EUROPEAN FEDERATION OF ACCOUNTS AND AUDITORS FOR SMES

INTEGRATED REPORTING OR INTEGRATED THINKING

WHATEVER WE CALL IT THE QUESTION REMAINS: IS IT JUST FOR BIG COMPANIES?

EFAA OUTLINES WHY A PRAGMATIC APPROACH TO INTEGRATED REPORTING SHOULD BE CONSIDERED IN AN SME CONTEXT.

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EXTERNAL REPORTING CONSIDERATIONS FOR EUROPEAN SMES

The European Commission, the European Council and the European Parliament spent over two years negotiating the New Accounting Directive [1] (the Accounting Directive). As of today, its implementation is still in the transposition phase in most European Union (EU) Member States.

Complementing the Accounting Directive is the recently published (15 November 2014) EU Directive 2014/95/EU on disclosure of non-financial and diversity information (Directive on Disclosure of Non-Financial Information). This Directive is aimed at increasing the transparency of European companies' performance on environmental and social matters. Why? It is hoped that doing so will effectively contribute to long-term economic growth and employment within the EU. These new rules will apply only to large public-interest entities meaning that listed companies, credit institutions, insurance undertakings and other public-interest entities designated by Member States with more than 500 employees will be required to fulfil the disclosure requirements for non-financial and diversity information.

So where does this leave statutory financial reporting for SMEs in Europe?

- European SMEs will soon be preparing accounts under the Accounting Directive but will not be subject to the requirements of the Directive on Disclosure of Non-Financial Information.
- The relative newness of the accounting legislation seems likely to suggest that critical review of any likely necessary changes to statutory reporting for SMEs in the EU will take place at some distant future time.
- The result of the legislative changes means that SMEs will soon be preparing statutory accounts under a simplified accounting disclosure regime (Accounting Directive) which may contain no information on non-financial items.

EFAA is not advocating in this paper that SMEs should be required by statute to disclose more than what is required under the Accounting Directive. Instead we are contending that there may well be merit to owners and advisors of SMEs in considering the use of Integrated Reporting (<IR>) or Integrated Thinking or certainly the use of concepts within <IR>.

THE ARGUMENTS FOR SHARING MORE INFORMATION

The majority of SMEs are service companies with low tangible fixed asset values

Most SMEs are service providers. As such their balance sheets will show only a small proportion of their entire value. The often highly valuable intangible assets that they own and control will not (in the main) be disclosed under the requirements of the Accounting Directive.

In this context, it is likely that SME financial reports are left with a significant information gap. Users of SME financial reports that need information on either intangible assets or need non-financial information to enable them to make informed investment or trading decisions will not be able to get this information from published statutory reports. This type of information would need to be provided voluntarily by SMEs.

So where the resources and assets of SMEs are principally intangible in nature (employees, customer relationships, and intellectual property etc.) their statutory accounts will not adequately disclose the value of those assets nor give the necessary insights as to the entities' generation of income.

Confidentiality issues

The longstanding tension between the desire for SMEs to publish more information to meet the needs of users and the concerns expressed by SME owners and managers by the publication of risk sensitive business information is both well-known and well accepted. The argument in favour of maintaining confidentiality has undoubted merit.

But whilst SMEs may not be legally required to publish what they consider to be sensitive information they often provide such information directly to external parties in situations where the benefits of doing so outweigh the costs. Examples of when this happens include obtaining bank finance and during tendering processes; the benefits of obtaining funding and winning business are clearly judged by SMEs to outweigh their concerns over privacy.

So what can be concluded?

Additional information, other than that required by law, is often desirable to a number of SME stakeholders, notably potential investors, customers and suppliers. When the business case for providing this information (the benefits of filling the information gap on intangible assets or of providing other relevant information) outweighs matters of confidentiality, it is often voluntarily provided at the discretion of SME owners and managers.

The nature of much of this additional information may well be covered by the current debate surrounding <IR>. Whilst <IR> might be well on the way to being understood for large and listed companies, EFAA is of the belief that the perspective of <IR> may differ when in an SME context but the concept of ultimately thinking in an integrated manner will be advantageous.

SMEs can use the concepts embodied within <IR> as a positive business tool with the proviso that it should never be a burden.

WHAT IS <IR>?

As defined by The International Integrated Reporting Council (IIRC), <IR> is *"a process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation".*

An integrated report should be a concise communication about how an organization's strategy, governance, performance and prospects lead to the creation of value in the short-, medium- and long-term.

The IIRC model identifies six capitals: financial, manufactured, intellectual, human, social and relationship and natural. Considering the existence and strength of such capital is useful in identifying future value creation.

In SME language and context we are talking about:
Financial Capital / What funds (equity, debt, grants) does the SME have available to it that can be used in the provision of goods or services?

Manufactured Capital / What tangible goods and infra-structure (state of the art machinery) does the SME own, lease or have access to that needs to be used in the provision of goods or services?

Intellectual Capital / What capital and knowledge (R&D, intellectual property, systems and processes, and brands) does the SME have at its disposal that speak to its competitive advantage and positively affect its future earning potential?

Human Capital / What capabilities, skills, experience and knowledge do employees and management of the SME possess that provide foundations for future development and growth?

Social and Relationship Capital / Where does the SME sit with respect to its supply chain management, the community in which it is based, competitor connections, customer loyalty and relationships with government agencies?

Natural Capital / Does the SME have access to natural resources that it can use to provide a return?

INTEGRATED REPORTING IN AN SME CONTEXT

Simply put, <IR> could offer SMPs and SMEs an insight into a meaningful comprehensive and holistic conversation about a business including, but not limited to, its assets, its performance, its governance, its unique selling points and competitive advantage, its corporate social responsibility, its environmental impact and carbon footprint and its mid- and long-term strategy.

The list is exhaustive but the use of an <IR> or "<IR> like" framework could assist SMPs and SMEs with considerations of long-term value creation and sustainability. The role of trusted advisor is a well-trodden path for SMPs and these conversations of value creation and sustainability often occur as a matter of routine.

LONG-TERM VALUE CREATION FOR SMES

For those that are less au fait with the SME sector and perhaps believe SMEs and their ultimate sustainability to be of little consequence then let's just pause a while and reflect on the importance of SMEs as a whole.

There are more than 20 million SMEs in the EU. They represent 99% of businesses, and are a key driver for economic growth, innovation, employment and social integration. Individually SMEs are unlikely to be significant but the entire SME population is clearly of significance. SMEs in the EU provide 67% of total employment representing some 100 million jobs[2].

SMEs are being more and more recognised as the backbone of entrepreneurial activity and their performance and sustainability is pivotal to our economies.

SPECIFIC APPLICATIONS FOR SMPS (AND SMES)

The examples below speak to value creation and when this information is included in a concise report alongside financial information it forms a powerful story sufficient to give context to enable stakeholders to invest in the business.

Transfer of business / succession planning

Those SMPs that engage in services to support their SME clients when buying and/or selling businesses will see common themes in <IR> to those seen in an information or sales memorandum. And perhaps very occasionally in a well thought-out business plan or strategy document.

Those SME shareholders and owners that aim to transfer their businesses will know the importance of having a defined strategy that is so much more than one which solely focuses on historic financial information. Business investors (and their funding partners) pay for future profitability and cash generation. Considerations of SME capital that generate future cash necessarily demand more than historic financial information.

Consider the sale of a company. A prospective buyer needs to know the capital base available for trading and expansion (financial capital). It needs to know what tangible assets and production equipment the company has with which it can service future trade (manufactured capital) and what processes and intellectual property can be used and maximised (intellectual capital). Allied to that employee churn and identification of experienced employees and management is often key (human capital) alongside the skills inherent in those employees.

Understanding the key connections that a business has with its customers (longevity of sales contracts and strength of relationship) and suppliers (security of supply chain) gives context to the future ability to trade and the company's relationships with those in its community and markets speak to the protection of its brand and image – all pointing to future sustainability and maintenance and growth in earnings. The geographical location of the business to the specific assets and resources (power, water, infrastructure, skill hubs) will strengthen further the proposition.

A future buyer or financier needs to understand the business outside of the historic financial information. <IR> offers such a framework.

The significance of business transfer or succession planning, of itself, should not be underestimated. The ability to transfer businesses to other parties or indeed to properly plan succession to the next generation is an issue of great importance for the EU. This is not a theoretical subject. Businesses that close, cost employees their jobs and cost EU economies GDP and tax revenues.

The <IR> framework could be applied to assist in reducing the incidence of such occurrences in the preparation of a business that is to be sold or transferred and ultimately in satisfying the demands of potential buyers and their financiers in the sale process.

Thinking in an integrated fashion shows that management have given appropriate time and consideration to their strategic direction and have challenged their own ideas and assumptions – that is, they have undertaken appropriate due diligence. Businesses need to have an idea of their strengths and weaknesses because others will critically assess these.

Tendering processes

More and more often government agencies and "not for profit" bodies search for commercial partners that can not only supply the goods and services that government and "not for profit" bodies need, but can do so for the long-term and in a manner that will not risk the service creditability.

Tendering processes often seek to understand the characteristics of the businesses that tender. This may include an appreciation of a business's ethical stance and its corporate social responsibility alongside the somewhat obvious ability to deliver for the entire contract term. Sustainability of supply, financial capital and some knowledge that the business has strong community ties may also play a key role.

New business: Financing requirements / start up

One of the significant features of the UK and EU economies is the dramatic increase in the self-employed businesses and micro businesses start-ups. The main source of funding for these entities is their own savings and funds from the three 'fs' – friends, family and fools. It is estimated that 170bn euros[2] are invested by the three 'fs' annually within the EU region. This sum is many times greater than what is invested by business angels, venture capitalists and banks in these entities. But a critical issue is that the three 'fs' will want information before they invest. No past financials will be available so the reliance will be on other information including:

- Being able to demonstrate the particular skills and knowledge in which the business has invested.
- The past and future deployment of capital.
- A holistic strategy and rounded business plan.

These information needs reflect <IR> thinking!

Existing business: Satisfying external stakeholder needs

One of the features of many SMEs today is that they operate in the service sector. It is estimated that 90 % of SMEs in the UK operate in this sector and are mainly knowledge based businesses. That is, income is generated from the knowledge and skills of the owner and employees rather than machines and other similar tangible assets. A particular feature of a conventional financial report is that it is impossible or difficult to fully understand the business model and specifically how the companies generate income and their financial value.

In cases where there are external stakeholders' just receiving annual financial reports these reports are unlikely to tell them much about the current state of the business and its future. Information is required that is much more informative about the owner and employees and the ability of the entity to operate in the market if these stakeholders are to stay on board or if they are to further invest in the business.

About EFAA and its role

The European Federation of Accountants and Auditors for SMEs ("EFAA") represents accountants and auditors providing professional services primarily to small and medium-sized entities ("SMEs") both within the European Union and Europe as a whole. Constituents are mainly small practitioners ("SMPs"), including a significant number of sole practitioners. EFAA's members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, tax and business advice) to SMEs.

EFAA considers it relevant and timely to engage in the debate on <IR> and offer a discussion platform to other interested stakeholders.

We are well placed to offer and increase cooperation with such stakeholders, including the IIRC, and to provide insight on how <IR> can be used within the SME and SMP sphere and to help inform the future development of best practice of such entities in respect of <IR>.

[1] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:182:0019:0076:EN:PDF

[2] afme Finance for Europe, Bridging the growth gap Investor views on European and US capital markets and how they drive investment and economic growth

ABOUT THE AUTHORS

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