

## Accounting for smaller businesses

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The [Financial Reporting Standard for Smaller Enterprises](#) (the FRSSE) has been a part of small corporate life for almost a decade. Despite this it remains as irrelevant to the reporting needs of the enterprises to which it applies as it was on the day it was introduced.

The fundamental flaw in the FRSSE is easy to spot. The ASB introduced it in response to criticism that more and more accounting standards were being introduced which were of little apparent relevance to smaller incorporated businesses. The consequence was that accounting bodies were imposing at least as much red tape on the accounts of the SME as anything that the government managed to produce. But instead of looking for a real solution by examining just what the sector needed they did instead decide what bits of the reporting standards for large entities they could do without, and the left over rump they entitled the FRSSE.

From the outset this doomed the FRSSE. This approach was bound not to meet the needs of the user of the accounts of smaller entities, simply because they are not the same as those of the user of accounts of large entities, just cut down a bit. Let's be clear why:

1) The accounts of larger entities are produced for shareholders who are not involved in the management and control of those enterprises. The primary users of the accounts of small entities almost always have involvement in the management and control of the reporting entity and so know its affairs intimately.

2) The secondary users of the accounts of larger entities have some satisfaction in knowing that those companies stand or fall on their own merits, and using their own capital. The accounts are, in themselves, a complete story. This is not true of the secondary user of the accounts of a smaller entity (banks, employees, the Inland Revenue, suppliers etc). The smaller entity is clearly not independent of those who own and control it, whatever the legal theory might be. Accordingly they need to know different things about it.

3) Larger entities have the support of in house professional accountants, external auditors and other advisors to ensure that the most complex of accounting rules can be properly applied to its affairs. This is untrue of smaller entities, and is increasingly so as the withdrawal of the audit requirement has advanced apace. What is obvious is that many of those who are now preparing the accounts for smaller entities have no such experience at all.

4) The large entity is incorporated. This is not true of the majority of smaller entities. This was not worrying until it became mandatory in tax law that all accounts be prepared in accordance with accepted accounting standards. This does in effect mean that the FRSSE applies to the accounts of all small enterprises, whether they are incorporated or not. The FRSSE simply fails to recognise this and does not as a result provide appropriate advice on key issues for smaller entities such as the consequence of VAT registration, use of special VAT schemes, partnership and sole trader drawings, the capital account of partnerships and whether or not a balance sheet is even required (despite which, and quite contrary to the FRSSE's expectation, most do not have them).

There is no argument for retaining the anachronistic FRSSE now. The change in audit regulation alone means that the time has come when there must be a set of simple, definitive rules for the accounting for smaller entities that must be followed if a true and fair view has to be presented by the accounts of the reporting entity. Either the profession rises to this challenge or someone else has to.

What is needed? I don't want to be definitive at this stage. I would rather start a debate. But let me suggest the following:

1) The accruals method has to be adopted in all cases, but must be subject to definition as to its meaning within the FRSSE.

2) All incorporated entities (including LLPs) will produce a balance sheet, as will all unincorporated entities turning over more than £150,000 per annum (a limit quite acceptable to the Inland Revenue for a long time now, although they've never publicly said so).

3) The accruals method shall apply to all sales and purchases of the entity and as such trade debtors and creditors must be reported if a balance sheet is prepared, and be noted if not.

4) Accruals and prepayments are immaterial to almost all small reporting entities and as such need only be included in the accounts at the discretion of the reporting entity, but if reported once must be consistently reported thereafter and if one is included, so must the other be also.

5) Stock will be valued at the lower of cost and net realisable value. In the case of work in progress this is material and labour costs, but on no occasion is overhead attribution

needed. Long-term work in progress is treated in the same way as other stock with sales on account being treated as revenue earned.

6) Fixed assets will be stated at their cost and will be written off on the straight-line basis over pre-ordained periods e.g. cars 4 years, IT 3 years, furniture and fittings 6 years. No consideration need be taken of residual values.

7) Leased assets will always be treated as being operating leases.

8) The entity will have a duty to report more information as to the trading that it undertakes since such information might otherwise be very hard to obtain. This might include:

- *details of the address of its trading premises*
- *a description of the trade undertaken and the types of commodity and service supplied*
- *the name of any web site run by the entity*
- *the names of those on whom the entity relies for any source of financial support*
- *the names and addresses of the holders of more than 5% of the entity (which has, anyway, to be reported in the annual return of a company and LLP)*
- *in the event that it employs more than 20 people who do not participate in ownership it should publish the average number of employees in a year and the aggregate remuneration paid to those people. What the owners pay themselves is not of relevance.*

9) If a balance sheet is published so will a statement of source and application of funds be published (remember them - SSAP 10 data was quite useful in a way that current cash flows aren't, to anyone).

10) If the entity is not incorporated and has a balance sheet it will publish a note showing movements on capital accounts, broken down by participator and with capital injections and drawings separately identified, but with expense reimbursements for these purposes being a negative drawing.

11) Specific VAT accounting rules will be published for the various schemes available for small entities.

Does all this make sense? I hope so, although equally I'd welcome input and comment as to what a new FRSSE should say. What I do guarantee is this:

- *these rules would be much easier to apply than the existing FRSSE*

- *they would save significant accounting burdens*
- *they would stop many pointless Inland Revenue enquiries*
- *they would be easier to build into automated reporting systems than the existing FRSSE*
- *the end accounts would make more sense to more people*
- *they would be easier to explain to the lay person*
- *they would greatly increase the chance of fair comparison being made between different entities.*

If those objectives are achieved this has to be worthwhile taking forward. As such I hope others will join this debate.

Note: A version of this article first appeared in 2005. Accounting issues that have arisen since then have only served to make these issues more pressing.