholds from two to five years, but some respondents were agreeable to increasing the period to three years.
- A small majority disagreed with the notion of exempting small entities from the requirement to publish their accounts.
- Those commenting were divided over the draft proposal to allow owner-managed medium-sized entities to use rules for small companies, but there was support for relaxation in the case of unlimited companies.

3. Methodology

3.1 Sample selection

One of the main challenges in financial studies of SMEs is the absence of a comprehensive database to provide a sampling frame. Previous research (for example, Collis and Jarvis, 2000; Collis, 2003) used the FAME database and this strategy was also adopted in the present study. Over the years, the FAME database has been extended and now contains up-to-date information taken from the annual returns made by 2.8m companies in the UK and Northern Ireland. However, one limitation remains: it is not fully representative of companies with a turnover under £0.5m.

[7] Sterling equivalents based on conversion rates used for EU 2008 size thresholds.

The qualitative selection criteria for the study were that the entity had a registered office in England or Northern Ireland and a director's name was provided; in addition, that it was active, private and independent,[8] and had filed the 2006 accounts by the end of August 2007. Companies with activities in code J Financial Intermediation were deselected, as they are excluded from the small companies' regime on grounds of public interest.

The quantitative selection criteria were based on balance sheet total and number of employees, using the April 2008 thresholds for a medium-sized entity (balance sheet total £12.9m and employees 250). Turnover was not used, to capture companies registering abbreviated accounts.

3.2 Data collection

The data collection method was a postal questionnaire. The questions were guided by case study research of SMEs and their external accountants (Marriott, Collis and Marriott, 2006) and draft proposals for regulatory reform. The questionnaire was developed jointly with BERR and discussed with experts in the accountancy profession before being piloted via face-to-face interviews with directors of SMEs. The final version was then sent to a named director in 9,458 companies in September 2007 and, by the cut-off date of 31 October, 1,294 completed questionnaires had been received.

3.3 Data analysis

The data was entered into SPSS and verified. As this paper presents a descriptive study, the analysis is mainly univariate, but key results are supported by measures of central tendency and tests of association based on a significance level of 5%. Since the qualification criteria for 'small' and 'medium' are complex, a simple approach to grouping the companies was taken in the study. Unless stated otherwise, the size analysis is based on the empirical finding that 54% of companies had the 2006 accounts audited because they were above the thresholds. Therefore, these companies were categorised as medium and the remaining 46% as small.

3.4 Generalisability

The survey achieved a response rate of 14%, which is considerably lower than the 30% achieved by a smaller, government-funded survey on raising the audit exemption threshold a few years earlier (Collis, 2003). There are a number of possible reasons, including the necessity of conducting the survey during the holiday season to provide timely interim results by the end of September 2007 and a series of unforeseen postal strikes. In addition, whilst the stationery used for the 2003 survey carried the well-known DTI logo, the present survey went out under the logo of the Department for Business, Enterprise and Regulatory Reform, which was barely a month old at the time.

[8] Subsidiaries were excluded.

Nevertheless, the response rate is satisfactory when compared to other postal questionnaire surveys of SMEs; for example, 12% achieved by Poutziouris, Chittenden and Michaelas (1998); 11% by the ICAEW (1996); and 13% in the seminal study by Bolton (1971) in his accounting survey. Moreover, a sample of 1,294 is sufficient to represent the population from which it was drawn, as it exceeds the minimum acceptable size of 384 for a population of 1m or more (Krejcie and Morgan, 1970, p. 608).

However, some bias was present in the sample. Table 4 compares the size characteristics of the population of 9,458 companies with the 1,294 sample companies.

Table 4 Descriptive statistics for size variables

Size criteria	N	Min	Max	Median	Mean	SD
Balance sheet total						
Population	9,458	-£2.91m	£12.89m	£0.35m	£1.24m	1.975
Sample	1,294	-£0.02m	£12.71m	£0.75m	£1.54m	2.125
Employees						
Population	9,232	1	250	9.00	38.63	52.840
Sample	1,246	1	248	25.00	47.57	54.991

Source: 2006 accounts

Since size is positively skewed in the population (considerably more companies at the smaller end of the scale), the median gives a more appropriate measure of central tendency than the mean. A cursory glance shows that the median balance sheet total and average number of employees is slightly larger for the sample than for the population. This means that non-respondents were likely to have been smaller in terms of these two size measures.

Two reasons for this emerge from the messages received from those unable to participate. First, the directors of very small companies are too busy running the business to answer surveys; and second, they feel the issues are of little relevance to them due to their small size. These sorts of problems and the lack of availability of up-to-date lists of small businesses are cited as the main reasons for poor response rates in small business research (Curran and Blackburn, 2001). The sampling frame for this study was based on the returns made to Companies House. At the time of the study, private companies could file their accounts up to 10 months after the end of their accounting reference period. Some start-up companies may not last long enough to file their first set of accounts, whilst others may have changed their legal form, been acquired or sold. This explains why it is difficult to obtain results that are generalisable to the very smallest companies.

4. Results

4.1 The sample companies

In 89% of cases, the questionnaire was answered by a director or company secretary and in a further 11% of cases by a manager or accountant. As in the wider population, the majority of the sample were at the smaller end of scale in terms of ownership and size: 77% had between one and four shareholders; 49% were wholly family-owned (only one shareholder or all are related) and a further 23% were partly family owned. Just over half (55%) can be described as owner-managed, since all their shareholders had access to day-to-day internal financial information.

In terms of size, approximately 50% had a maximum turnover of £5.6m, 83% had a maximum balance sheet total of £2.8m and 59% had up to 50 employees (thresholds for a small company at the time of the study). One respondent pointed out that 'the average number of employees in the year may be a poor proxy for size, given the increased use of outsourcing to other firms and self-employed contractors'. Thus, a company in the service sector with few assets and a large but fluctuating population of self-employed staff (eg market research consultancies) may qualify as small, regardless of its turnover being above the threshold each year.

A quarter of the companies had been incorporated for up to 5 years at the time of their 2006 accounts. A large proportion of the sample (83%) had debt finance in 2006. At least a third of the small companies used directors' loans and/or bank finance, and more than half the medium-sized companies used bank finance and/or asset-based finance (hire purchase or leasing). Older companies tended to have higher credit rating scores than younger companies, but size was also a factor since larger companies tended to have lower scores than smaller companies.

4.2 Main accounting results

The vast majority of the companies (83%) used an external accountant to prepare the 2006 accounts for shareholders, for registering at Companies House and for the tax authorities. Many companies also received advice on accounting and/or auditing regulations.

4.2.1 Filing decision in 2006

Most companies (68%) had registered full accounts in 2006, including 25% whose directors had done so on a voluntary basis. Table 5 shows that only 32% had filed abbreviated accounts, but the sample was not representative of the smallest companies, whose directors were likely to have chosen this option.

Table 5 Filing decision in 2006

Decision	% of companies
Statutory full accounts (above the size thresholds)	43
Voluntary full accounts (small or medium company)	
Because there are benefits in doing so	21
Because the company was close to the threshold	4
	68
Abbreviated accounts (small or medium company)	32
Total	**100**

N = 1,294

As shown in Table 6, the main factors influencing the filing decision in 2006 was the desire for consistency with previous year (65% agreed) and the belief that the published accounts are useful to users (56% agreed). Only 27% had reviewed the costs and benefits since 2003 and cost was a major factor for only 21% of companies. Although abbreviated accounts avoid disclosing turnover, this was not a factor in the filing decision for 66% of companies.

Table 6 Factors affecting the filing decision in 2006 (% of companies)

Factor	Agree	Disagree	N/R	Total
Consistency with previous years was a major factor	65	27	8	100
We knew whether the company had a choice	60	27	13	100
Disclosing annual accounts is the 'price' paid for limited liability	58	34	8	100
Our registered accounts are useful to users	56	33	11	100
We had reviewed the costs and benefits since 2003	27	60	13	100
Disclosing turnover is/would be a major disadvantage	22	66	12	100
The cheapest option was a major factor	21	67	12	100
Our accounts are also on our website	3	84	13	100
We only file full accounts when the results are good	1	86	13	100

N = 1,294

4.2.2 Users of the published accounts

The direct recipients of the 2006 accounts (apart from shareholders and Companies House) were lenders and the tax authorities, as shown in Table 7. With regard to the accounts filed at Companies House, the respondents believed the main users are suppliers and other trade creditors (64%), credit rating agencies (62%), competitors (57%) and banks/lenders 46%.

Table 7 Direct recipients of the 2006 accounts

Recipient	% of companies
Bank and other lenders	67
Tax authorities	50
Directors or other employees who are not shareholders	31
Major suppliers and trade creditors	12
Major customers	10
Credit rating agencies	9
Industry regulators (eg FSA, CAA, ABTA)	5

N = 1,294 (more than one response was possible)

4.2.3 Accounting standards

Most of the small companies (69%) stated that their 2006 accounts had been prepared using the FRSSE. However, respondents who were not familiar with accounting standards may not have verified this information.

A quarter of directors (25%) considered it would be an advantage to use the IFRS for SMEs (now the IFRS for PEs). It was explained that this is based on the standard terms and methods of measurement used by large companies in the EU and many other countries, and that it could aid comparability for overseas users of the company's accounts. Further analysis found this was likely to be directors of medium rather than small companies (chi-square 5.916; $p \leq 0.05$).

4.2.4 Draft simplification proposals

The majority of companies (65%) supported the European Commission's draft proposal to exempt smaller entities from the requirement to register accounts. Table 8 shows that the greatest proportion of these (33%) supported exemption for micro entities only (0 to 9 employees). Not surprisingly, this view was significantly associated with small rather than medium companies (chi-square 91.770; $p \leq 0.01$).

Table 8 Filing exemption for micro entities

Response	% of companies
Exemption for	
Micro entities (0 – 9 employees)	33
Small entities (0 – 50 employees)	18
All SMEs (0 – 250 employees)	14
	65
No exemption	35
Total	**100**

N = 1,275

There were a number of comments on this issue, including the following:

- 'Small company accounts are already too meaningless to be of much use'.
- 'Traders who wish to use a company format ... should be able to have an "unlimited" company if they do not wish to be audited and/or do not wish to disclose their results'.
- 'Any business limiting its liability to creditors should be required to be audited and to report its financial status (ie balance sheet and p&L a/c). Personally, I think companies not wishing to file their accounts are likely to be precisely the ones to benefit most from being forced to publish a cash flow statement too.'

If a small company exceeds the size thresholds for two consecutive years, company law requires it to apply the more stringent accounting and auditing rules for medium-sized companies. This would prevent the company from qualifying for audit exemption and using the FRSSE. The survey found that 37% supported the European Commission's draft proposal to extend the transition period to five years and these were more likely to be small rather than medium companies (chi-square 8.153; $p \leq 0.01$).

4.3 Main auditing results

4.3.1 Audit decision in 2006

Table 9 analyses the audit decision in 2006 for the small companies in the sample and shows that 39% of the directors had chosen a voluntary audit.

Table 9 Audit decision by small companies in 2006

Decision	**% of small companies**
Voluntary audit	
Because there are benefits in doing so	32
Because the company was close to the threshold	7
	39
Not audited	61
Total	**100**

N = 592

Further analysis found that small companies whose directors had chosen to have a voluntary audit in 2006 were more likely to have filed full accounts on a voluntary basis (chi-square 66.849; $p \leq 0.01$). Table 10 gives further details.

Table 10 Auditing and filing decisions small companies in 2006

	Voluntary full accounts (% of small companies)	Abbreviated accounts (% of small companies)
Voluntary audit	54	20
Not audited	46	80
Total	**100**	**100**

N = 592

Taking the sample as a whole, the directors perceived the main benefits of audit as the check on accounting records and systems (74%), improving internal controls (44%) and the positive effect of the credit rating score (44%). However, 33% considered the costs outweigh the benefits. These views are reflected in Table 11, which shows that the main influence on the audit decision in 2006 (irrespective of the size of the company) was the desire for consistency with previous years (45% agreed this was a major factor). Only 19% acknowledged they had reviewed the costs and benefits since 2003 and cost was a major burden for less than a quarter of the companies. This was more likely to be small rather than medium companies (chi-square 85.353; $p \leq 0.01$). Further analysis found strong positive correlation between the directors wanting the accounts audited for the bank/lenders and wanting them audited for shareholders (Spearman's *rho* 0.553; $p \leq 0.01$).

Table 11 Factors affecting the audit decision in 2006 (% of companies)

Factor	Agree 5	4	3	2	Disagree 1	N/R	Total
Consistency with previous years was a major factor	21	24	22	8	14	11	100
We knew whether the company had a choice	29	16	24	6	11	14	100
Bank/lenders require audited accounts	28	16	15	7	22	12	100
Shareholders require audited accounts	20	13	17	12	25	13	100
The cost of audit was a major burden	12	10	26	15	24	13	100
We had reviewed the costs and benefits since 2003	8	11	29	16	22	14	100
Major suppliers/customers require audited accounts	9	9	15	15	36	16	100
The audit revealed fraud in the past	1	1	6	9	68	15	100

N = 1,294

4.3.2 Audit fees

Table 12 provides a breakdown of the audit fees in 2006 by size. Not surprisingly, they were likely to be lower in small companies than in medium companies (chi-square 152.490; $p \leq 0.01$).

Table 12 Audit fees in 2006

Audit fee	% of small companies	% of medium companies
Up to £1,000	15	1
£1,001 – £5,000	39	18
£5,001 – £10,000	29	38
£10,001 – £15,000	9	21
More than £15,000	8	22
Total	**100**	**100**

N = 232 small and 696 medium

Among the small companies reporting reduced total fees from external accountants on discontinuing the audit since 2003, the amount saved was typically £5,000 or less. However, 54% reported no change in total accountancy fees and 2% experienced increased fees due to other services.

The majority of the sample companies (69%) were interested in a less rigorous and cheaper form of assurance, and this was significantly associated with small companies whose accounts had not been audited in 2006.

4.3.4 Auditor independence

Among the companies whose 2006 accounts had been audited, the average length of time the current firm had been providing auditing services was 12 years. In 78% of cases, the auditor was either someone from the same firm that was responsible for preparing the accounts (but not the same person) or someone from a different firm.

4.3.5 Extending audit exemption to medium companies

A significant proportion of companies (58%) did not support the European Commission's draft proposal to extend audit exemption to medium-sized companies. Among owner-managed medium companies, 73% indicated that if they were granted exemption, they would have a voluntary audit.

5. Conclusions

By focusing on a wide range of accounting and auditing issues, the results of this empirical study contribute to the knowledge base, both updating and extending previous research (for example, Collis and Jarvis, 2000; Collis, 2003; Collis, Jarvis and Skerratt, 2004; Marriott, Collis and Marriott, 2006, POB, 2006). It reports the views of the directors on the present financial reporting options in UK company law and possible future developments being developed by the European Commission and the IASB. The views of the directors are important, because they bear the administrative and cost burdens of compliance, which the regulators are trying to reduce by 25%.

The study has some limitations, since the sample was not representative of the smallest companies. Moreover, this is an initial descriptive study and further analysis of the data is required within a theoretical framework before drawing final conclusions from the directors' perspective. There is also scope for future research to examine the perspective of other stakeholders, such as small accountancy practices providing services to SMEs, lenders and creditors and other users of the published financial statements.

Companies House statistics show that the majority of SMEs take up the financial reporting concessions available to them, but this survey suggests a significant proportion of directors believe there are benefits in following the rules for larger entities. Therefore, further simplification of accounting and auditing rules is unlikely to assist such companies, unless their circumstances change. The study demonstrates that consistency with previous years is one of the driving forces behind the directors' financial reporting decisions and that cost is a major factor in only a minority of companies. These results suggest that most companies are likely to maintain their current pattern of financial reporting behaviour in the short term.

The directors' views on the European Commission's draft simplification proposals for SMEs can be summarised and compared with the views expressed in comment letters to the Commission from 23 countries (including 22 member states) as follows:

- 65% of directors supported the notion of exempting micro entities from the requirement to register accounts (compared to 80% of commentators)
- 63% of directors were against increasing the transition period for crossing the size thresholds from two to five years (compared to a small majority of commentators)
- 35% of directors disagreed with the notion of exempting small entities from the requirement to publish their accounts (compared to a small majority of commentators)
- 42% of directors were in favour of extending audit exemption to medium-sized entities in general, but the directors of 73% of owner-managed medium companies predicted they would continue to have the accounts audited (commentators' views were divided on this subject).

In conclusion, this study contributes to the debate on better regulation and reducing administrative burdens and the results should also be of interest to national regulators, the European Commission, the IASB and the accountancy profession.

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