The Contradictory Consequences of Regulation: The Influence of Filing Abbreviated Accounts on UK Small Company Performance

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Abstract

This study develops the conceptualisation of regulation as a dynamic force, enabling and motivating actions that contribute to small company performance as well as being a burden, cost or constraint. Using interview and survey data from a study of preparers and users of small company abbreviated accounts, we argue that regulation generates contradictory consequences for small companies because both confidentiality and disclosure potentially serve their interests. We present an analytical framework specifying the mechanisms through which regulation influences small company performance directly and indirectly. Regulation affects small companies directly by requiring the disclosure of financial information. Regulation also impacts small companies indirectly by influencing important stakeholders – for instance, banks, suppliers, customers, credit reference agencies, trade credit insurers and others - to provide vital resources, such as credit, and market opportunities. Indirect regulatory influences might be only partly visible to small companies, and to stakeholders, yet exert a powerful effect on performance.

Keywords: regulation, financial reporting, disclosure, small company, abbreviated accounts, credit risk

Introduction and Research Objectives

Business regulation has been an important subject of academic and policy debate in the UK for three decades (Kitching 2007). International sources differ as to whether the regulatory burden on UK businesses is high (World Economic Forum 2012) or low (World Bank 2012). The UK government has implemented several initiatives intended to reduce the regulatory burden, particularly for micro and small firms, as part of a policy agenda to make the UK one of the best places in Europe to start, finance and grow a business (HM Treasury/BIS 2011). A key plank of this policy programme aims to improve the corporate governance framework, including financial reporting (BIS 2013a).

The purpose of this paper is to investigate the influence of financial reporting regulation on small company performance using data from a study of the value of small company abbreviated accounts for preparers and users. Performance refers to business outcomes sought by small company owners. The study was conducted in the context of tighter product and credit markets following the global financial crisis of 2008, although the argument and findings are intended to be of wider import (Kitching et al. 2011). Specifically, the study seeks to answer two questions. First, how does financial reporting regulation influence small company performance – does it constrain performance, enable higher levels of performance, or generate contradictory effects? Second, through what mechanisms does financial reporting regulation shape small company performance? Does it produce performance effects solely through placing obligations directly on small companies – or, indirectly, through influencing the activities of small company stakeholders? These questions go to the heart of contemporary academic and policy debates regarding the impact of regulation on businesses. Using the example of UK financial reporting regulation, we seek to contribute to these debates.

To address these questions, we elaborate on a theoretical framework developed previously (Kitching 2006, Kitching et al. 2013) and illustrate it empirically. Our principal focus is on micro-level impacts, although we comment briefly on macro-level effects too. We set out a framework specifying the various mechanisms through which regulation shapes small company performance, an approach that enables us to critique prior studies and propose new interpretations of empirical findings. We argue that regulation mandating financial disclosure generates contradictory tendencies, enabling action that contributes to stronger small company performance *as well as* constraining such action. The study is particularly pertinent in light of the UK government's intention to act (BIS 2013a) on new European Accounting Directive (2012/6/EU), which permits Member States to exempt a new category of business, 'micro-entities', from certain financial reporting obligations (henceforth, the Micros Directive) (European Commission 2012).

We begin by setting out the UK regulatory context for small company financial reporting. Next, we review the literatures on regulation and small firm performance, small company financial reporting and the effects of disclosure on the cost of capital. Then, we outline our analytical framework and methodological approach before presenting the findings. We conclude by briefly considering the wider implications of the study for understanding the influence of regulation on business performance more generally.

The UK Regulatory Context

The Fourth Company Law Directive (78/660/EEC) requires limited liability entities (most of which are companies) to prepare and file audited annual financial statements. The rationale for making accounts available at a public registry is that anyone should be able to access the financial statements. Public disclosure is widely regarded as the price that companies must pay for the privilege of limited liability (Hicks and Goo 2008). In the UK, the requirements of the Fourth Directive are incorporated in the

Companies Act 2006, which obliges limited liability entities to prepare accounts giving a true and fair view, distribute their annual report and accounts to members and to file a copy at Companies House. This allows accounts users such as present and potential investors, lenders and creditors, to assess the financial position, performance and prospects of the entity and to make informed economic decisions.

The Fourth Directive allows Member States to provide options for qualifying small and medium-sized entities to register less detailed abbreviated accounts in place of the full statutory accounts, and for qualifying small entities to forgo the statutory audit. Member States can choose how far to relax the rules within the parameters of the Directive; the UK permits the greatest degree of abbreviation. Small company abbreviated accounts comprise an abbreviated balance sheet with related notes; a profit and loss account is not required. The accounts therefore exclude commercially sensitive information on revenue and costs that might be useful to competitors and others. Unless excluded for reasons of public interest,[1] a UK company will generally qualify as small if it does not exceed any two of the following three thresholds: annual turnover £6.5 million; balance sheet total £3.26 million; and average number of employees 50. Apart from newly incorporated entities, these conditions must have been satisfied in two of the last three years. In 2012/13, 2.5 per cent of UK registered annual accounts were categorised as 'abbreviated - small' (Companies House 2013: Table F2). The 'audit exempt' category, comprising 72 per cent of accounts filed, includes many small companies filing abbreviated accounts, as these companies are also exempt from the statutory audit.

The Micros Directive (2012/6/EU) permits Member States to exempt micro-entities (including companies, qualifying partnerships and qualifying limited partnerships) from certain financial reporting requirements otherwise applicable to small undertakings that impose unnecessarily onerous administrative burdens (BIS 2013a). The Directive defines micro-entities as not exceeding two of three size criteria,[2] permitting exemption from a general publication requirement, provided that balance sheet

information is filed with a designated authority and transmitted to the business register (European Commission 2012).[3] The Directive seeks to reduce the administrative burden of statutory reporting and to align micro-entities' reporting requirements with the purported real needs of users and preparers of accounts, whom it is argued do not require sophisticated accounting and extensive disclosures (European Union 2011). Information filed by micro-entities might not be routinely made publicly available and instead be available only on request (Davies 2012). The published Directive has watered down the original draft which exempted micro-entities from *any* reporting requirement. Its impact on micro-entity reporting may, therefore, be more limited than envisaged initially. The draft Directive estimated cost savings of €5.9-6.9bn (European Union 2011), a figure which should perhaps now be reduced. The UK government has welcomed the Directive and plans to implement changes in October 2013 (BIS 2013b).

Small Companies, Regulation and Financial Reporting

Different literatures imply opposing positions regarding the impact of financial reporting regulation on small companies. Most research examining the regulation/performance relationship in small enterprises conceptualises regulation and its effects in a partial, one-sided way (Kitching 2006). Most studies emphasise the burdens, costs and constraints regulation imposes (e.g. Chittenden et al. 2002; Hansford et al. 2003; Crain and Crain 2010), which are assumed to deter start-up, investment, innovation and growth. Studies rarely consider whether regulation might enable small enterprises to act in ways that benefit them (Kitching 2006), although there are exceptions (e.g. Edwards et al. 2003). Nor do studies typically discuss the particular impact of financial reporting regulation on small companies; yet the burden/cost/constraint view of regulation provides the underlying rationale for the Micros Directive and the UK government response.

An alternative view of regulation derives from the financial reporting and cost of capital literature. These studies focus on the benefits of disclosure for companies with regard to the availability and cost of capital, through reducing information asymmetries between companies and their external stakeholders (e.g. Healy and Palepu 2001; Beyer at al. 2010). Disclosure enables stakeholders to address the information and agency risks faced by existing and potential investors, lenders and suppliers. Stakeholders rely on the integrity of directors to provide high quality financial information in the annual report and accounts to mitigate the problem of information asymmetry (Jensen and Meckling 1976). While most studies have focused on large, publicly listed companies and their access to capital markets, similar arguments have been proffered in relation to privately-held, informationally opaque small businesses seeking credit (Ang 1992; Binks et al. 1992; Fraser et al. 2013). Regulation mandating higher levels of disclosure might, therefore, improve access to finance for small companies.

Stakeholders often seek public or private information on small companies, or make trading and financing conditional on the provision of collateral or personal guarantees (Ang 1992; Binks et al. 1992; Berry et al. 1993; Ang et al. 1995; Berger and Udell 2006). Some stakeholders possess the power to demand information privately from small companies in the form of detailed, timely management accounts (Berry et al. 2004; Marriott et al. 2006) and a proportion of UK micro and small companies file full, audited accounts voluntarily because the directors believe the benefits exceed the costs (Collis 2012). Dedman and Kausar (2012) report that companies opting for voluntary audit enjoy significantly higher credit ratings than those choosing exemption. Cost savings arising from regulatory relaxations might be outweighed by the costs of preparing special purpose financial statements for individual stakeholders, particularly where such requests are common or where transactions involve more than two parties (Arruñada 2011). Regulation, therefore, exerts contradictory pressures on small company performance, imposing constraints but also enabling access to vital resources and markets.

Conceptualising the Impact of Financial Reporting Regulation on Small Companies

Drawing on a critical realist conception of regulation developed previously, as a system of state-authorised and –enforced rules, we theorise regulation as a dynamic force shaping small company performance (Kitching et al. 2013). Regulation is a particular type of institution, possessing causal powers to influence business performance in particular ways - by mandating, prohibiting and enabling action by individuals and organisations. Our conception of regulation is intended to enable explanation of its micro-level effects in market economies, in times of recession and in more buoyant conditions. This approach permits us to highlight several key features of the regulation/performance relationship that other studies ignore or do not fully appreciate, and to make visible and explain a wider range of regulatory effects than studies adopting different approaches. First, regulation only produces effects through the exercise of human agency by small companies and the stakeholders with whom they interact whose activities causally affect them. Unless agents change their behaviour as a consequence of regulation mandating, prohibiting or enabling action, its impact is nil.

Second, regulation generates dynamic influences on business performance by enabling and motivating action as well as constraining it, thereby producing variable firm-level performance effects (e.g. Edwards et al. 2003; Kitching 2006; Mayer-Schönberger 2010; Kitching et al. 2013). Regulation imparts contradictory influences simultaneously: it enables by making particular activities possible, it motivates by encouraging particular responses rather than others *as well as* constraining businesses. It is an empirical question whether, in particular cases, regulation's constraining influences dominate the enabling ones. Studies of small enterprises typically assume that regulation is *necessarily* constraining, but if this is true, how could small companies act at all? Small businesses are subject to a great number of regulations and yet many still trade profitably.

Third, from the standpoint of an individual small company, regulation produces effects through a variety of mechanisms, directly and indirectly (Kitching 2007; Kitching et al. 2013). The consequences of regulation include not only the constraints imposed directly on small companies, including any purported 'administrative burden' or 'compliance cost' (e.g. Chittenden et al. 2002), but also any enablements arising from stakeholder responses (Kitching 2006, 2007; Arruñada 2011; Kitching et al. 2013). Our approach situates small companies at the centre of a network of stakeholders whose actions affect them. Studies typically take a firm-centric view of the influence of regulation on small company performance, focusing on direct impacts, neglecting indirect impacts arising from stakeholder action, both as a response to small company adaptation to regulation and also from their responses and to the regulatory mandates, prohibitions and enablements placed directly upon stakeholders themselves. Financial reporting regulation, for instance, influences small company performance directly by mandating the filing of accounts at Companies House and indirectly by shaping stakeholder provision of vital resources and market opportunities as a response to small company filing and other decisions. Relevant stakeholders include customers, suppliers, banks, investors, credit reference agencies, trade credit insurers and others. Indirect regulatory effects on small company performance via the actions of close and distant stakeholders are just as much a consequence of regulation as are the more obvious direct influences such as the administrative burden of filing accounts at Companies House.

Regulation mandating higher levels of small company disclosure might encourage stakeholders to act in ways that enable companies to enhance performance by motivating customers to do business, suppliers to offer credit, credit reference agencies to award higher ratings and trade credit insurers to provide cover to policy-holders trading with small companies. Such arguments resonate particularly strongly in the post-financial crisis period, as the UK emerges, falteringly, from the deepest, longest recession for 80 years. Many small companies have struggled to access the

credit and market opportunities needed to survive in a testing trading environment (BIS 2012; BDRC 2013; Armstrong et al. 2013), particularly micro firms (Cowling et al. 2012), following the 5-quarter recession of 2008-9 during which UK GDP fell 7 per cent (ONS 2013). The recession led credit reference agencies to downgrade small firms' risk ratings substantially (Fraser 2009). Micro companies have poorer ratings than larger small businesses and small firms have become increasingly defined as higher risk (BIS 2013c; BDRC 2013). Stakeholders relying on credit ratings to support their business decisions might choose not to enter into relationships with small companies or refuse credit when requested. Credit ratings take on a heightened significance, particularly where stakeholders are neither able nor willing to seek additional information from small companies privately.

Conversely, where regulation permits reduced disclosure, as does the abbreviated accounts legislation, this might lead stakeholders to act in ways that constrain the reporting entity's performance. Powerful stakeholders may withhold valuable resources with serious consequences for small companies (Kitching et al. forthcoming). Such pressures might be felt particularly keenly in times of recession when stakeholders are especially sensitive to the risks posed by financing or trading with small companies about whom they possess little information. Small companies filing abbreviated accounts might experience difficulties accessing adequate finance or winning sufficient orders; in extreme cases, these problems might lead to market exit. Indirect regulatory influences emanating from stakeholder action might, therefore, exert just as powerful an effect on small company performance as the better-understood direct administrative burdens and compliance costs.

Fourth, the reality of regulatory effects, direct and indirect, is not dependent upon small company agents' (directors, managers, employees) awareness of them (Kitching 2006; Kitching et al. 2013). Small companies are affected by regulation permitting them to file abbreviated accounts *whether or not* respondents perceive it as the cause of those effects. Neither small company agents nor stakeholders possess perfect

information concerning regulatory processes and outcomes. Regulation generates small company performance effects that are only partly visible to, or misperceived by, those affected, shaping action without entering agents' conscious reasoning, and producing effects whether business owners (or stakeholders) are aware of them or not. Small company agents might not know the reasons for failing to win new business or to access trade credit: indeed, they may be unaware of the very existence of stakeholders whose actions affect them. The regulatory impacts experienced and reported by small company respondents constitute only a subset of the sum total of such impacts.

Methodological Approach

Quantitative survey approaches to investigating corporate financial reporting practices dominate the literature but arguably provide limited understanding of the motivational and process issues surrounding filing and using statutory company accounts. The study, therefore, incorporates a strong qualitative component. Our arguments regarding the contradictory influences of financial reporting regulation are constructed from interview and survey data from both small companies *and* from a wide variety of stakeholders. The qualitative data permits us to contribute fresh insights into small company owner rationales for filing abbreviated accounts, stakeholder perceptions of the value of abbreviated accounts, problems of limited disclosure and their influence on stakeholder decision-making and action. We juxtapose small company views of the benefits of filing abbreviated accounts with the assessments of a diverse range of accounts users (Table 1). While relying principally on the qualitative interview material for the analysis, we also draw selectively on postal and online survey data from small company preparers and stakeholders.

Insert Table 1 here

The *small company preparers/users of abbreviated accounts* samples were constructed from a stratified random sampling frame of 2,750 companies from three broad regions (London, Scotland, and the rest of England and Wales), assembled using the FAME database. FAME identifies small companies filing abbreviated accounts and provides contact details. The postal survey produced 149 responses from preparers of abbreviated accounts (response rate 5 per cent). The survey collected data on: company profile; how directors discovered the option to file abbreviated accounts; the preparation of abbreviated accounts; reasons for filing abbreviated accounts; the use of other small companies' abbreviated accounts; motivations for use; influence on decision-making; alternative information sources used and perceptions of the relative value of abbreviated accounts and other information sources. Follow-up interviews were conducted with 12 small company respondents who were both preparers *and* users of abbreviated accounts; 42 per cent of small company preparers in the survey sample were also accounts users. The 12 interview respondents were asked in depth about the rationale for, and circumstances surrounding, the filing decision, and the use of other small companies' abbreviated accounts and their impact on decision-making and performance. In both the small company survey and interview samples, three quarters of respondents were micro-companies. We discuss survivors' experiences only; we are unable to say whether surviving small companies differ from non-survivors in their motivations for, and the consequences of, filing abbreviated accounts.

The *accounts users and intermediary* sample comprises a diverse group of senior managers or officials in 18 organisations, including banks, credit reference agencies, credit insurance companies, professional bodies, trade associations and a small business membership organisation. Respondents were asked questions regarding the value of small company abbreviated accounts, their influence on decision-making and their limitations. As, at the outset of the study, we were unsure who used abbreviated accounts, we adopted a 'snowball' approach to sampling, inviting respondents to identify additional potential sources and, where possible, facilitate access: 50

organisations were approached, although most declined to participate on the grounds they did not use, or feel able to comment upon, such accounts.

Survey and interview data were also obtained from two groups of accountants identified using the Institute of Chartered Accountants of Scotland membership organisation database: *accountants in practice* working in their own businesses were distinguished from *organisational accountants* working in private, public and voluntary sector organisations. The survey data from these two groups is drawn upon selectively in order to elaborate on particular processes.

Next, we turn to the empirical findings in order to identify the constraining and enabling influences set in motion by financial reporting regulation. We begin by exploring small company respondents' motivations for filing abbreviated accounts before examining stakeholder perceptions of the value of abbreviated accounts data, motivations for accounts use and problems of use.

'Filing the Legal Minimum' – Regulation Enables Limited Public Disclosure

Prior studies report restricting public disclosure of business information and following accountants' advice as the principal reasons why small companies file abbreviated accounts (Collis and Jarvis 2000; POBA 2006). The survey data from our small company respondents strongly support the literature on these points. Small company respondents were asked their reasons for filing abbreviated accounts and to specify a primary reason. Most reported following their accountants' advice or emphasised confidentiality (Table 2). But, crucially, in view of the Micros Directive and the UK government response, very few reported reasons consistent with the 'administrative burden' thesis: only 2 per cent reported 'ease, simplicity, saving time' as reasons for their filing choice. The widespread availability of accountancy software means that the administrative cost of generating abbreviated accounts from the full accounts that must be prepared for members rarely constitutes a major burden (Arruñada 2011;

Collis 2012). Survey data from accountants in practice also demonstrates their influence on the small company filing decision. Most reported their 'default position' with small company clients was to encourage filing abbreviated accounts: 71 per cent of the 240 accountants with small company clients at the time of the survey reported that *all* such clients filed such accounts.[4]

Insert Table 2 here

The interview data strongly reinforce the view that small company respondents file abbreviated accounts in order to limit disclosure rather than to avoid any alleged administrative burden. A printer with 50 employees (Small Company 1) reported that he would always 'file the legal minimum' at Companies House in order to limit financial disclosure , while none of the 12 small company respondents interviewed reported administrative burdens. In small companies, limiting public disclosure is a means of keeping both personal and corporate income details private; at very small levels of company scale, the two are barely distinguishable. Accounts users might be able to estimate directors' personal incomes where companies employ only their owners.

> "[Full accounts][5] would give more information to competitors, for one thing. But also because it's a private company – so, essentially, just myself and my wife, who are the directors - it would give a great deal of information about our personal finances to the outside world which I don't want them to know about." (Company 3: tax consultancy, 2 employees)

Restricting the public disclosure of information that stakeholders might use to harm small company owners' interests facilitates greater influence over the terms of important external and internal stakeholder relationships – primarily with competitors, but also with customers, suppliers and employees. Competitors, for instance, might be attracted to the company's markets if they believe there are substantial profits to be made; high-margin items are often easier to identify in smaller companies where there are usually fewer product lines. But, in addition, suppliers might raise prices, employees might seek higher salaries and customers might seek discounts in order to

capture a greater share of the value the company creates. Small company respondents explained the importance of limiting disclosure in relation to competitors, suppliers and employees respectively; prior research has tended to focus on competitors alone.

> "It was really to stop competitors finding out about us … My concern, for instance, with full accounts is that my competitors can find out my gross margins, which I don't want them to know." (Small Company 11: wholesaler, 3 employees)

> "It was unnecessary for us. We didn't *need* to file full accounts ... [The owners] don't particularly want to publicise what we're doing and how well we're doing. I think that was the key driver in terms of filing abbreviated accounts. It was keeping things private. There's no sense in letting suppliers work out how well we're doing." (Small Company 8: kitchenware wholesaler, 26 employees, italics denote respondent emphasis)

> "For example, we wouldn't particularly want our staff to know what the directors' remuneration was or any of that kind of thing. The less information we can lodge to meet our requirements is the way to go as far as we're concerned." (Small Company 10: flooring contractor, 11 employees)

Limiting disclosure might also influence client perceptions of company size. Several small company respondents reported size concealment as a reason for filing abbreviated accounts, in order to win business from clients considered cautious to award contracts to small suppliers - although we lack data from clients to confirm such perceptions are valid.

> "If you're working with large companies and people start pulling your accounts and saying, 'Oh they only turned over 100 grand! We'd best not give them this order for 5,000 envelopes'. The public availability of information damages people." (Small Company 5: mail service, 5 employees)

Regulation permitting small company directors to 'file the legal minimum', abbreviated accounts, constrains and enables small company directors to act in particular ways. While imposing a reporting obligation upon them, this reporting option was valued

highly by the small company directors interviewed. Not because it reduces the administrative burden of filing full accounts but rather because it enables them to limit public disclosure of information that stakeholders might use to harm them. The small company respondents interviewed believed this enabled them to control access to sensitive personal and corporate information, facilitating greater influence over stakeholder relationships and permitting them to capture a larger share of the value their companies create.

Regulation Mandating Disclosure Enables Small Company Access to Resources and Markets

This section presents argument and evidence from accounts users to support the proposition that regulation permitting small companies to file the legal minimum requirement, abbreviated accounts, might constrain them regarding access to resources and markets. Accounts users acquire small company information direct from Companies House and via intermediaries such as credit reference agencies. Assuming abbreviated accounts are downloaded from the Companies House website in proportion to their presence on the database, we estimate that approximately 935,000 abbreviated accounts are downloaded annually.[6] A large but unknown number of accounts users, in addition, access abbreviated accounts indirectly from intermediaries.

Data from stakeholders suggests that published accounts often constitute the starting point for enquiry into small company creditworthiness, influencing the decision to continue or discontinue information search or, alternatively, such accounts comprise one element in a larger 'information jigsaw' stakeholders construct from a range of public and private information sources (Kitching et al. 2011, forthcoming). Small company preparers' survey data showed that many of them use statutory accounts, both abbreviated and full, when choosing a new supplier or customer, to find out about competitors or to consider an acquisition (Table 3). Most small companies used

abbreviated accounts infrequently: only 20 per cent of users reported 10 or more uses in the previous year, and only 5 per cent reported 50 or more uses.

Insert Table 3 here

Most stakeholders reported abbreviated accounts to be a useful, though limited, data source to support credit risk assessments and decisions. *Some* information is better than none, but most stakeholders were also critical of limited disclosure and, by extension, of the regulation permitting it. One high street bank respondent referred to abbreviated accounts users as 'users under sufferance', whose motivation is based on accessibility and low cost, rather than because they are adequate for user needs. The impact of abbreviated accounts regulation on stakeholders varies with the availability and cost of alternative information sources. Stakeholders differed considerably in their capacity to access information privately and, consequently, in their perceptions of the value of abbreviated accounts (Kitching et al. forthcoming). Powerful stakeholders such as banks and large suppliers and customers, for instance, are usually able to demand comprehensive, up-to-date financial information privately from small companies – or decline to place orders with, or offer credit to, them if they refuse. For these stakeholders, the statutory abbreviated accounts are of limited value. Small trading partners, credit reference agencies and trade credit insurers, on the other hand, might find it more difficult or costly to acquire information privately from small companies and are thereby more dependent on the published accounts. Some stakeholders, moreover, might not wish to reveal their interest in particular companies by approaching them directly for information. Stakeholders able and willing to access superior information privately are better placed to assess the creditworthiness of small companies in order to initiate, continue, renegotiate the terms of, or terminate, relations with them.

Credit management professionals (credit reference agencies, trade credit insurers and professional bodies) were particularly critical of abbreviated accounts because of their

limited information content. Such accounts required supplementation from other information sources in order to facilitate a well-informed credit, risk rating or insurance decision. Limited disclosure, credit management professionals insisted, leads stakeholders to act cautiously, with adverse consequences for small companies – as seekers/beneficiaries of client orders, credit, risk rating and credit insurance decisions. Several respondents reported that, other things being equal, companies with known turnover and profit data, both available in statutory full accounts, would likely obtain a superior credit rating than others - unless the published figures reveal poor performance.

> "The consensus view that I get forcibly … is that the abbreviated accounts are very difficult and really not worth much. Because, you know, you lose the detail that you can get from full accounts … At one level you can't even see turnover … so it doesn't help very much if you don't know what level of stock they've got. The beauty of accounts is that you can understand the business and what makes it happen and how it's comprised. Without full accounts you can't do that. So it's seriously limiting in terms of what conclusions you can draw from businesses' activity and from its status." (Stakeholder interview 15: trade association)

For accounts users, abbreviated accounts provide only limited information, exacerbating the challenge of assessing credit risk, where they lack access to private information sources. This has implications for stakeholder decision-making, for small companies themselves and for the wider economy in terms of the supply of credit and market opportunities. Critics of abbreviated accounts were particularly vocal given the difficult business environment prevailing in the UK following the 2008 financial crisis.

Assessing Small Company Credit Risk after the Financial Crisis

Regulation exerts its influence in a wider socio-historical context. The constraints it imposes, and enablements it affords, influence small company performance in particular ways at particular times. Arguably, regulation permitting reduced statutory disclosure in difficult economic circumstances might contribute to deteriorating access

to resources and markets by discouraging credit provision and reducing demand for small company goods and services.

Interview data from accounts users confirmed that credit risk assessments had tightened markedly as a consequence of the financial crisis. Users increasingly perceived statutory accounts – both abbreviated and full – to be of only limited value because they are several months out of date on publication.[7] The crisis intensified stakeholder demand for real-time management accounts or customer payment data (CBI/ACCA 2010). Credit reference agencies, trade credit insurers and brokers treated small companies filing abbreviated accounts as greater credit risks than companies filing full accounts and, consequently, likely to suffer with regard to risk ratings and insurance cover.

> "We use them [abbreviated accounts] but that's because it's all that's there for us. From our standpoint, we would want every company that's limited, and regulated, to file full accounts … We want full transparency. That's what we need. And, I think, frankly, that is what the whole of the credit management industry needs at this point in time." (Stakeholder interview 7: credit insurer)

One credit insurer reported that the financial crisis had led to a 'credit limit cull' with policy-holder requests to obtain cover for their dealings with small businesses being declined unless up-to-date management accounts data were available. Insurers reported being hit hard by a high volume of low value claims, typically arising from small firm defaults, and had taken a more cautious approach to issuing trade credit insurance cover. Such claims are supported by secondary sources. Association of British Insurers data indicated a 227 per cent increase in the value of claims to £125m between Q3, 2008, and Q3, 2009 (ABI 2009). Poorer provision of trade credit insurance cover impacts small companies indirectly as prospective clients and creditors withdraw credit facilities and market opportunities.

> "There is a direct correlation between the abbreviated accounts that are filed, the content of those accounts and the level of cover that we can

> obtain for our clients … It was only when we hit a crisis and liquidity started to be strained that insurers found it difficult to, or were unwilling to, provide some level of cover that was previously given - and they used a lack of information for not granting credit.” (Stakeholder interview 16: trade credit broker)

The consequences of limited small company disclosure for the wider economy are also likely to be adverse. In a difficult economic environment, businesses might choose not to trade with suppliers and customers about whom they know very little. Better information facilitates trading, credit allocation and economic development. Recent regulatory changes according to one stakeholder had restricted the value of abbreviated accounts to users:

> “They have lost value, significant value, over the past decade, and I would say that whilst we had benign economic conditions in this country, for the best part of 10-15 years, these law changes in terms of changing small and medium company thresholds, raising them, also introducing unaudited accounts, a couple of years ago, for small businesses. These changes to legal obligations went almost unnoticed by the credit world because, basically, as we all know, credit was just so easy to get hold of no-one gave a damn ... It took the first economic downturn, in my opinion, to expose the folly of these government decisions.” (Stakeholder interview 10: credit reference agency)

Summarising, accounts users made it clear that credit risk assessments were particularly responsive to wider economic circumstances. Trade suppliers, credit reference agencies, insurers and brokers reported a heightened sensitivity to credit risk and a tightening of risk ratings, credit provision and credit insurance cover. Regulation permitting small companies to file abbreviated accounts might, therefore, indirectly impact their performance adversely by constraining their capacity to access trade credit and to win new business. While such difficulties are mitigated by small companies providing information privately to stakeholders, there are limits to their ability to share information with large numbers of potential trading partners.

The Partial Visibility of Indirect Regulatory Influences

The analytical framework presented specifies a range of mechanisms through which regulation influences small company performance. While direct regulatory burdens, costs and constraints are well-researched and understood, regulation also generates impacts on small companies indirectly as a consequence of stakeholder activity. . Stakeholder action and its effects may not be fully visible to, or misperceived by, small company agents. This section presents data from stakeholders and from secondary sources to support these arguments.

Where stakeholders respond to small company decisions to file abbreviated accounts by refusing to trade with, or provide credit to, them, owners and directors might not attribute such responses to the regulation. Substantial data has been presented from a variety of accounts users to show that limited disclosure influences their decisions to withhold credit and market opportunities, to award higher credit risk ratings and to refuse trade credit insurance cover to those trading with small companies. Several stakeholders questioned whether small companies were fully aware of the risks associated with filing abbreviated accounts, or of the benefits of greater disclosure with regard to access to trade credit.

> "A lot of companies say there's no negative impact. But they may not *know* they've had their credit limit reduced. They may not know that they could have opened up more credit with a particular supplier had they had that information available to them." (Stakeholder interview 9: credit reference agency)

The partial visibility of indirect regulatory effects is explicable in terms of accounts users acting without small company awareness of their decisions or effects. Several stakeholders reported using abbreviated accounts to identify possible suppliers, customers and acquisition targets, for example, without alerting the target company of interest.

> “With credit information, they don’t know who’s making enquiries on them ... Small businesses, whether they like it or not, or whether they understand it or not, they are suffering as a result of the lack of information.” (Stakeholder interview 10: credit reference agency)

In contrast, none of the 12 small company interview respondents reported losing customers or being unable to access sufficient finance because they filed abbreviated accounts. All claimed to have access to sufficient internal or external finance to fund current operations and future plans. So how might these contrary pieces of evidence be assessed?

First, it is possible that our sample of 12 small company interview respondents had suffered no disadvantage arising from filing abbreviated accounts. Indeed, we recognise that small companies are a highly heterogeneous population; not all will be affected adversely, or to the same degree, by limiting statutory disclosure. For some – perhaps sole director companies operating alone without employees, with few tangible assets, funded by personal savings, with no intention to expand or desire for external finance, and trading mainly with customers whose decisions are not influenced by credit reference agencies or insurers – the impact of filing abbreviated accounts may generally be limited. Second, most small company respondents insisted that filing abbreviated accounts caused no disclosure problems. If major stakeholders requested the management accounts, these could be made available.

Both points no doubt have merit for particular companies but we would question whether such arguments can be generalised to the entire UK small company population. A point stakeholders made forcefully was that small companies might miss credit and market opportunities because prospective clients decide not to approach them, or because suppliers choose not to offer credit, because they file abbreviated accounts and were either unable or unwilling to seek further information from the company privately. Small company respondents, they claimed, would not necessarily be aware of this. The intensity of accounts user criticism that poor information

contributes to credit supply problems, particularly by credit management professionals, suggests that small companies are often unaware of the disadvantages of filing abbreviated accounts in specific circumstances. Our argument does not rest on small company respondents being entirely ignorant of the consequences of their filing decisions, but rather on them being only *partly* cognisant of the effects of their actions as regulated entities on the stakeholders with whom they interact.

More generally, evidence from respected sources (Bank of England 2009), suggests that the tightening of credit and commodity markets contributed to higher levels of small company liquidation following the onset of the financial crisis (Insolvency Service 2013). Many companies ceased trading during the recession, the vast majority of which are likely to have been small. There were 19,077 compulsory company liquidations and creditors' voluntary arrangements in England and Wales during 2009, a 23 per cent increase on 2008 (Insolvency Service 2013).[8] Even if our interview sample of 12 small companies reported few problems accessing the orders and credit sought, many others have not been so fortunate.

Regulation generates effects on small companies directly and indirectly, with and without directors' (or stakeholders') knowledge. Direct regulatory influences are perhaps easier to identify: small company directors find it easier to report a legislative burden imposed on them, or to report their response to a regulatory constraint. But indirect regulatory influences on small companies, shaped by the actions of close or distant stakeholders, impact such companies, even where such effects go unperceived, or unattributed, by small company respondents themselves. While offering the benefit of limited disclosure, filing abbreviated accounts might also generate unintended, difficult-to-manage effects, such as market opportunities not won, lower credit ratings restricting access to finance, and the higher cost of credit insurance increasing the cost of trade credit from suppliers. Such problems are likely to be aggravated in future where stakeholders place a higher value on comprehensive, real-time information to assess and address risk.

Conclusions

Regulation, including financial reporting regulation, is a dynamic influence on small company performance. In contrast to studies that focus solely on the burdens, costs and constraints regulation imposes directly on small companies, we have presented an analytical framework specifying a range of different mechanisms through which regulation might also enable and/or motivate small companies to achieve higher levels of performance and sought to illustrate its value empirically. To do this we have drawn on data from a study of the value of abbreviated accounts to small company preparers and a wide range of accounts users. Regulation impacts businesses directly and indirectly, influencing small company agents and their stakeholders to act in ways that contribute to higher levels of performance as well as constraining them. Managing contradictory regulatory influences is the normal condition of doing business and small companies would face this task under any regulatory regime and in any macroeconomic conditions.

How such contradictory influences play out in particular settings is contingent upon how small company agents, and stakeholders, exercise their agency. Small company directors may or may not choose to take up the opportunity to file abbreviated accounts; and stakeholders choose how to respond to small company filing choices, by offering or withholding valuable resources and market opportunities. Financial reporting regulation can motivate stakeholders to provide orders, finance, and credit ratings to small companies, and to provide trade credit insurance cover to organisations trading with small companies. These decisions are as much an effect of regulation permitting the filing of abbreviated accounts as any purported reduction in the administrative burden of financial reporting obligations.

For small companies, the contradictory consequences of financial reporting regulation arise from the paradox that both confidentiality *and* disclosure potentially serve their

interests. Inevitably, therefore, financial reporting regulation imparts contradictory pressures on small companies. Regulation mandating, or facilitating, greater confidentiality protects small companies from stakeholders whose actions might cause them economic harm while, at the same time, limiting access to the resources and market opportunities that clients, credit reference agencies, trade creditors and insurers might offer, possibly unbeknown to small company agents themselves. Regulation mandating greater information disclosure enhances the potential benefits while also making it easier for competitors, suppliers, employees, customers and others to appropriate a higher share of the value the company creates. In the aftermath of the financial crisis, and the part played by poor credit risk assessment, greater disclosure is increasingly valued as a means of assessing credit risk. Today, regulation permitting small companies to file abbreviated accounts might indirectly constrain performance more than laws mandating increased disclosure, whatever policy-makers intend.

Our findings have wider implications for understanding the influence of regulation on small company performance. Focusing on a single subset of regulatory influences, as many studies have done – the direct constraints placed on small companies – provides only a partial insight into regulatory processes and outcomes. Indirect regulatory influences are potentially just as important, although more difficult to identify – indeed, they may be only partly visible to small company agents themselves. Researchers, policy-makers, support providers and practitioners need to be alert to the possible opportunities for small companies arising from regulation as well as to the constraints imposed. Policy-makers might wish to consider carefully the likely consequences of taking up the regulatory relaxations permitted by the Micros Directive (2012/6/12) as this might generate more problems than benefits for many of the companies who are its intended beneficiaries.

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Table 1. Respondent groups

	Survey sample	*Interview sample*
Small company preparers/users of abbreviated accounts	149	12
Accounts users and intermediary bodies	-	18
Accountants in practice	255	10
Organisational accountants	159	10

Table 2. Small companies' reasons for filing abbreviated accounts

	% of small companies reporting as the primary reason	*% of small companies reporting as a reason*
Following accountants' advice	65	71
To reduce public disclosure	26	42
Lower costs	5	5
Ease, simplicity, save time	2	2
Other reasons	2	2
All	100	N/A

Base: Small company postal survey (n = 149)
Note: Respondents could rank up to three reasons as first, second or third most important

Table 3. Small companies' use of abbreviated accounts

	% of small companies reporting use of source
Any source	42
Potential customers	24
Competitors	21
Existing customers	13
Existing suppliers	11
Potential suppliers	11
Potential collaborative partners	8
Potential acquisitions	5
Potential investors	1
Other sources	6

Base: Small company postal survey (n = 149)

Endnotes

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[1] Under the Companies Act 2006, 'an entity is excluded from the small companies regime if it is a public company, a company that is an authorised insurance company, a banking company, an e-money issuer, an ISD investment firm or a UCITS management company, or carries on insurance market activity, or is a member of an ineligible group' (c. 46, Part 15, Chapter 1, p. 178).

[2] These criteria are: total assets of £289,415 (€350,000), net turnover of £578,830 (€700,000), and average employment of 10. Calculated at the exchange rate of €1=£0.82690 published in the Official Journal of the European Union on 10 April, 2012, the date the Directive came into force.

[3] The Directive also permits exemption from other accounting and reporting obligations (BIS 2013a). Our concern is solely with publication of the annual accounts.

[4] Fifteen accountants are excluded because respondents reported no small company clients at the time of the survey or because none filed abbreviated accounts.

[5] Square brackets contain text inserted to retain the sense of verbatim quotations.

[6] During April-November 2010, there were 1.001m downloads (or 1.5015m per annum). An estimated 62.3 per cent of accounts filed during April-December 2010 were small company abbreviated accounts. 1.5015m x 62.3 per cent = 934,435 downloads (email communication with Companies House). This figure may be subject to error due to variation in accounts classification. It is not possible to estimate the number of users accessing abbreviated accounts indirectly via intermediaries such as credit reference agencies or FAME.

[7] Some users were also sceptical of the quality of statutory accounts as Companies House does not validate the accounts filed. Exemption from statutory audit reinforced such scepticism.

[8] Annual insolvency figures for 2010 through 2012, though slightly lower at 16,045, 16,886 and 16,138 respectively, were higher than in the years immediately proceeding the 2008 recession (Insolvency Service 2013).