

<b>Title:</b> Simpler financial reporting for micro-entities: The UK's proposal to implement the 'Micros Directive' <b>IA No:</b> RPC12-FT-BIS-1676  <b>Lead department or agency:</b> Department for Business, Innovation and Skills <b>Other departments or agencies:</b>	<b>Impact Assessment (IA)</b>		
	<b>Date:</b> 19 August 2013		
	<b>Stage:</b> Fast track validation		
	<b>Source of intervention:</b> EU		
	<b>Type of measure:</b> Secondary legislation		
<b>Contact for enquiries:</b> Angela Rabess 020 7215 1661 angela.rabess@bis.gsi.gov.uk			
<b>Summary: Intervention and Options</b>			<b>RPC Opinion: Green</b>

Cost of Preferred (or more likely) Option			
Total Value	Net Present Value	Present Value	Net cost to business per year (EANCB on 2009 prices)
0	0	0	0
			<b>In scope of One-In, Two-Out?</b>
			Yes
			Zero net cost

**What is the problem under consideration? Why is government intervention necessary?**

Current EU accounting requirements place a regulatory burden on micro-entities which is disproportionate to their size. Therefore, as part of the EU's "think small first" approach to legislation, a new Directive has been introduced which allows Member States to exempt micro-entities from certain requirements of the Fourth Company Law ("Accounting") Directive. Consequently, the Government must now decide whether and how to best implement this new Directive in the UK.

**What are the policy objectives and the intended effects?**

The Government is seeking to reduce the regulatory burden on the smallest companies in the UK with the aim of encouraging and supporting their growth, whilst also continuing to protect the interests of third parties such as creditors, shareholders and tax authorities. This policy intends to achieve this, in part, through reduced financial reporting to the registrar in the UK, Companies House.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

Option 0: Do nothing/status quo.  
Option 1: Implement all parts of the Micros-exemption  
Option 2: Implement the Micros-exemption, with the exception of removing the obligation to present prepayments and accrued income and accruals and deferred income, and the obligation to recognise only certain prepayments and accrued income and accruals and deferred income.

Option 2 is the preferred option. This reflects the consultation responses.

<b>Will the policy be reviewed?</b> It will be reviewed. <b>If applicable, set review date:</b> 08/2018						
Does implementation go beyond minimum EU requirements?				No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.		<b>Micro</b> Yes	<b>&lt; 20</b> No	<b>Small</b> No	<b>Medium</b> No	<b>Large</b> No
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)				<b>Traded:</b>		<b>Non-traded:</b>

*I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.*

Signed by the responsible Minister:

Jo Swinson

Date:

21/10/13

# Summary: Analysis & Evidence

# Policy Option 1

## Description:

### FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -£4.74m	High: -£2.37m	Best Estimate: -£3.95m

COSTS (£m)	Total (Constant Price)	Transition Years	Average (excl. Transition) (Constant Price)	Annual (Constant Price)	Total (Present Value)	Cost
Low	£4.95m				£4.95m	
High	£12.10m				£12.10m	
Best Estimate	£8.92m				£8.92m	

#### Description and scale of key monetised costs by 'main affected groups'

The cost of Companies House upgrading their systems to allow micro-entity accounts to be filed is estimated at £0.22m. We are not **requiring** commercial software providers to make changes to their software so we assume they will not do this unless the benefits to them outweigh their costs. Familiarisation costs for accountants and book-keepers could be viewed as part of their ongoing Continuous Professional Development obligation, as members of professional bodies, to keep up with changes to guidance/standards. We assume that these additional changes will nevertheless result in an opportunity cost of their time of £6.07m. There will also be a cost on the 23% of micro-entities, which do their own accounts, and choose to take up the exemptions, totalling £2.62m

#### Other key non-monetised costs by 'main affected groups'

There may be a loss of transparency which may adversely affect the companies, their stakeholders and credit providers. This could be through the reduced financial information leading to a higher cost of capital and delayed credit decisions, though much of the information will still be available. The impact of these small changes is uncertain because the degree of separation between owner and manager is likely to be narrow and there is likely to be a small number of stakeholders, so the principal agent problem is limited. Also the scale of reduced transparency depends on the share of micro-entities choosing to use the exemption: evidence suggests that perhaps only half of those eligible might take it up. Exempting prepayments and accruals (unlike option 2) will also impose costs relating to accounting inconsistency and increased complexity for accountants/book-keepers, companies and stakeholders.

BENEFITS (£m)	Total (Constant Price)	Transition Years	Average (excl. Transition) (Constant Price)	Annual (Constant Price)	Total (Present Value)	Benefit
Low	£2.58m		Optional		£2.58m	
High	£7.35m		Optional		£7.35m	
Best Estimate	£4.96m				£4.96m	

#### Description and scale of key monetised benefits by 'main affected groups'

Applying the same assumptions as option 2, if 6% of micro entities (which currently contract out to an accountant) were able to do their accounts themselves, as a result of the exemptions, the best estimate of the benefits would be £4.96m. We consider that the corresponding total of only 72,100 micro-entities needing to compile their own accounts entirely plausible. It is also reasonable to assume that the same number of micro entities would do their own accounts under option 1 and 2 given the limited difference between them.

**Other key non-monetised benefits by 'main affected groups'**

Existing Micro-Entities: The key non-monetised benefits arise from the simplification of reporting requirements and the increased level of flexibility for micro-entities. (This benefit is less than that offered by option 2 due to the complexity of correctly identifying those items for which it was not necessary to present or recognise accruals and prepayments.) It might also lead to some of the simplest micro-entities no longer needing external accountancy/bookkeeping services. The owners and managers of micro-entity businesses may feel increased confidence in the understanding and use of financial statements due to their reduced complexity and increased certainty that their legal obligations have been met.

New Businesses: The option of simplified reporting obligations may encourage the incorporation of new companies and so encourage entrepreneurs to develop their businesses and support growth.

Government: This deregulatory measure also aligns with government efforts to facilitate entrepreneurship and free companies from unnecessary regulatory burdens. Establishing the existence of micro-entities as a category of company in UK law should pave the way for considering how the burdens on these smallest companies might be relieved in other areas of the legislative framework.

**Key assumptions/sensitivities/risks****Discount rate (%)** 3.5

Given their simplicity, in the light of consultation we have assumed that the exemptions will only take a small amount of time for accountants/book-keepers or micro-entities to understand. We make assumptions around the number of micro-entities who produce their own accounts and take up the exemption. We also assume that the software companies will not make changes to their products if the benefits to them do not outweigh their costs. There is potential risk of a loss of transparency to third parties but this remains limited based on evidence suggesting that many micro-entities will not take up the exemptions and the ongoing ability for key third parties to request financial information of companies.

**BUSINESS ASSESSMENT (Option 1)**

<b>Direct impact on business (Equivalent Annual) £m:</b>			<b>In scope of OITO?</b>	<b>Measure qualifies as</b>
<b>Costs: £0.9m</b>	<b>Benefits: £0.5m</b>	<b>Net:-£0.4m</b>	No	NA

# Summary: Analysis & Evidence

# Policy Option 2

## Description:

### FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -£7.35m	High: -£2.58m	Best Estimate: 0

COSTS (£m)	Total (Constant Price)	Transition Years	Average (excl. Transition) (Constant Price)	Annual (Constant Price)	Total (Present Value)	Cost
Low	£2.58m				£2.58m	
High	£7.35m				£7.34m	
Best Estimate	£4.96m				£4.96m	

#### Description and scale of key monetised costs by 'main affected groups'

The cost of Companies House upgrading their systems to allow micro-entity accounts to be filed is estimated at £0.22m. Because we are not **requiring** commercial software providers to make changes to their software we consider that they will not do this unless the benefits to them outweigh their costs. Familiarisation costs for accountants and book-keepers could be viewed as part of their ongoing Continuous Professional Development obligation, as members of professional bodies, to keep up with changes to guidance/standards. However, we make a conservative assumption here that these additional changes will nevertheless result in an opportunity cost of their time of £3.32m. There will also be a cost on the 23% of micro-entities, which do their own accounts, and choose to take up the exemptions, totalling £1.43m In this case the fewer changes compared to Option 1 reduces the familiarisation costs.

#### Other key non-monetised costs by 'main affected groups'

There may be a loss of transparency which may adversely affect the companies, their stakeholders and credit providers. This could be through the reduced financial information leading to a higher cost of capital and delayed credit decisions, though much of the information will still be available. The impact of these small changes is uncertain because the degree of separation between owner and manager is likely to be narrow and there is likely to be a small number of stakeholders, so the principal agent problem is limited. Also the scale of reduced transparency depends on the share of micro-entities choosing to use the exemption: evidence suggests that perhaps only half of those eligible might take it up.

BENEFITS (£m)	Total (Constant Price)	Transition Years	Average (excl. Transition) (Constant Price)	Annual (Constant Price)	Total (Present Value)	Benefit
Low	£2.58m		Optional		£2.58m	
High	£7.35m		Optional		£7.35m	
Best Estimate	£4.96m				£4.96m	

#### Description and scale of key monetised benefits by 'main affected groups'

Adopting break-even analysis, if 6% of micro entities (which currently contract out to an accountant) were able to do their accounts themselves, as a result of the exemptions, the benefits would outweigh the costs. We consider that the corresponding total of only 72,100 micro-entities needing to compile their own accounts entirely plausible.

**Other key non-monetised benefits by 'main affected groups'**

Existing Micro-Entities: The key non-monetised benefits arise from the simplification of reporting requirements and the increased level of flexibility for micro-entities. It might also lead to some of the simplest micro-entities no longer needing external accountancy/bookkeeping services. The owners and managers of micro-entity businesses may feel increased confidence in the understanding and use of financial statements due to their reduced complexity and increased certainty that their legal obligations have been met.

New Businesses: The option of simplified reporting obligations may encourage the incorporation of new companies and so encourage entrepreneurs to develop their businesses and support growth.

Government: This deregulatory measure also aligns with government efforts to facilitate entrepreneurship and free companies from unnecessary regulatory burdens. Establishing the existence of micro-entities as a category of company in UK law should pave the way for considering how the burdens on these smallest companies might be relieved in other areas of the legislative framework.

**Key assumptions/sensitivities/risks****Discount rate (%)** 3.5

Given their simplicity, we have assumed that the exemptions will only take a small amount of time for accountants/book-keepers or micro-entities to understand. We make assumptions around the number of micro-entities who produce their own accounts and take up the exemption. We also assume that the software companies will not make changes to their products if the benefits to them do not outweigh their costs. There is potential risk of a loss of transparency to third parties but this remains limited based on evidence suggesting that many micro-entities will not take up the exemptions and the ongoing ability of key third parties to request financial information of companies.

**BUSINESS ASSESSMENT (Option 2)**

<b>Direct impact on business (Equivalent Annual) £m:</b>			<b>In scope of OITO?</b>	<b>Measure qualifies as</b>
<b>Costs: £0.45m</b>	<b>Benefits: £0.45m</b>	<b>Net: £0m</b>	Yes	Zero net cost

# Evidence Base (for summary sheets)

## Executive Summary

The Micros Directive is the first deregulatory measure published by the European Union. It identifies the “micro-entity” as the smallest business category and establishes a legal definition. This is an important first step. It provides the EU and Member States with a firm foundation from which to consider the needs of our very smallest businesses and the statutory burdens which it is reasonable to place upon them. The Directive recognises the important role that micro-entities play within national economies and it encourages Member States to take account of the specific conditions and needs of their own markets when making decisions about how or whether to implement its provisions. Consequently, it has no mandatory elements and Member States are free to decide how and whether to implement none, one or more exemptions from a micro-entities regime.

The impact of the reliefs offered by the Directive is reduced in the UK as we have already taken the opportunity to relieve small companies of financial reporting burdens through take up of existing Member State options in the 4<sup>th</sup> Company Law (“Accounting”) Directive. (This is the “small company regime” established under the Companies Act 2006.) However, the Directive supports the Government’s objective of reducing burdens, particularly on small businesses, and provides an opportunity to give our smallest, simplest companies the choice of providing much simplified financial statements, if they so wish. In addition to relieving the burdens on existing businesses, the ability to operate under a much reduced financial reporting regime may also encourage entrepreneurs to take that first step to establishing a new company. Further, the Government considers it is important to establish the existence of micro-entities in UK law and so pave the way for considering how the burdens on these companies might be relieved in other areas of the legislative framework.

This measure is considered deregulatory and received confirmation from the RPC triage assessment that it is suitable for the fast track procedure and should be submitted for RPC validation. It is also one of a series of measures that has been announced in the first phase of the Commercial and Company Law Red Tape Challenge.

Micro-entities number 1.56 million and are defined as companies which do not exceed two of the three following conditions:

Balance sheet total:	€350,000	(£316,000)
Net turnover:	€700,000	(£632,000)
Average number of employees during the financial year:	10	

The underlying **problem** for micro-entities is that existing reporting requirements are disproportionate to their size – they are required to follow burdensome and complex financial reporting procedures designed primarily for larger companies.

The **rationale for intervention** is to address this disproportionate impact of government failure. Detailed financial reporting is a cost to micro-entities but does not deliver the same benefits to their stakeholders, at least in part because their ownership structure is so concentrated; 45% of micro-entities have only one shareholder. Greater flexibility is needed to allow these companies to produce the financial statements that better suit their needs.

The proposed deregulatory measures aim to fulfil the **policy objectives** of bringing the reporting requirements for micro-entities in line with their size as well as encouraging and protecting their growth.

We propose three options, including do nothing. **Option 2** is considered the most appropriate approach to UK implementation of the Micros Directive in the light of the consultation responses.

In its original form, the EU Directive consists of seven components, which enable the preparation of simplified accounts that focus on key financial information, and provide further choice in terms of financial accounts preparation:

Proposal	Description
i)	<i>Exempt qualifying micro-entities from the obligation to present 'prepayments and accrued income' and 'accruals and deferred income'</i>
ii)	<i>Exempt qualifying micro-entities from the obligation to recognise certain types of 'prepayments and accrued income' and 'accruals and deferred income on the balance sheet, provided that such charges do not relate to the cost of raw material and consumables, staff costs, value adjustments and tax</i>
iii)	Exempt micro-entities from the obligation to prepare an annual report provided that an appropriate note on the acquisition of own shares is disclosed at the foot of the balance sheet
iv)	Exempt micro-entities from the obligation to publish annual accounts provided that the balance sheet is filed with a competent authority (Companies House)
v)	Exempt micro-entities from the obligation to draw up notes on the accounts provided that commitments by way of guarantee of any kind, information on advances and credits to administrative, managerial or supervisory bodies, and the acquisition of own shares are disclosed at the foot of the balance sheet
vi)	Permit micro-entities to draw up an abridged balance sheet
vii)	Permit micro-entities to draw up an abridged profit and loss account

Option 1 entails the full implementation of all of these components, whereas the preferred option 2 omits parts (i) and (ii). These components were considered highly unpopular in the consultation due to potential confusion and inconsistency that could arise for accountants, companies and stakeholders with associated, if unintended, administrative costs; and risks of reduced confidence in the UK's financial reporting framework.

The **benefits of option 2** are largely non-monetised with relatively limited overall cost savings because the proposals only consist of minor changes to reporting requirements. Given that much of the accounting procedure is automated, the same amount of the accountant/book-keeper's time is spent on collecting and verifying raw data to feed into software package. However, there might be savings by accountants/book-keepers not needing to provide input to the notes for the accounts. Having said that, the exemptions are only optional and evidence suggests that many micro-entities, perhaps half, may opt to voluntarily file full or small company abbreviated accounts.

However, a simplified reporting regime might mean that in the future a number of the simplest micro-entities could avoid the cost of external accountancy/book-keeping services, once told of the changes and where they felt able to present the accounts correctly themselves,

There might also be **wider benefits** resulting from the simplification of micro accounts by making them more useable and understandable to their stakeholders. In addition, the extra flexibility would enable micro-entities to choose the format of their financial reporting that best fits their needs or operation. There might also be wider benefits from greater moves towards deregulation, including an increase in start-ups.

The **costs of option 2** are one-off costs totalling £4.96m. Of this one-off cost, £0.22m is the cost to Companies House to upgrade their systems and processes – as they are a public body this is not a cost to business. Private sector software companies are assumed to make changes to their software only if the benefits to them outweigh their costs. One-off familiarisation costs for accountants/book-keepers as well as micro-entities which compile their own accounts are found to be £4.74m. For accountants and book-keepers, this reflects their Continuous Professional Development requirement to keep up with changes to regulations and guidance but also taking into account the opportunity cost of their time.

The **non-monetised costs** arise from a potential loss of transparency for stakeholders. This could slow credit decisions down, and potentially raise the cost of capital for these companies where uncertainty over the financial health of a company exists. However, creditors can request additional financial information from companies so they do not necessarily rely on company financial statements, and the scale of this cost depends on the take-up of the exemptions.

Adopting **break-even analysis**, if 6% of micro entities (which currently contract out to an accountant) were able to do their accounts themselves as a result of the exemptions, the benefits would outweigh the costs. We consider that the corresponding total of only 72,100 micro-entities needing to compile their own accounts entirely plausible. This estimate allows for a cost-saving of approximately £75 each for the relevant micro-entities.

As micro-entities are a new category of company, the amount of data and other evidence available on the burden of financial reporting obligations for micro entities is limited. As a result, we have used estimates provided through discussions with a range of stakeholders, as well as those acquired from the small body of research currently available.

The preferred option is option 2. The derogations offered by exemptions (i) and (ii) are not adopted under option 2 to avoid the likely administrative and financial burdens/costs for the preparers and users of financial statements from arising from potential confusion and inconsistency around the application of these options and the consequential risks of reduced confidence in the UK's financial reporting framework. Importantly this responds to concerns raised in the consultation responses.



## Problem under consideration

The Micros Directive is the first deregulatory measure published by the European Union. It has no mandatory elements and Member States are free to decide how and whether to implement none, one or more exemptions from a micro-entities regime.

This measure is considered deregulatory and received confirmation from the RPC triage assessment that it is suitable for the fast track procedure and should be submitted for RPC validation. It is also one of a series of measures that has been announced in the first phase of the Commercial and Company Law Red Tape Challenge.

Under current EU accounting requirements, very small companies are generally subject to the same financial reporting obligations as larger companies and therefore are subject to a regulatory burden which is not in proportion to their size. Such requirements include preparing and publishing financial statements and reports to the same financial reporting rules as other small entities<sup>1</sup>. They can adopt the simpler requirements of the FRSSSE (Financial Reporting Standards for Smaller Entities) which, although less complex than financial reporting requirements for larger companies, may place a burden that is disproportionate to the size of the smallest entities.

To reduce the administrative burden on such enterprises, the European Parliament has adopted a new Directive 2012/6/EU (the Micros Directive<sup>2</sup>) which establishes a new category of company - *the micro-entity* - and allows Member States to exempt such companies from certain provisions of the 4<sup>th</sup> Company Law ("Accounting") Directive (78/660/EEC)<sup>3</sup> which deals with the annual accounts of companies with limited liability. The exemptions apply to individual company accounts. (Further background to the Directive and an explanation of the impact is in Annex A)

A micro entity is defined as a company which, on its balance sheet date, does not exceed two out of the following three criteria:

Balance sheet total:	€350,000	(£316,000) <sup>4</sup>
Net turnover:	€700,000	(£632,000)
Average number of employees during the financial year:	10	

Based on this definition, there is a population of approximately 1.56m micro entities in the UK, using estimates from the FAME database<sup>5</sup>. This represents over half of the total number of active companies in the UK. On this basis, there is no doubt that micro entities are an important part of the UK economy.

The Government is currently deciding whether and how best to implement the Micros Directive in the UK.

## Rationale for intervention

The rationale for company reporting requirements is best represented in the form of a principal-agent problem. Shareholders (the principal) delegate the responsibility of company management to company executives (the agent). It is this separation of ownership and control, which generates a potential informational asymmetry because shareholders, and more broadly other stakeholders, do not have full information on the performance of their executives.

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<sup>1</sup> Small entities classed as satisfying any 2 of the 3 criteria – turnover below £6.5m, balance sheet total below £3.26m and fewer than 50 employees.

<sup>2</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:081:0003:0006:EN:PDF>

<sup>3</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1978:222:0011:0031:EN:PDF>

<sup>4</sup> The exchange rate used (€1=£0.85995) is that on the date of entry of the Accounting Directive 2013/34/EU, with the allowed 5% adjustment to enable the use of a round figure in national currencies.

<sup>5</sup> FAME database. 2013. Bureau Van Dijk Electronic Publishing.

Reporting requirements for companies aim to reduce this asymmetry by making companies as transparent as possible.

However, this principal-agent arrangement does not hold as strongly for micro entities because there is often little or no separation between ownership and control. For instance, of the 1.56 million micro-entities, approximately 700,000 (45%) only have one shareholder. As a result, for the smallest of companies, the costs associated with financial reporting requirements may be disproportionate to the value of the financial statements for stakeholders and hence which may not deliver significant benefit to stakeholders.

In essence, this represents a government failure, whereby the impact of reporting requirements is placing a disproportionate and unnecessary administrative burden on micro entities. For all companies, administrative burden is thought to consist of a relatively high fixed cost element, which has a disproportionate impact on smaller companies<sup>6</sup>. Evidence also suggests that larger companies benefit from substantial economies of scale and efficiency gains over smaller companies<sup>7</sup>. Overall, this means that micro-entities must divert a greater share and absolute value of resources to address a simple reporting requirement, including if reporting is outsourced to external professionals.

These deregulatory measures are expected to lead only to a small cost in terms of lost transparency for investors. This is particularly the case because some stakeholders (banks, other finance providers and HMRC) have the power to request extensive financial information from companies so they do not necessarily rely on company financial statements. Furthermore, the majority of micro entities tend to have only a small number of external stakeholders<sup>8</sup>.

Overall, the proposals will offer greater choice for micro-entities to produce financial statements to suit their needs better. The proposed changes will also ensure reporting requirements are better aligned to the needs of the end users of their financial statements. In addition to relieving the burdens on existing businesses, the ability to operate under a much reduced financial reporting regime may also encourage entrepreneurs to take that first step to establishing a new company. Further, the Government considers it is important to establish the existence of micro-entities in UK law and so pave the way for considering how the burdens on these companies might be relieved in other areas of the legislative framework.

## **Policy objective**

In the Plan for Growth<sup>9</sup> published in March 2011, the Government set out its ambition “to make the UK one of the best places in Europe to start, finance and grow a business”. It identified that this could be achieved, in part, by lessening the domestic regulatory burden on business. This Directive offers government the opportunity to assess further how the regulatory burden on the smallest businesses might be relieved and how real benefits to this population of companies might be provided.

The policy objectives, targeted at the 1,560,000 micro entities in the UK, are:

- to reduce the regulatory burden in proportion to their size, and
- to encourage and protect growth of these very small businesses;

The proposed policy will simplify further statutory financial reporting for micro-entities, whilst continuing to protect the interests of third parties such as creditors, shareholders and tax authorities.

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<sup>6</sup> European Commission, (2007), Report to the expert group. ‘Models to reduce the disproportionate regulatory burden on SMEs’

<sup>7</sup> Ramboll Management, (July 2007) ‘Study on administrative costs of EU company law’

<sup>8</sup> European Commission, (2009), ‘Impact assessment accompanying Directive to amend Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities’

<sup>9</sup> [http://cdn.hm-treasury.gov.uk/2011budget\\_growth.pdf](http://cdn.hm-treasury.gov.uk/2011budget_growth.pdf)

The proposals will largely introduce minor presentational changes to the reporting requirements imposed on micro-entities. This is because the UK has already taken the opportunity to relieve small companies of financial reporting burdens through take up of existing Member State options in the 4<sup>th</sup> Company Law (“Accounting”) Directive. (This is the “small company regime” established under the Companies Act 2006.) The benefits offered by the micro-exemptions are incremental, rather than substantial. Ultimately, the same volume of data will need to be collected in order to fulfil the reporting requirements (and hence will be available if requested by finance providers and HMRC) – it will only be a simplified version of these data which is presented. As a result, the proposals will remove the requirement for micro-entities to make disclosures which are unnecessary for companies of their size and confer little informational advantage for stakeholders.

### **Description of options considered (including do nothing);**

We propose three options, including do nothing. Option 2 is considered the most appropriate approach to UK implementation of the Micros Directive.

#### **Option 0 – Do nothing**

If no parts of the Micros-Exemption Directive are implemented, micro-entities would continue to make use of the existing small companies’ regime. As a result, micro-entities would remain subject to the same financial reporting obligations as other small companies. The choice of financial statement would remain restricted for micro-entities and they would remain subject to the same disproportionate administrative burden.

#### **Option 1 – Implement all parts of the Micros-Exemption:**

In its original form, the Directive outlines the following seven components:

Proposal	Description
i)	Exempt qualifying micro-entities from the obligation to present ‘prepayments and accrued income’ and ‘accruals and deferred income’
ii)	Exempt qualifying micro-entities from the obligation to recognise certain types of ‘prepayments and accrued income’ and ‘accruals and deferred income’ on the balance sheet, provided that such charges do not relate to the cost of raw material and consumables, staff costs, value adjustments and tax
iii)	Exempt micro-entities from the obligation to prepare an annual report provided that an appropriate note on the acquisition of own shares is disclosed at the foot of the balance sheet
iv)	Exempt micro-entities from the obligation to publish annual accounts provided that the balance sheet is filed with a competent authority (Companies House)
v)	Exempt micro-entities from the obligation to draw up notes on the accounts provided that commitments by way of guarantee of any kind, information on advances and credits to administrative, managerial or supervisory bodies, and the acquisition of own shares are disclosed at the foot of the balance sheet
vi)	Permit micro-entities to draw up an abridged balance sheet
vii)	Permit micro-entities to draw up an abridged profit and loss account

However, we propose to modify components (iii) and (v), as explained below. The explanation below also offers additional detail for the remaining component parts of the Directive. Overall, each of the components combine to enable the preparation of much simplified accounts that focus on key financial information, and provide further choice in terms of financial accounts preparation.

*Prepayments and accruals (i) and (ii)*

The Micros Directive notes that the calculation of prepayments<sup>10</sup> and accrued income<sup>11</sup> and accruals and deferred income can be burdensome for some micro-entities. The exemption from the obligation to calculate and present certain charges (other than the cost of raw materials and consumables, value adjustments, staff costs and tax) will reduce the administrative burden that may be involved in calculating some relatively small balances.

#### *Annual accounts – preparation and publication (iii)*

The UK currently implements Member State options in the 4<sup>th</sup> Company Law (“Accounting”) Directive to relieve small companies of certain obligations and to permit these companies to submit abbreviated accounts to Companies House. The UK small companies’ regime excludes companies from the publication of annual accounts so micro-entities also already benefit from this exemption.

However, small companies, including micro-entities are already required to disclose the acquisition of own shares in their Directors’ Report. In its original form, this component of the Directive requires the disclosure of acquisition of own shares to be also footnoted in the micro-entities’ balance sheet. To remove this duplication, we propose to remove this requirement to footnote the acquisition of own shares in the company balance sheet. This will only require the disclosure to be made once, in the Directors’ Report, which further simplifies reporting requirements.

#### *Filing of balance sheet (iv)*

Micro-entities, which chose to take advantage of the small company regime in the UK, are currently exempt from the requirement to publish annual accounts. However, they must file the balance sheet and have the option to publish/file an abbreviated version of the balance sheet. Thus component (iv) will therefore have no impact because of the existing exemption provided by the small company regime.

#### *Notes to the accounts (v)*

At present, micro-entities must prepare full notes to the accounts and have the option to file abbreviated notes to the accounts with Companies House. To reduce duplication we propose to remove the requirement to include the footnote on acquisition of own shares, as per the explanation of (iii). Micro-entities will still be required to disclose commitments by way of guarantee and information on advances and credits at the foot of the balance sheet.

On this basis, micro-entities only provide the own-share disclosure once in the Directors’ Report, further simplifying the balance sheet and reducing the burden.

#### *Abridged balance sheet (vi)*

Currently all small companies must prepare a full balance sheet, but may file an abbreviated balance sheet with Companies House. This proposal is that micro-entities may prepare an abridged balance sheet which consists of very limited items and footnotes. However, if a micro-entity chooses not to prepare an abridged balance sheet, the micro-entity must file a copy of the balance sheet as prepared.

#### *Abridged profit and loss account (vii)*

Currently, all small companies must prepare a full profit and loss account and have the option to file the profit and loss account. This proposal is that micro-entities may prepare an abridged profit and loss account consisting of limited items and have the option to file the profit and loss account further simplifying the profit and loss account and reducing the burden.

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<sup>10</sup> A prepayment is defined as a payment made by the company before the goods or services have been received at year end.

<sup>11</sup> An accrual occurs when the goods/services which have been received but they have not been paid for by the company at year end.

**Option 2 – Implement the Micros-Exemption excluding the parts that exempt micro entities from the obligation to present prepayments and accruals (i), and the obligation to recognise certain types of prepayments and accruals (ii).**

As per option 1, with the exception of (i) removing the obligation for presenting prepayments and accruals and (ii) the recognition of certain type of prepayments and accruals.

The majority of consultation responses (Annex B) opposed parts (i) and (ii) of the Micros-exemption. Many noted the approach would introduce mixed measurements to accruals accounting, and potentially create confusion. Current UK accounting practices allow companies to ignore the accrual concept for certain amounts that are not material to an understanding of the company's financial position. Therefore, the exemption would apply to those items that would otherwise be considered material to a proper understanding of the financial statements. In addition, it would lead to consequential impacts on the distributable profits, directors' fiduciary duties, and insolvency issues. In effect there would be additional burdens on business from these reforms, which would interact negatively with information needed for credit, profit distribution, and tax purposes.

On this basis, Option 2 is considered to be the most appropriate approach to the implement the Directive. This avoids the potential confusion and inconsistency that could arise for accountants, companies and stakeholders with associated, if unintended, administrative costs; and risks of reduced confidence in the UK's financial reporting framework. Additional detail and a comparison between the reporting regime for micro-entities and small companies is available in Annex A.

## **Benefits and costs of each option**

### **Benefits**

#### **Option 1 (Full implementation)**

The bulk of the benefits arising from full implementation of the Directive are non-monetised. These non-monetised benefits occur due to the simplification and additional choice conferred on micro-entities. Most of the components create limited benefits in terms of time savings.

*(i) and (ii) Exemption from the obligation to present prepayments and accruals; and exemption from the obligation to recognise certain types of prepayments and accruals*

Many responses during the consultation indicated that with or without the application of this exemption, the figures generated are automated using accountancy software and are based on the same data inputted by accountants/book-keepers. Therefore, there are ultimately no time savings for accountants/book-keepers to switch to partial-accrual accounting for micro-entities. Furthermore, micro-entities may still opt to forgo their exemption and request their accountant to consider full accruals and prepayments.

*(iii) Exemption from the obligation to prepare an annual report*

The UK implemented the option in the 4<sup>th</sup> Company Law ("Accounting") Directive to exempt small companies from the preparation of an annual report. Given that micro-entities currently enjoy this exemption, there is no quantifiable benefit from it. As described in the description of options section, we propose to omit the requirement to footnote the acquisition of shares in the balance sheet because this is already disclosed in the Directors' Report.

*(iv) Exemption from the obligation to publish annual accounts provided the balance sheet is filed with Companies House*

Micro-entities are currently not required to publish a profit and loss account and have the option to circulate abbreviated accounts or a summary financial statement to members of the company

instead of circulating a copy of the accounts and reports. Again, this exemption will confer no further benefit on micro-entities. It is also likely that many micros would opt to file accounts voluntarily. Collis (2012)<sup>12</sup> finds that 45% of the micro-entities surveyed in 2006 volunteered full accounts rather than filing abbreviated accounts.

*(v) Exemption from the obligation to draw up notes to the accounts (a limited number of disclosures would be required at the foot of the balance sheet)*

There will be some benefit in removing the obligation for micro-entities and accountants to make specific disclosures on the balance sheet. Although the process is largely automated, whereby the relevant data are input into the accountancy software and the notes are automatically produced, occasionally the input of an accountant/book-keeper is required to offer additional narrative. When this applies, the benefit in terms of time saved arises for the accountant/book-keeper. We do not have information as to how regularly accountants need to feed into the notes but the consultation suggested it would be limited.

*(vi) and (vii) Permission to prepare abridged accounts*

Similarly to (v), because the process of producing abridged balance sheet and profit and loss accounts is automated, there is no time saved for the accountant/book-keeper. Whether the micro-entity chooses to produce abridged accounts or unabridged accounts, the same amount of the accountant's time is spent on collecting and verifying raw data to feed into software package<sup>13</sup>. This aspect of preparing the annual accounts will not change.

The above exemptions might however enable some of the simplest micro-entities avoid the need for external accountancy/bookkeeping services because they are confident that they can present the now simplified information themselves (once they had been told of the exemptions by their existing accountants/book-keepers). The cost of external accountancy/bookkeeping services for a micro-entity is £250-350 per company per annum<sup>14</sup>. However, much of those costs would still be incurred by the company anyway doing its own accounts.

*Wider Non-monetised benefits*

During the consultation (Annex B), the majority of responses commented that implementing the Directive would yield only minor measurable cost savings. However, intangible benefits will accrue to micro-entities.

Firstly, the Micros-Exemption fully implemented would introduce further simplification to the preparation and presentation of financial information for micro-entities. Given that 45% of micro-entities have only one shareholder, the production of a complicated set of accounts is of little or no benefit if it is purely done to fulfil legal obligations. The simplification will condense the end year reports down to the top 'headline' facts and figures and remove unnecessary disclosures. As noted in the related European Commission's IA, many owners of micro-entities do not fully understand or utilise all the information in annual accounts. Simplifying it may encourage greater usage and improved understanding of the accounts.

Secondly, it would also provide an increased level of flexibility for micro-entities in financial reporting and disclosures. The key point behind these exemptions is that they remain optional. Micro companies often voluntarily go beyond legal requirements to enhance transparency for stakeholders. However, if there is no discernable benefit in disclosing the information to

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<sup>12</sup> Collis, J. (2012) 'Determinants of voluntary audit and voluntary full accounts in micro and non-micro small companies in the UK' <http://dx.doi.org/10.1080/00014788.2012.667969>

<sup>13</sup> This is supported by case study evidence (Mariott et al. 2006), which suggests that although the typical fee charged by accountants for abbreviated accounts was £100, some did not charge because of the ease with which the software allowed them to publish both abbreviated accounts and statutory accounts.

<sup>14</sup> Institute of Certified Book-keepers

creditors for particular micro-entities, deregulation will leave them free to choose what best fits their needs or operation.

Thirdly, in addition to relieving the burdens on existing businesses, the ability to operate under a much reduced financial reporting regime may also encourage entrepreneurs to take that first step to establishing a new company.

Beyond the gains to micro-entities, there are further benefits from these proposals. There is the broad principle of the UK being a good place to set up businesses and encouraging and facilitating entrepreneurship, and hence supporting economic growth. These proposals are a part of delivering that aspiration by helping to provide that “light touch” environment. Also, these proposals are part of a general movement towards deregulation, especially for the smaller firms. This follows the European Commission’s efforts to embed a ‘think small first’ principle amongst policymakers. Finally, there is the benefit gained to those doing business with micro-entities. To a certain extent being faced with less irrelevant information on a customer, supplier or collaborator can make the act of doing business potentially lower cost.

### **Option 2 (Partial implementation)**

The benefits of partial implementation remain the same as for option 1 with the exclusion of components (i) and (ii). Option 2 would allow for further simplification to the presentation of financial information for micro-entities as Option 1, but not potentially impact on existing accruals accounting principles in the preparation of the accounts. As with Option 1, the overall savings are expected to be limited.

The majority of consultation responses were opposed to the introduction of exemptions (i) and (ii) because of the potential increased risk of doing business with these micro-entities, for example by being less certain of the financial health of the company. Nearly all noted that the level of work required to prepare the accounts would not change in a significant way for these exemptions. As previously noted, micro-entities may need to prepare the additional information in order to meet legal obligations for tax purposes, the distribution of profits and to satisfy lenders and credit rating agencies.

A key additional benefit of option 2 is the acknowledgement of this tension between lighter touch regulation and the need for information by those looking to reassure themselves about the risk of doing business. The omission of exemptions (i) and (ii) is potentially necessary for particular business transactions to take place. Without this, there might be beneficial trades that do not take place because the lack of information increases the risks perceived by one of the parties.

## **Costs**

### **Option 1 (Full implementation)**

#### *1. One-off familiarisation costs*

The exemptions (apart from (iii) and (iv) which are in effect the status quo), will require a one-off familiarisation cost for all chartered and certified accountants as well as practising book-keepers, who will compile company accounts. However, as noted in Collis (2012), 77% of micro-entities deferred the preparation of their accounts to external professionals. This implies that 23% of micro-entities will prepare their own accounts so there will be some familiarisation cost for the share of these micro-entities that take on the exemption.

Once an understanding of the exemption is assimilated, there will be no ongoing cost to enact the exemptions given their simplicity. Accountancy contacts have indicated that it would take between 15 and 30 minutes to understand the changes for exemptions (i) and (ii). We take a conservative assumption of a best estimate of 25 minutes. These exemptions are technical changes whilst exemptions (v), (vi) and (vii) are presentational and so are somewhat more

straightforward. On this basis we assume that it will take 5-15 minutes for familiarisation of each presentational exemption. These assumptions hold for the micro-entities which take up the exemptions and chose to do their own accounts.

Using the Annual Survey of Hours and Earnings, the wages for accountants and book-keepers (plus non-wage labour cost uplift of 17.8%<sup>15</sup>) are £21.10 per hour and £12.97 per hour respectively. The wage used for micro-entity owners is £15.87 (again including a 17.8% uplift for non-wage costs).

In terms of the number of accountants and book-keepers in the UK, the Professional Oversight Board (2012) notes that in 2011 there were 312,104 members of the seven accountancy bodies in the UK<sup>16</sup>. In addition, consultation with the Institute of Certified Book-keepers revealed that there are 3,500 practising book-keepers in the UK. We have assumed that these figures provide reasonable estimates of the number of professionals affected by the Directive in the UK.

Analysis undertaken by Collis in 2012 estimated that 23% of micro-entities compile their own accounts and around half of all micro-entities had taken up the exemption allowing them to file small company accounts. Taking these factors and applying them to the 1.56 million micro-entities in the UK indicate that around 360,000 (23%) might compile their own accounts and, of these, half might take up the exemptions proposed here. On this basis around 180,000 micro-entities are expected to undertake some familiarisation with the changes. Given the simplicity of the exemptions, we envisage this familiarisation will take a micro-entity the same amount of time as an accountant or book-keeper.

Thus the **total one-off familiarisation costs will be £4.74m to £11.86m, with a central case of £8.70m**. The detailed calculations are the same for each exemption with a difference around the amount of time taken for each one. The calculation is as follows:

Time x (((Accountant wage + 17.6% uplift) x (Number of accountants)) + ((Book-keeper wage + 17.6% uplift) x (Number of book-keepers)) + ((Micro owner wage + 17.6% uplift) x (Number of micro entities completing own accounts x 50% take-up of exemptions)))

*(i) and (ii) Exemption from the obligation to present prepayments and accruals; and exemption from the obligation to recognise certain types of prepayments and accruals*

The calculation above with time taken of between 15-30 minutes, with a best estimate of 25 minutes gives estimated total costs of:

	Costs for accountants	Costs for book-keepers	Costs for micros	Total costs
<b>High</b> (30mins)	£3.29m	£23,000	£1.43m	<b>£4.74m</b>
<b>Best</b> (25mins)	£2.74m	£19,000	£1.19m	<b>£3.95m</b>
<b>Low</b> (15mins)	£1.65m	£11,000	£0.71m	<b>£2.37m</b>

*(v) Exemption from the obligation to draw up notes to the accounts (a limited number of disclosures would be required at the foot of the balance sheet)*

A range of 5-15 minutes of time taken, with a best estimate of 10 minutes, for familiarisation:

	Costs for accountants	Costs for book-keepers	Costs for micros	Total costs
<b>High</b> (15mins)	£1.66m	£11,000	£0.71m	<b>£2.37m</b>
<b>Best</b> (10mins)	£1.11m	£8,000	£0.48m	<b>£1.58m</b>
<b>Low</b> (5mins)	£0.55m	£4,000	£0.24m	<b>£0.79m</b>

*(vi) and (vii) Permission to prepare abridged accounts*

<sup>15</sup> Based on Eurostat data: [http://europa.eu/rapid/press-release\\_STAT-13-54\\_en.htm?locale=en](http://europa.eu/rapid/press-release_STAT-13-54_en.htm?locale=en)

<sup>16</sup> FRC (June 2012) 'Key facts and trends in the accountancy profession' : <http://www.frc.org.uk/getattachment/395dede0-38d4-40d6-93a5-9545fd47d177/Key-Facts-and-Trends-2012.aspx>



For each of these exemptions we assume, as with (v) above, that it take 5-15 minutes for accountants/book-keepers and micro-entities to familiarise themselves.

Thus for (vi) and (vii) together the estimated total costs are:

	Costs for accountants	Costs for book-keepers	Costs for micros	Total costs
<b>High</b> (30mins)	£3.29m	£23,000	£1.43m	<b>£4.74m</b>
<b>Best</b> (20mins)	£2.19m	£15,000	£0.95m	<b>£3.16m</b>
<b>Low</b> (10mins)	£1.10m	£8,000	£0.48m	<b>£1.58m</b>

However, it should be noted that the accountancy and bookkeeping professional bodies require their members to maintain up-to-date knowledge as part of their day-to-day work. Each body sets down its own requirements for the number of hours expected to maintain a satisfactory level of CPD. For example the Association of Chartered Certified Accountants (ACCA) requires 40 hours a year of which 21 must be verifiable. This includes reading latest notices, articles etc, through to understanding the application and implications of any new/revised standards, Directives etc.

There are frequent changes per annum to the FRC accountancy guidance/standards. A 2013 IA by the Financial Reporting Council<sup>17</sup> indicates that “For accountants involved in preparing, auditing or using financial statements, one would expect annual CPD activities to include ensuring that their knowledge of relevant accounting and reporting requirements are kept up to date”.

## 2. Software changes

### *(vi) and (vii) Permission to prepare abridged accounts*

In consultation with Companies House, we have identified that a one-off accounts software development cost will be incurred. This will enable the software to produce abridged accounts if micro-entities request them. Once the change has been made, there will be no further cost to produce the abridged accounts. The same data will be input and it will only require the user to select ‘abridged’ versions rather than ‘unabridged’ versions.

Companies and accountancy firms may opt to use the web-based filing service offered by Companies House or more bespoke platforms offered by alternative software providers.

During consultation, we identified the costs for Companies House and received estimates for market leading software providers:

- IT and development costs for Companies House were estimated to be between £160,000 and £190,000, whilst the underlying project, business and legal costs were estimated to be £50,000 (totalling between £210,000 and £240,000).
- Market leaders were thought to require a somewhat lower amount to upgrade their paper electronic systems. There are approximately 20 accounting software companies which provide software systems that enable the electronic filing of accounts by small firms with HMRC and Companies House.

However, these exemptions are permissive and we are not requiring companies or software producers to make any changes. Thus we consider that it is reasonable to assume that the software companies will only undertake the software update if, in their commercial opinion, the business case for the change indicates that their benefits will outweigh their costs. Thus we

<sup>17</sup> <http://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Impact-Assessment-FRS-100,-FRS-101-and-FRS-102.aspx>

consider that there will not be a net cost to business from this. We do however assume that Companies House, as a public body, will undertake the changes.

### 3. *Non-monetised costs*

During the consultation (Annex B), a number of responses pointed to the potential loss of transparency due to the micro exemptions as there could be a reduction in the amount of financial information that is publicly available. Consequently, there is a potential cost for stakeholders, who would suffer a loss of information, as well as the companies themselves.

Business information providers, such as credit rating agencies, use information contained in the annual accounts to supply information on companies to the market. Therefore, such providers may find it more difficult/expensive to provide information on micro entities if they have to rely on specific requests for information. Even so, the related EU IA reports that the level of enquiries to company registers in the UK is low – the average number of enquiries per year is less than two for micro-entities.

Nonetheless, the data are used to underpin many of the scoring models in the credit granting process. A reduction in the information provided would impact on these models and lead to more investigation and data gathering to cater for the absence of data. This could slow credit decisions down, and potentially raise the cost of capital for the companies where uncertainty over the financial health of a company remains. A study by Barth et al. (2013)<sup>18</sup> supports this argument, finding a strong link between transparency and a company's cost of capital. However, where this might occur it might be that the micro-entity decides not to take up the exemption.

Also for the exemptions i) and ii), during the consultation, there was almost universal concern. The main problems related to:

- the potential for inconsistency of accounting across different sized companies and between micro-companies;
- the impacts on rules around distributable profits, directors' fiduciary duties and the corresponding potential for a misleading financial position to be provided; and
- the complexity for accountants and companies preparing the reports, and for the end-users of the reports.

If these are taken up by micro-entities there is the likelihood that the uncertainties created in the accounts would lead to third parties, including in particular HMRC, to require additional information. Thus companies would have to undertake additional work to address reduced confidence levels in the veracity and reliability of published accounts.

### **Option 2 (Partial implementation)**

The costs of partial implementation remain the same as for option 1 with the exclusion of components (i) and (ii). It was these two components that prompted the greatest negative response for consultees, thus the exclusion of these from option 2 potentially reduces the above costs to the preparers of accounts and third parties.

Thus the familiarisation costs for option 2 are from exemptions (v), (vi) and (vii). Using the above calculations these range from £2.37m to £7.11m with a best estimate of £4.74m. The same level of costs for the software changes - £210,000 to £240,000 - is expected. **This gives a total one-off cost best estimate of £4.96m** with a range of £2.58m to £7.35m.

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<sup>18</sup> Barth, M.E., Konchitchki, Y. and Landsman W. R. (2013) 'Cost of capital and earnings transparency' [http://haas.berkeley.edu/faculty/papers/konchitchki\\_transparency.pdf](http://haas.berkeley.edu/faculty/papers/konchitchki_transparency.pdf)

## **Break-even analysis - Option 2 (Partial implementation)**

For illustrative purposes, below we adopt 'break-even' analysis to demonstrate the limited take-up required to counteract the costs imposed on business. Applying the exemptions under option 2, if micro entities were able to do their accounts themselves rather than paying for an accountant they could reap the benefit of the corresponding cost-savings. If micro entities consider these exemptions to simplify their accounts sufficiently, a large number of them could benefit.

Evidence suggests that it costs a micro-entity on average around £300 per annum to pay for external accountancy/bookkeeping services. At a wage rate of £21.10 per hour for an accountant (including the appropriate 17.8% uplift detailed above), this equates to just over 14 hours of an accountants time to do one set of micro accounts.

If a micro-entity were to compile their own accounts, assuming it takes the same time as an accountant<sup>19</sup>, at the wage rate quoted above of £15.87 (including 17.8% uplift), this would cost just over £225. In doing so, the micro-entity would save around £75 (£300 - £225).

As stated above, 77% of micro-entities defer the preparation of their accounts to external professionals, which leaves around 1.2 million micro-entities which could potentially make this cost saving.

If all of these 1.2 million micro-entities took up the exemptions and compiled their own accounts, this would give rise to a benefit of £89.3m (1.2m x approximately £75). However, we cannot foresee the exemptions having an impact of this scale.

Nonetheless, to break-even against the costs of our preferred option of £4.96m, approximately 6% of the 1.2 million micro-entities, which contract out to accountants to do their accounts, would need to do their accounts themselves. We consider 6% of such micro-entities (72,100 companies in total) compiling their own accounts as a direct result of these exemptions entirely plausible.

## **Break-even analysis - Option 1 (Full implementation)**

Applying the same analysis in option 2 to option 1, whereby 6% of relevant micro-entities (72,100 companies in total) compile their own accounts, option 1 gives a net benefit 'best' estimate of -£3.95m, with a range of -£4.74m to -£2.37m. To arrive at the best estimate, we total the benefit of £4.96m, as detailed in option 2, to the cost for option 1 of £8.92m. Assuming that the same number of micro-entities compile their accounts under option 1 and 2 seems to be a reasonable assumption given the limited difference between option 1 and 2.

**The preferred option is option 2 which takes account of consultation responses which expressed concerns around exemptions (i) and (ii). The preferred option does not adopt all the available derogations to avoid unintended burdens on micro-entities and to ensure confidence in the UK's financial reporting framework is maintained.**

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<sup>19</sup> We would expect it to take longer for a micro owner to compile their accounts than it would an accountant but this is to some extent accounted for in the 14 hour estimate. To explain further, the £300 cost estimate does include other costs beyond wages but we cannot fully account for these. If these additional costs could be removed, the £300 figure would likely fall substantially and therefore, so would the time taken by the accountant. As a result, multiplying the 14 hour estimate by the wage of a micro owner, is likely to overestimate costs and therefore reduce the scale of the corresponding cost saving. As such, these form conservative estimates.



## **Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)**

As micro-entities are a new category of company, the amount of data and other evidence available on the burden of financial reporting obligations for micro entities is limited. As a result, in assessing the costs and benefits of the options outlined above, we have used estimates provided through discussions with a range of stakeholders, as well as those acquired from the small body of research currently available. Given the limited scale of the costs and benefits associated with the Directive, we consider this level of analysis to be appropriate.

## **Risks and assumptions**

The key assumptions in terms of costs and benefits are set out above. The most important assumptions are:

- that accountants and book-keepers can familiarise themselves relatively quickly with the exemptions but these actions are additional to the Continuous Professional Development requirements
- that owners of micro-entities can familiarise themselves with the exemptions in the same amount of time it would take an accountant or book-keeper
- that the number of micro-entities who produce their own accounts and who would take up the exemptions reflect the analysis undertaken by Collis in 2012.
- that software companies would not update their product if the benefits to them did not outweigh the costs.

The underlying risks of the exemptions emerge from the potential loss of transparency. As noted in the non-monetised cost section, there is a potential risk to micro-entities in terms of access to finance and cost of capital and a loss of mutual beneficial trades between micro-entities and other enterprises. However, as mentioned above, banks, other finance providers and HMRC have the power to request extensive financial information from companies so they by no means rely on company financial statements. On this basis, key stakeholders will still have access to the same information available now, which essentially acts to mitigate this risk. Also the level of take-up, perhaps half of those eligible, will reduce this transparency risk further.

## **Wider impacts**

After screening the potential impact of this proposal on race, disability and gender equality, it has been decided that there will be no impact. It is not expected to have any impact on the Convention Rights of any person or class of persons, or have an effect on rural proofing.

The main objective of the proposal is to reduce the administrative burden on micro-entities (a significant sub-set of all small companies) so a further small firms impact test is not considered necessary.

## **Summary and preferred option with description of implementation plan.**

The Micros Directive provides Member State options to reduce further the burdens associated with EU accounting requirements for the smallest of businesses, known as micro-entities. The Directive exempts these micro-entities from certain requirements of the 4th Company Law (“Accounting”) Directive.

The UK currently implements Member State options in the 4th Company Law (“Accounting”) Directive to reduce burdens on small companies, including the exemption from the publication of the annual accounts. The Government sought views through a consultation on how best to implement further the Directive in the UK.

Consideration was given to implementing fully all parts of the Micros-exemption and, in response to the public consultation, implementing the majority of the Micro-exemption, excluding the option to exempt micro-entities from the obligation to present 'prepayments and accrued income', and 'accruals and deferred income', and the obligation to recognise certain types of 'prepayments and accrued income' and 'accruals and deferred income'.

Following careful consideration of the consultation responses, the preferred approach to implementation is Option 2.

The Government intend to bring forward legislation to amend the Companies Act 2006 to implement the Directive.

There will be a review of the policy in 5 years. Over the intervening period information will be gathered on the take-up rate and implications of transparency loss in particular to determine whether the level of benefits accruing to micro-entities.

## ANNEX A – Micros-exemption

The Micros Directive provides Member States with the option to exempt micro-entities, as defined above, from any or all of the following financial reporting obligations:

- presenting “prepayments and accrued income” and “accruals and deferred income” on the balance sheet,
- recognise certain types of “prepayments and accrued income” and “accruals and deferred income” provided such charges do not relate to the cost of raw material and consumables, staff costs, value adjustments and tax;
- drawing up notes to the accounts provided commitments by way of guarantee of any kind and information on advances and credits to administrative, managerial or supervisory bodies is disclosed at the foot of the balance sheet;
- preparing an annual report provided that an appropriate note on the acquisition of own shares is disclosed at the foot of the balance sheet;
- publishing annual accounts provided the balance sheet is filed with a designated competent authority (Companies House in the case of the UK);

Furthermore it provides for Member States to allow micro-entities to draw up:

- an abridged balance sheet; and
- an abridged profit and loss account.

At present the UK small company regime allows for small companies to file abbreviated accounts. The abridged balance sheet is further shortened by limiting disclosure to the main headings preceded by a letter in the following approved formats and must consist of at least the following items

Format 1	Format 2
A. Called up share capital not paid B. Fixed assets C. Current assets D. Creditors: amounts falling due within one year E. Net current assets (liabilities) F. Total assets less current liabilities G. Creditors: amounts falling due after more than one year. H. Provisions for liabilities I. Capital and reserves.	Assets A. Called up share capital not paid B. Fixed assets C. Current assets  Liabilities A. Capital and reserves B. Provisions for liabilities C. Creditors

The practical effects of these changes is a shorter, less detailed balance sheet which focuses on key financial information relating to the undertaking's performance.

Similarly, the abridged profit and loss account is greatly shortened to present key financial data. The abridged profit and loss account will show separately at least the following items, where applicable:

- (i) net turnover
- (ii) other income
- (iii) cost of raw materials and consumables
- (iv) staff costs
- (v) value adjustments
- (vi) other charges
- (vii) tax
- (viii) profit or loss

Accounts prepared in accordance with the Directive are deemed to be 'true and fair'; that is, for undertakings of this size, this level of disclosure is sufficient to present a true and fair view of the company's financial position.

Investment companies, financial holding companies and listed companies are excluded from the scope of this Directive, given their systemic importance. Therefore, they will be unable to avail themselves of any of these options, should they be taken forward. The nature of these businesses means that a higher level of transparency is appropriate and their exclusion from the Directive is consistent with their treatment elsewhere in regulation.



**Comparison of reporting regime between micro and small companies under the proposed changes of option 2**

	<b>Micro Companies</b>	<b>Small Companies</b>
Defined as	Meeting two of the following three criteria: Net turnover – not more than £578,830 Balance sheet total – not more than £289,415 Employees – Average of 10 during financial year	Meeting two of the following three criteria: Turnover - not more than £6.5m Balance sheet total - not more than £3.26m Employees – not more than 50
Notes to the accounts	No requirement to prepare full or abbreviated notes to the accounts, if micro includes the three following footnotes on the balance sheet: 1) Acquisition of own shares 2) All commitments by way of guarantees of any kind 3) Advances and credits to directors  To reduce duplication we will remove the requirement to include the footnote on acquisition of own shares, so that micros only provide the disclosure <u>once</u> in the Directors' Report, further simplifying the balance sheet and reducing burden.	<u>Must</u> prepare full notes to the accounts and submit to HMRC.  May present abbreviated notes for filing with Companies House.
Preparation of annual report	Micros exempt from all but one requirement companies are required to report in relation to annual report. Obligation to provide information regarding acquisition of own shares retained as for other small companies.  Prepare a limited Directors' Report (the small company exemption from requirements in relation to the directors report ensures that micros are simply required to state the name(s) of directors, principal activities of the company details concerning and acquisition of own shares).	Position in relation to annual report as for micros.  Prepare a limited Directors' Report as micros.

<p>Publication of annual accounts and annual report</p>	<p>No requirement to publish annual accounts provided the balance sheet is filed.          Required to circulate a copy of annual accounts and the Directors' Report to members of company; and make accounts available on request.          Option to file Directors' Report and Profit &amp; Loss account with Companies House.</p>	<p>May publish abbreviated balance sheet.          Required to circulate a copy of annual accounts and the Directors' Report to members of company; and make accounts available on request. Option to file Directors' Report and profit and loss account with Companies House.</p>
<p>Balance sheet</p>	<p>May prepare an abridged balance sheet consisting of very limited items and footnotes. Must file a copy of the balance sheet.</p>	<p><u>Must</u> prepare full balance sheet.          May file an abbreviated version of the balance sheet.</p>
<p>Profit &amp; loss account</p>	<p>May prepare an abridged profit and loss account consisting of limited items.          Option to file the Profit &amp; Loss account.</p>	<p>Must prepare full profit and loss account.          Option to file the profit and loss account.</p>

## Annex B - Consultations

In August 2011, while the Micros Directive was being negotiated, the Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) jointly published a discussion paper on *Simpler Reporting for the Smallest Businesses*<sup>1</sup> which explored the theme of how the financial reporting requirements of micro-entities might be reduced. While a reduction in requirements was welcomed by some, a significant number of respondents (particularly accounting professionals and representative bodies) reacted negatively towards the prospect. Concerns were largely expressed over the potential benefits of reduced reporting requirements, in particular with respect to possible risks to business resulting from reduced transparency and to the potential level of savings available, indicating that a reduction in regulation may not necessarily lead to simplification, reduced costs or benefit to business.

### Response to consultation

BIS issued a consultation document on *Simpler Financial Reporting for Micro-Entities: The UK's proposals to implement the "Micros Directive"* in February 2013. A number of responses commented that some level of simplification may be achieved by the proposals, but many stated that the changes were unlikely to result any significant cost savings for micro-entities.

A majority expressed concerns around the deeming of 'true and fair' to accounts prepared in accordance with the provisions in the Micros Directive, and commented on the potential for accounting standards to be undermined. Companies accounts are deemed to be true and fair if the accounts are prepared in accordance with the appropriate UK accounting standards and practices. Attention was drawn to UK's Generally Accepted Accounting Practice (UKGAAP), which is the combination of company law underpinned by accounting standards, which forms the basis for companies understanding if the business is solvent, calculating distributable profits, dividends and tax calculations. If the micro accounts were deemed true and fair on only a legal basis (as defined by the Micros Directive), it would remove the requirement to apply UK accounting standards to micro accounts and could create conflict with other legislation on matters such as tax and insolvency.

Significant concerns were raised around the options to remove the obligation to present 'prepayments and accrued income' and 'accruals and deferred income', and the recognition of certain types of 'prepayments and accrued income' and 'accruals and deferred income'. These options would allow for a mixture of different accounting measurements which in turn would not reflect fully the true financial position of the company. In some instances, companies would not have sufficient information to determine if the company was still solvent and ensure that any distributions from the profits were lawful. Therefore, companies may need to keep two sets of accounts or retain the additional information separately. The benefits from preparing the accounts using the exemption is described as minimal at best, but likely to increase costs overall and create unnecessary complexity for preparers, and potential confusion for users. Various comments also pointed to the potential for fraud, tax avoidance, and tax arbitrage. Additionally, HMRC will require the profit calculations to comply with UK GAAP. A small number of responses note the potential for simplification and possible small savings in costs and time.

It should be noted that these concerns would not prevent companies from submitting micro accounts, but HMRC are likely to require adjustments to the micro accounts, which may potentially lead to additional costs if the information has not been prepared.

Further issues were raised around the reduction in the quality of publically available information for lenders, trade creditors, and other users. Many noted the potential for delays to obtaining credit and increased costs to companies who may be required to produce full statutory accounts

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<sup>1</sup> <http://www.bis.gov.uk/assets/biscore/business-law/docs/s/11-1100x-simpler-reporting-for-smallest-businesses-discussion-paper.pdf>

to obtain credit rating references and satisfy lenders of the financial status of the company. There may also be a risk to creditor protection that is expected when trading with a registered business.

The Government is therefore cautious in moving forward with implementation of all of the options available under the Micros Directive, and seeks to assess if and how best the exemptions available under the Directive could be used to relieve the regulatory burden on micro entities in the UK.