EUROPEAN COMMISSION
ENTERPRISE AND INDUSTRY DIRECTORATE-GENERAL

Promotion of SMEs' competitiveness

FINAL REPORT OF THE EXPERT GROUP

ACCOUNTING SYSTEMS FOR SMALL ENTERPRISES

- RECOMMENDATIONS AND GOOD PRACTICES

November 2008

Legal Notice

This project has been conducted by the European Commission and experts in the field of accounting appointed by the national authorities, under the Multiannual Programme for Enterprise and Entrepreneurship coordinated by the European Commission's Directorate-General for Enterprise and Industry.

Although the work has been carried out under the guidance of Commission officials and by experts nominated by the Member States, the views expressed in this document do not necessarily represent the opinion of the European Commission or the Member States.

Further information:

European Commission
Directorate-General for Enterprise and Industry
Unit E.3: Crafts, small businesses, cooperatives and mutuals
Fax: +32-2-299.81.10
E-mail: Entr-Craft-Small-Business@ec.europa.eu

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Information on other projects jointly carried out by the European Commission and by the national administrations that are addressing the issues of promoting entrepreneurship can be found on the web, at the following address:
http://ec.europa.eu/enterprise/entrepreneurship/support_measures/

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EXECUTIVE SUMMARY

There were around 20 million enterprises in the non-financial business economy across the EU-27 in 2005; of these enterprises 99.8% were SMEs, the majority of which were micro enterprises. It is recognised that an SME-friendly business environment (e.g. in the Small Business Act), both at Community level and in the Member States, is crucial for growth and jobs in Europe. In some key industries, such as textiles, wood products, metal products, publishing, construction and furniture-making, they account for more than 70% of all jobs.

It is recognised that appropriate accounting information is important for a successful management of a business whether it is large or small. At EU level, accounting legislation is in place for listed companies, i.e. the International Accounting Standards/International Financial Reporting Standards and for non-listed limited liability companies, the Fourth and the Seventh Directives i.e. the Accounting Directives. However, at EU level there is no accounting legislation applicable to those enterprises which are not listed or are not limited liability companies; in most cases we would be referring to small enterprises. Because of the importance of appropriate accounting information for owners and managers of small enterprises and their different stakeholders, it was considered important to have a project to analyse the various accounting systems applied in Member States in the case of non-regulation at EU level.

The objective of this project is to come forward with views on how to improve the accounting systems of small enterprises so that they can provide the owners, managers and other stakeholders with appropriate financial information. This can be achieved through the identification and exchange of views in the area of accounting systems of small enterprises in Member States. The purpose is in no way to add regulation or administrative burdens at EU or national level, which would be contrary to the aim of simplifying the business environment for small enterprises and reducing administrative burdens; therefore proposals to change the accounting legislation at EU level are beyond the scope of this project.

In defining the scope of the project, it was considered helpful to use a three layer model of existing accounting legislation at EU level. The small enterprises which are in focus in this project were defined to belong to the third layer i.e. sole proprietorships/traders and partnerships with unlimited liability.

On the basis of collected data from Member States on applied accounting systems in small enterprises, the experts of national administrations and the business organisations came forward with the following good practices for the accounting systems which may be considered appropriate for small enterprises according to their particular circumstances and needs. However it is recognised that not all of these practices will assist all businesses, e.g. firms that operate on a simpler business model may find only some of them useful, so that selection will have to be made on a case by case basis:

- Keeping the most important financial records such as the sales day book, purchases day book, cash receipt book, cheque payments book, petty cash book, general journal, nominal ledger, debtors' ledger and creditors' ledger and a payroll system. This improves the accuracy and reliability of the accounting transactions which further provide the input to the financial statements for small enterprises;

- Doing double-entry bookkeeping, because it offers a much better control of the transactions being recorded properly;

- Using simplified formats for financial statements i.e. the balance sheet and the income statement presenting only the main headings;

- Preparing projected cash flow statements on a regular basis;

- Applying accrual basis accounting, because such an accounting method provides a more accurate and complete picture of the enterprise's financial position, performance and changes in its financial position than cash basis accounting;

- Applying the matching principle, because of the importance that revenues are matched with expenses to provide a truthful view of the enterprise's financial performance;

- Applying the true and fair view principle, because it is very important to ensure that accounting information is presented accurately and consistently;

- Using a standardised chart of accounts, because it removes some barriers when changing an accounting software package, but also because it facilitates the introduction of taxonomy to supply financial information, and

- Applying the ”only once” principle meaning an administrative simplification in the supplying of financial information to different or the same authorities for different or the same purposes (e.g. taxation, statistics, Basel II, banks);

1. INTRODUCTION

1.1. Background

Small and medium-sized enterprises (SMEs)[1] – enterprises with fewer than 250 employees, with annual turnover of less than €50 million, and independent of larger enterprises – make up the backbone of the European economy. In 2005 across the EU-27, there were around 20 million enterprises in the non-financial business economy; of these enterprises 99.8% were SMEs, the majority of which were micro enterprises.[2] SMEs accounted for 67.1% of the EU-27 non-financial business economy workforce. It has been recognised that an SME-friendly business environment, both at Community level and in the Member States, is crucial for growth and jobs in Europe. In some key industries, such as textiles, wood products, metal products, publishing, construction and furniture-making, they account for more than 70% of all jobs.

One of the most common complaints by businesses and their organisations is the amount and complexity of the various regulatory and administrative obligations that have to be observed by enterprises. SMEs suffer disproportionately from the regulatory burden compared to larger companies, since the smaller enterprises often do not have sufficient financial and human resources to manage their obligations in the most efficient way. In general, small business managers should be able to manage their accounts themselves. However, they may prefer to outsource their accounting for a number of reasons.

Normally statutory accounts of small enterprises are not considered to be particularly useful for managing the enterprise, but the majority of directors receive management advice or further analysis at the same time. Many small enterprises have a computerised or partly computerised accounting system and this is positively associated with the frequency or availability of management information.[3]

There is a strong emphasis on controlling cash and monitoring performance in the context of maintaining relationships with the bank. The most widely used and most useful sources of financial information are cash flow information in various forms and the monthly/quarterly management accounts.[4]

The European Union and its Member States have agreed the Charter for Small Enterprises[5] to improve the business environment for small enterprises. By

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1 Commission recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, Official Journal of the European Union L124/36, 20.5.2003. Further information at: http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm

2 http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-08-031/EN/KS-SF-08-031-EN.PDF

3 How owner-managers use accounts, Jill Collis & Robin Jarvis (ICAEW, 2000)

4 Financial information and the management of small private companies, Jill Collis and Robin Jarvis (Journal of Small Business and Enterprise Development, 2002)

5 The European Charter for Small Enterprises, Santa Maria da Feira, 19-20 June 2000. Available online at: http://ec.europa.eu/enterprise/enterprise_policy/charter/docs/charter_en.pdf

encouraging public authorities at all levels to share experiences of their work on policies in this area, each can learn from examples which have worked for others and so speed up improvements of their own. The participating countries have committed themselves to better legislation and regulation to simplifying national and EU rules and to reducing administrative burdens wherever possible.

A Communication from the Commission on a Small Business Act (SBA) was adopted by the Commission on 25 June 2008[6]. The Commission proposed some guiding principles that need to be complemented by a comprehensive set of concrete actions which address all remaining problems that SMEs face throughout their life-cycle. As part of the Community Lisbon Programme, the Commission will implement a number of new initiatives. In parallel, the Commission invites the Member States to take any necessary measures to achieve the objectives.

The importance of accounting as a source of information for owners and managers of small enterprises and their different stakeholders is obvious. In the EU, we have accounting legislation in place for different kind of companies. As regards listed companies in the EU, we have the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) as adopted by the EU (IAS Regulation (EC) N° 1606/2002)[7]. Concerning limited liability companies, we have at EU level the Fourth Directive (78/660/EEC)[8] and the Seventh Directive (83/349/EEC)[9] which are to be transposed by Member States into their national accounting legislation to become local GAAP (General Accepted Accounting Principles). However, there is no accounting legislation in force at EU level for those enterprises which are not covered by the IAS Regulation and the Fourth and Seventh Directives, therefore it was considered important to have a project to analyse the various accounting systems applied in Member States in the case of non-regulation at EU level.

1.2. Aim and method of the project

In recent years, accounting issues have become more and more important in the business world. IAS/IFRS are aimed to provide the international capital markets with very detailed and sophisticated information on the performance of mainly large corporations. Besides this, there are also some other projects in the international accounting area to produce accounting standards for SMEs.

6 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions "Think Small First" COM(2008) 394 of 19 June 2008, http://ec.europa.eu/enterprise/entrepreneurship/sba_en.htm

7 IAS Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/l_243/l_24320020911en00010004.pdf

8 http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1978/L/01978L0660-20040501-en.pdf

9 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31983L0349:EN:HTML

The Accounting Directives (i.e. the Fourth and Seventh Directives) are intended mainly for limited liability companies. Although this group is an important one in the EU, the biggest group of enterprises are still the SMEs which in many cases are not part of any accounting legislation at EU level. As a consequence of this fact, a large number of Member States have developed their own national accounting legislation (local GAAP) for those enterprises (see Annex 3). This has resulted in a diversified accounting legislation for small enterprises such as sole proprietorships and partnerships with unlimited liability.
For small enterprises, which often do not have a separate cost accounting or managerial accounting, the financial statements and records can provide some information for owners and managers. It is often stated that business decisions need to be supported by good quality financial information which needs to be relevant, user-friendly and available in a timely manner. Where appropriate, accounting should be an active steering tool to run and manage a business instead of representing another administrative burden that the small enterprise has to comply with.
It is important that the accounting systems for small enterprises should fulfil such functions as providing essential financial information for their owners and managers in order for them to be able to manage their businesses in a competitive environment and to make informed decisions to prevent business failure and to expand the business. However, small enterprises and their management may have particular needs and conditions, so that accounting systems need to be flexible in order not to impose unnecessary administrative burdens.

Also small enterprises may have to comply with many different commercial and fiscal laws, information requirements for statistical purposes and Basel II etc. depending on the jurisdiction they are operating in. Apart from that, small enterprises may best decide for themselves which accounting systems are most suitable for their particular circumstances and the business environment they are operating in.

This project follows the open method of coordination in the field of enterprise policy. Its purpose is to identify good practices in accounting for small enterprises and to focus high-level political attention on key issues, agreed with experts of national administrations and in consultation with business organisations.

1.3. The result of the project

The objective of this project is to provide views on how to improve the accounting systems of the small enterprises so that they can provide the owners/managers with appropriate financial information. This can be achieved through the identification and exchange of views in the area of accounting systems of small enterprises in Member States. The aim of the project is in no way to add regulation or administrative burdens at EU level but rather to make suggestions to reduce administrative burdens at national level. As a result of the project, descriptions of accounting systems, guidance and good practices in the accounting area for small enterprises will be delivered; proposals to change the accounting legislation at EU or national level are beyond the scope of this project.

1.4. Definitions and sources of information

For the purpose of this report, we do not define different concepts as e.g. accounting systems, etc. These concepts are already well established in the literature and elsewhere and do not need further explanations.

However, the following definitions were considered necessary for this project:

Enterprise: An enterprise is considered to be any entity engaged in an economic activity, irrespective of its legal form. This includes in particular self-employed persons and family businesses engaged in craft or other activities and partnerships or associations regularly engaged in an economic activity.

Financial statements: Financial statements are concerned with classifying, measuring and recording the transactions of a business. At the end of an accounting period it is useful to prepare the following financial statements to show the performance and position of the business: a profit and loss account[10], a balance sheet[11], notes to the accounts and cash flow statements.

Financial records: All documentation and books used during the preparation of financial statements e.g. the sales day book, purchases day book, cash receipt book, petty cash book, general journal and debtors' ledger.

SMEs are generally defined in Commission recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.[12] For accounting purposes the definitions of small and medium-sized entities are laid down in the Fourth Directive (78/660/EEC); small entities in Article 11 and medium-sized entities in Article 27.

The main sources of information in this report are the expert group, business organisations and other official publications mentioned in the footnotes of the report.

2. SCOPE OF THE PROJECT

Within the scope of the project are those enterprises whose accounting legislation is not regulated at EU level, i.e. non-regulated enterprises such as sole proprietorships/traders and partnerships with unlimited liability. At national level, some Member States have regulated the accounting for these enterprises, while other Member States have not. The aim of the project is not to add accounting regulation neither at Member State nor at EU level but to contribute good practices to the improvement of the accounting systems of small enterprises at national level.

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[10] Also known as an income statement in some countries

[11] Also known as statement of financial position in some countries

[12] Official Journal of the European Union L124/36, 20.5.2003. Further information at: http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm

Auditing issues are not part of the project.
In determining the scope of this project, it was considered helpful to categorise the accounting legislation at EU level in force using a three layer model which determines the accounting requirements for different kind of companies/enterprises. This model makes no attempt to be complete, but provides a general overview of the situation concerning accounting legislation at EU level (N.B. all aspects of the legal situation are not included in the model).

2.1. First layer

The first layer consists of **the listed companies in the EU** falling under the scope of the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) as adopted by the EU (IAS Regulation (EC) N° 1606/2002)[13] for their consolidated accounts. When drawing up the annual accounts, the listed companies have to apply local GAAP unless Member States have used the option to also extend IFRS to annual accounts. In some Member States the scope of the IAS Regulation has been extended by using available options to also include other companies than listed ones e.g. banks and insurance companies. [14]

2.2. Second layer

The second layer consists of **the limited liability companies** falling under the scope of the Fourth Directive (78/660/EEC)[15] and the Seventh Directive (83/349/EEC)[16], the so called Accounting Directives, as transposed by Member States into their national accounting legislation to become local GAAP (General Accepted Accounting Principles). It is important to note that the use of IFRS by some companies can largely take them out of the scope of the Fourth and Seventh Directives.

2.3. Third layer

The third layer consists of **the residual of enterprises which are not covered by the EU accounting legislation in the first and second layers**. **This residual group of enterprises is a part of the scope of this project**. Some Member States have at their own initiative transposed the Fourth and Seventh Directives to include some of the enterprises in this layer. However, at EU level these enterprises are not regulated. The sizes and the legal forms of enterprises included in the third layer are not exactly specified.

For this project it is important to note that we have narrowed down the target group to be only the small enterprises (including the micro enterprises) within the third layer. More specifically we focus on sole proprietorships/traders and partnerships with unlimited liability. In the definition of the size of a small

[13] IAS Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards http://eur-lex.europa.eu/LexUriServ/site/en/oj/2002/l_243/l_24320020911en00010004.pdf

[14] http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf

[15] http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1978/L/01978L0660-20040501-en.pdf

[16] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31983L0349:EN:HTML

enterprise, we have used the thresholds as laid down in Article 11 of the Fourth Directive (78/660/EEC)[17], because it is used for accounting purposes:

Article 11

"The Member States may permit companies which on their balance sheet date do not exceed the limits of two of the three following criteria:

- balance sheet total: EUR 4 400 000

- net turnover: EUR 8 800 000

- average number of employees during the financial year: 50"

Hereafter "small enterprise" will be used according to this definition.

The Commission recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises is not used for accounting purposes and therefore not used in this project.

Annex 1 gives an overview per Member State of the legal forms of the small enterprises that fall within the scope of this project and whether thresholds are used for this category in Member States. In addition, information is provided on whether the scope of the Accounting Directives has been extended by Member States on their own initiative to also include other companies/enterprises than those that are within the scope of the Accounting Directives.

3. USERS AND THEIR NEED FOR FINANCIAL STATEMENTS

Since the enterprises in the target group of this project are all sizes of enterprises according to the defined thresholds in Article 11 of the Fourth Directive (78/660/EEC), the users and their needs might be quite different. Therefore, each enterprise needs to decide who the main users are and what their needs are. Annex 2 provides a summary per Member State of the users of financial statements and their needs. On the basis of data provided, the following possible users and their needs were described for small enterprises, subject to the particular circumstances of each enterprise:

3.1. Users

The objective of financial statements is to help develop the business by providing useful information to users. Therefore the financial statements should be designed to reflect users' needs. The principal users of financial statements within the scope determined may be:

- Business owners/investors
- Management
- Governments and its agencies
- Banks and other creditors
- Customers/suppliers
- Employees

17 As amended by Directive 2006/46/EC of the European Parliament and the Council of 14 June 2006

3.2. Needs

The most likely needs of these users may be:

Business owners/investors

- To evaluate how the enterprise is performing
- To assess the risk in the business and whether to keep, buy (i.e. invest more) or sell the enterprise
- To determine whether profits can be distributed

Management

- To evaluate how the enterprise is performing
- To manage cash flow, collect money due from debtors etc.
- To find out possible financing needs
- To use the financial information for planning, forecasts etc.
- To propose to the owners the portion of profits to retain and distribute
- To propose to the owner a change in the range of products or business activities

Governments and their agencies

- Tax authorities need information to assess the taxation
- Statisticians need information for statistical purposes

Banks and other creditors

- To assess risk in the credit decisions
- To evaluate how the enterprise is performing

Customers/suppliers

- To assess whether to enter into and/or continue a business relationship with the enterprise

Employees

- To assess whether to enter into and/or continue employment with the enterprise

4. ACCOUNTING SYSTEMS

In small enterprises there can be different kinds of accounting systems such as external, internal and tax accounting. Annex 3 summarises data per Member State concerning accounting system requirements for small enterprises. On the basis of this data, the following descriptions of accounting systems are given:

4.1. Internal accounting

Internal accounting, also called management accounting is based on the enterprise's internal accounting procedures and recorded accounting information. Internal accounting is intended for managers within organizations, to provide them with the economic basis to make informed business decisions that would allow them to be better equipped in their management and control functions. For example, managers may want to be able to assess the contribution or the profitability of different products or services that they supply by comparing the revenues and costs that they generate. Unlike external accounting information, internal accounting is usually confidential and it is accessible only to the management. In most cases, small enterprises do not use internal accounting at all due to their size. Internal accounting is normally not governed by national legislation. However, in some Member States internal accounting is compulsory even for small enterprises.

4.2. External accounting

External accounting, also called financial accounting is concerned with the preparation of financial statements for decision makers, such as the owners, suppliers, banks, governments and its agencies, customers and other stakeholders outside the enterprise. Regarding formats for financial statements see chapter 7. External accounting makes use of the accounting information from the internal accounting system. In the preparation of the external accounting, the small enterprise may be governed by local GAAP. Some Member States have introduced external accounting rules for small enterprises, while others have no accounting rules in place and leave it to the enterprises themselves to decide which accounting systems they consider to be appropriate for their particular circumstances and business environment.

4.3. Tax accounting

Tax accounting is normally based on the external/financial accounting system. There may be differences between the profits for tax purposes and the profits per the accounts. Tax authorities often ask for additional adjustments to be made to the profits per the accounts and these are captured in a "tax computation". Some examples of adjustments which are quite common between profits per accounts and tax profits:

- Depreciation differences
- Accruals
- Expenses which are disallowed for tax purposes
- Non-taxable income

In some Member States, taxation is carried out on a cash basis accounting system, in which case further adjustments (when the enterprise uses accrual basis accounting) like accruals, unrealised income and unrealised expenses are to be made to the enterprise's results before the tax computation.

5. ACCOUNTING FRAMEWORK

The accounting framework lays down the concepts and principles that are the basis for preparing and presenting the external financial statements of an enterprise. These principles may not necessarily be applicable in all Member States to all enterprises all the time because of e.g. the size of the enterprise or different user's needs. Therefore, each enterprise needs to decide which principles it considers most important and applicable to its particular circumstances and business environment.

The principles presented below are not ranked in order of importance but are classified as either accounting principles or principles for drawing up external financial statements. Many of the principles described below are based on the Fourth Directive (78/660/EEC) because these are often already used by businesses that are strictly outside the scope of the Fourth Directive as well as those within the scope of the Fourth Directive. Annex 4 provides an overview per Member State on what kind of accounting framework is applied to small enterprises. On the basis of this information, the following principles and concepts are described for an accounting framework for a small enterprise, although we note that not all small enterprises in all Member States will want to apply all the principles:

5.1. Accounting principles

5.1.1. Cash basis accounting

In cases when an enterprise is a micro or even a very small enterprise, it might be more appropriate to use cash basis accounting. In this case the accounting and the resulting financial statements are prepared on a cash basis. A cash basis means that a cost or an income is accounted at the equivalent amount of cash paid or received for it. Some Member States use cash basis accounting for taxation of small enterprises and some Member States consider it sufficient for external accounting of micro enterprises in their local GAAP.

5.1.2. Accrual basis accounting

Often the financial statements are prepared on an accrual basis. Under the accrual basis accounting, income and expenses are recognized as follows:

- Income recognition: Income is recognized when both of the following conditions are met:

  a. *Income is earned*. Income is earned when products are delivered or services are provided, i.e. you recognise income when it is earned, not when you receive the money.

  b. *Income is realised or realisable*. Realised means cash is received. Realisable means it is reasonable to expect that cash will be received in the future.

- Expense recognition: Expense is recognized in the period in which the related product or service has been obtained.

5.1.3. The matching principle

In some Member States the expenses are matched with revenues. When expenses are matched with income, they are not recognized until the associated income is also recognized. For instance, wages paid to manufacturing workers are not recognized as expenses until the actual products are sold. When the products are sold, the expenses are recognized as part of the cost of goods sold. If no connection with revenue can be established, cost can be charged as expenses to the current period (e.g. office salaries and other administrative expenses). This principle allows greater evaluation of actual profitability and performance (shows how much was spent to earn revenue). Depreciation is another example of the matching principle: the cost of purchasing a fixed asset is spread over the period in which it is expected to generate revenue. See also the chapter on "Accrual basis accounting".

5.1.4. Materiality concept

In accounting, the concept of materiality is a characteristic of information which helps to optimize the information presented in the financial statements. Materiality states that if information is of such magnitude that it has no influence on the user's judgment and decision-making, it can be left out.

5.2. Principles for external financial statements

For many businesses the principles outlined in 5.1 above may also lead to these additional principles:

5.2.1. The true and fair view principle

The financial statements provide a true and fair view of the enterprise's assets, liabilities, financial position and income and expenses. To support the application of the true and fair view, accounting has adopted certain concepts and principles which help to ensure that accounting information is presented accurately and consistently.

5.2.2. The going concern principle

Financial statements are prepared on the assumption that the entity is a going concern, meaning it will continue in operation for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of operations.

5.2.3. The prudence principle

The principle of prudence requires that:

- Only profits made (realised) at the balance sheet date are included
- All liabilities of the financial year are included; even if the liabilities become apparent after the financial year but before the date the balance sheet is drawn up

5.2.4. The opening balance principle

The opening balance sheet for each financial year shall correspond to the closing balance sheet of the preceding financial year.

5.2.5. The consistency principle

The methods of valuation and presentation are applied consistently from one financial year to another. The principle can also be defined as conformity to enforced rules and laws.

5.2.6. *The separate valuation principle*

Asset and liability components are valued separately; i.e. netting is generally prohibited. One should show the full details of the financial information and not seek to net off a liability with an asset, an income with an expense, etc.

6. RECORDING OF ACCOUNTING TRANSACTIONS

The accounting transactions of an enterprise need to be recorded in the accounting books. Some form of recording will be essential to all businesses for the day-to-day management of their operations and the fulfilment of unavoidable governmental obligations (e.g. taxation). It is well known that inadequate record keeping is frequently associated with failures in small businesses even if it is not actually the direct cause of failure. For record keeping purposes the enterprise can use different methods. Annex 5 summarises per Member State some information on the recording of accounting transactions. On the basis of this information, the following main methods are described:

6.1. Financial records

Financial records are e.g. the sales day book, purchases day book, cash receipt book, cheque payments book, petty cash book, general journal, nominal ledger, debtors' ledger and creditors' ledger. Quite often a separate payroll system is maintained and payroll transactions are summarised through general journals. However, all enterprises do not necessarily need all the above mentioned financial records; the enterprise has to decide this on the basis of its needs. When the enterprise makes the judgement of what financial records to maintain it also needs to take into account whether some financial records are compulsory in the particular Member State. Annexes 6 - 9 contain some examples on financial records.

6.2. Double-entry bookkeeping

Double-entry bookkeeping is used in many Member States. In double-entry bookkeeping, there are always two entries required for every transaction recorded. This is because any change in one account automatically results in a change in another account. Both changes must be recorded. The means by which these are recorded is by way of debit and credit entries. In double-entry bookkeeping, accounting for each transaction means that the total debit amount must equal the total credit amount i.e. they must balance and at any time be equal. However, in some cases a single-entry bookkeeping is justified when the enterprise is a micro and the transactions are not that many or complex.

6.3. Chart of accounts

Some Member States have imposed a standardised chart of accounts for the recording of accounting transactions. A standardised chart of accounts may facilitate the collecting of accounting information, but it can also be an inflexible system not taking into account different needs of users. Today many accounting software packages, which are used by small enterprises, are using different sets of charts of accounts which may create a barrier for an enterprise to change from one software package to another one. A uniform chart of accounts together with a uniform content of record items is also a good basis to compare financial information between enterprises.

7. COMPONENTS OF FINANCIAL STATEMENTS

7.1. Objectives

The objective of financial statements is to deliver information about an enterprise's financial position, performance and changes in its financial position. The information for the financial statements is taken from the financial records. Normally the financial statements cannot deliver all relevant information for the users, because the statements reflect historical data and non-financial information is not always given. Small enterprises may use simplified financial statements that are based on Articles 9, 23 and 25 of the Fourth Directive (78/660/EEC). Within the national framework, the small enterprise has to decide on the basis of its needs if and which financial statements are suitable for its particular situation. Annexes 10 – 12 contain some examples on simplified financial statements.

7.2. Profit and loss account by nature

If a small enterprise is e.g. in the construction sector, it might choose to apply a simplified profit and loss account classified according to the nature of charges. This profit and loss account might contain the following headings:

Net turnover

Change in stocks

Other operating income

Raw materials

Other charges

Staff costs

Other operating charges

Depreciation, amortisation

Financing costs

Extraordinary income and charges

Corporate/income tax

Profit or loss for the financial year

7.3. Profit and loss account by function

As an alternative a small enterprise might choose a simplified profit and loss account classified according to the function of charges. When the small business is e.g. in the trading sector it might choose this format. The profit and loss account might contain the following headings:

Net turnover

Cost of sales

Gross profit or loss

Distribution costs
Administrative expenses
Other operating income
Depreciation, amortisation
Financing costs
Extraordinary income and charges
Corporate/income tax
Profit or loss for the financial year

7.4. Balance sheet

A simplified balance sheet might contain the following headings:

ASSETS

Fixed assets

Intangible assets
Tangible assets
Financial assets
Other non current assets

Current assets

Stocks
Work in progress
Sales receivables
Other debtors
Investments

Cash

Total assets

LIABILITIES

Owners' capital and reserves

Owners' capital

Reserves

Profit or loss brought forward

Profit or loss for the financial year

Provisions

Non current liabilities[18]

Bank loans

Current liabilities

Accounts payable

Other creditors

Short term bank loans

Other short term liabilities

Accruals

Total liabilities

7.5. Cash flow statement

Managing cash flows well is considered very important for a successful business. Small enterprises can often face difficulties to access finance for their working capital and therefore the projection of cash flows becomes an important factor in the daily operation of the business. The accounting systems play an important role when the cash projections are drawn up, since the information base is normally the accounting systems, which therefore have to be reliable.

7.6. Other financial statements

Other financial statements that are used by some small enterprises are e.g. notes on the accounts of the financial statements. However, extensive notes on the accounts are not common among small enterprises.

8. Good Practices

Considering the described accounting systems from the point of view of small enterprises in chapters 3-7 in this report, the following good practices are provided for the improvement of the accounting systems for small enterprises. The aim is not to add to regulation or administrative burdens. The "Think Small First" principle has been considered when identifying the good practices. It should be noted that these good practices are in no way intended to encroach upon the sovereignty of Member States in accounting matters.

8.1. Users and their needs

For small enterprises it is especially burdensome to supply financial information to many different users/stakeholders, therefore administrative simplification in the

[18] Non current liabilities are sometimes known as long term liabilities

supplying of financial information to different or the same authorities for different or the same purposes (e.g. taxation, statistics, Basel II, banks) should be implemented as far as possible, meaning that the information should be supplied only once i.e. the “only-once principle”. Therefore Member States are encouraged to promote the use of e-government portals. For this purpose there are already some tools/taxonomy[19] e.g. XBRL (e**X**tensible **B**usiness **R**eporting **L**anguage[20]) available in the market.

Applying the “only-once principle” in accounting issues means that:

1. During one and the same accounting period, enterprises do not have to provide the same financial information to the Member State or to its various bodies more then once;

2. Without prejudice to any necessary updating, enterprises are not obliged to provide the Member State with information that is already received by any other route and that

Some Member States have projects to implement on-line financial reporting for small enterprises using the XBRL as a basis as a user friendly format.

8.2. Accounting framework

As large and small enterprises operate in quite different ways, it is not possible to apply the same accounting framework for all enterprises. A small enterprise is not simply a smaller version of a large enterprise. Considering this circumstance, only the most important accounting concepts and principles are listed here as good practices, which small enterprises should take into consideration when deciding on appropriate accounting systems.

8.2.1. Accrual basis accounting

The bookkeeping is recommended to be prepared on an accrual basis. Accrual basis accounting provides a more accurate and complete picture of the enterprise’s financial position, performance and changes in its financial position than cash basis accounting.

8.2.2. The matching principle

It may be helpful to use the matching principle in bookkeeping, because of the importance that revenues are matched with expenses to provide a truthful view of the enterprise’s financial performance.

8.2.3. The true and fair view principle

The financial statements should present a true and fair view of the enterprise’s assets, liabilities, financial position and income and expenses. The application of this principle is very important to ensure that accounting information is presented accurately and consistently. Other principles follow from this principle.

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[19] A taxonomy is a standard description and classification system for the contents of reports

[20] **XBRL** is an open standard for composing electronic reports and data exchange by means of the internet, based on XML (eXtensible Markup Language).. It provides benefits in the preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data.

8.3. Recording of accounting transactions

8.3.1. Double-entry bookkeeping

Double-entry bookkeeping may be applied by small enterprises, because the double-entry bookkeeping offers a much better control of the transactions being recorded properly compared to the single-entry bookkeeping system. Double-entry bookkeeping would also increase the quality of the accounting information.

8.3.2. Chart of accounts

Small enterprises normally use standardised accounting software packages for their external and tax accounting. When these software packages are developed, it may be useful that a uniform chart of accounts would be used by the software providers which in turn could facilitate the reporting burdens for the small enterprises (see the "only-once principle") when e-government portals are being developed. A standardised chart of accounts for the recording of accounting transactions could also simplify the life of small enterprises, because it would remove some barriers when changing an accounting software package. A uniform chart of accounts could also be useful in promoting the use of e-government portals (see chapter 8.1).

8.3.3. Financial records

Small enterprises should consider keeping at least the following financial records:

- sales day book
- purchases day book
- cash receipt book
- cheque payments book
- petty cash book
- general journal
- nominal ledger
- debtors' ledger and creditors' ledger and
- a payroll system

The keeping of these financial records would improve the accuracy and reliability of the accounting transactions which further give input to the financial statements for small enterprises, depending on the particular circumstances and its business environment.

8.4. Financial statements

Small enterprises may use simplified formats for financial statements i.e. for the balance sheet and the profit and loss account as presented in chapter 7. Depending on the business environment in which the enterprise operates, it can choose the format of the profit and loss account i.e. by nature or by function. Normally the financial statements would be prepared once a year when the tax declaration has to be provided.

A projected cash flow statement can be very useful for small enterprises because the cash management of a small enterprise is especially important. Cash flow projections are partly based on information from the accounting systems of the enterprise. Cash management becomes especially important in situations when the economy is heading for a downturn.

To help speed up and professionalize negotiating loans, it is useful to agree on binding standards about form and contents of information provided between SME-organizations and banks. Small enterprises and banks gain transparency about the scope and the quality of the information. The bank guarantees a decision within a short period. (e.g. 10 days). The SME-organization may offer support to the small enterprise in the preparation of the records and the negotiations[21].

9. CONCLUSIONS

The accounting systems in place for small enterprises in Member States vary a lot. There are cases when there are no accounting requirements at all and cases where the accounting requirements are relatively strict for small enterprises. However, in practical terms, all small enterprises will need to keep some kind of financial records in order to keep financial control over their businesses. This report summarises the likely accounting systems from the point of view of small enterprises in Member States and identifies some good practices on how to improve the accounting systems for small enterprises.

The objective of this report is to provide views on how to improve the accounting systems so that they can provide the owners/managers of the small enterprises with appropriate financial information. The aim is not to add to regulation but to identify good practices which small enterprises may consider before deciding on an appropriate accounting system. However, these recommendations are in no way intended to encroach upon the sovereignty of Member States in accounting matters.

[21] Initiative of the chambers of skilled crafts with mutual savings banks (Sparkassen) and co-operative banks in Bavaria (Germany) "fast loan for skilled crafts" - http://www.hwkno.de/76,0,627.html

MEMBERS OF THE EXPERT GROUP

Not all experts listed below participated actively in the project and therefore some of the material can be less complete concerning some participating countries.

National experts

Austria

Mr. Mag. Christian Mayer
Wirtschaftsprüfer, Steuerberater
Schwindgasse 7/6A
A-1040 Wien
Phone: +43 1 505 69 96
Fax: +43 1 505 69 96-4
Email: christian.mayer@mayer-wp.at

Mr. Mag. Christoph Zimmel
Gmc-unitreu
Wirtschaftsprüfungs- und Steuerberatungs GmbH
Schwindgasse 7/6
A-1040 Wien
Phone: +43 1 50 604-106
Fax: +43 1 50 604-190
Email: christoph.zimmel@gmc-unitreu.at

Belgium

Mr. Serge Rompteau
Scientific Secretary
Belgian Commission for Accounting Standards
North Gate III, Boulevard du Roi Albert II 16
B-1000 Brussels
Phone: +32 2 277 98 15
Fax: +32 2 277 61 74
Email: serge.rompteau@CNC-CBN.BE

Mr. Jean-Pierre Maes
Chairman
Belgian Commission for Accounting Standards
North Gate III, Boulevard du Roi Albert II 16
B-1000 Brussels
Phone: +32 2 277 61 75
Fax: +32 2 277 61 74
Email: jean-pierre.maes@CNC-CBN.be

Bulgaria

Ms. Cornelia Ilieva
Senior expert SME Development
Bulgarian Small and Medium Enterprise Promotion Agency (BSMEPA)
1, Sveta Nedelya Sq.
BG- 1000 Sofia
Phone: +359 2 932 92 74
Fax: +359 2 932 92 64
Email: c.ilieva@sme.government.bg

Cyprus

Mr. Panikos Tsiailis
Head of tax and legal services
PWC Cyprus
Julia House 3, Themistocles Dervis Street Po
CY-1066 Nicosia
Phone: +357 22 555 000
Fax: +357 22 5550 009
Email: panikos.n.tsiailis@cy.pwc.com

The Czech Republic

Ms. Irena Vavřinová, Ing.
Ministry of Finance
Department of Accounting and Auditing
Letenská 15
CZ-118 10 Prague 1
Phone: +420 257 044 417
Fax: +420 257 044 332
Email: irena.vavrinova@mfcr.cz

Denmark

Mr. Stig Windfeld
Special consultant
Erhvervs- og Selskabsstyrelsen
Kampmannsgade 1
DK-1780 Copenhagen
Phone: +45 3330 7552
Email: stw@eogs.dk

France

Mr. Jean-Charles Boucher
Chartered Accountant and Registered Auditor
Tuillet Associés

160, boulevard Haussmann
F-75088 Paris
Phone: +33 1 40 73 87 87
Fax: +33 1 41 30 02 78
Email: jean-charles.boucher@tuillet.fr

Germany

Mr. Andreas Günther
Federal Ministry of Justice
Division for corporate accounting, disclosure of results, statutory auditing
Mohrenstrasse 37
D-10117 Berlin
Phone: +49 30 18580 9338
Fax: +49 30 18580 9339
Email: guenther-an@bmj.bund.de

Greece

Ms. Eleni Vrentzou (PhD)
Ministry of Economy and Finance
Accounting and Auditing Specialist
5-7 Nikis street
GR-10180 Athens
Phone: +30 210 333 2812
Fax: +30 210 333 2821
Email: vrentzou@mnec.gr

Hungary

Ms. Petra Sipos
Ministry of Finance
Department for Accounting
Josef nandor ter 2-4
H-1051 Budapest
Phone: +36 1 327 5967
Fax: +36 1 327 2500
Email: petra.sipos@pm.gov.hu

Ireland

Ms. Anne Brady
Anne Brady McQuillans DFK
Chartered Accountants and Registered Auditors
Iveagh Court
Harcourt Road
Dublin 2
Phone: +353 1 478 6600

Fax: +353 1 475 0170
Email: abrady@annebrady.ie

Italy

Mr. Arsenio Pica
Dottore Commercialista
Revisore Contabile
Via del Plebiscito 107
I-00186 Rome
Phone: +39 06 6990564
Email: arsenioapica@virgilio.it

Latvia

Ms. Laima Matisone
Head of Division
Rural Support Service Riga
Elizabetes Str. 57a-25
LV-1050 Riga
Phone: +371 70 27 287
Fax: +371 63 57 922
Email: matisone.laima@apollo.lv

Ms. Ruta Teresko
Rural Support Service Riga
Madonas Str. 27-93
LV-1035 Riga
Phone: +371 91 660 009
Email: ruta.t@inbox.lv

Lithuania

Ms. Dalia Pranckenaite
Representative of Association of Lithuanian Accountants and Auditors (LBAA)
Audit Manager
UAB Moore Stephens Vilnius
J. Kubiliaus g. 6-11
LT-082234 Vilnius
Phone: +370 68 682 490
Fax: +370 52 268 5932
Email: dalia@msv.lt

Luxembourg

Mr. Norry Dondelinger
Conseiller de Direction
Chambre des Métiers
2, Circuit de la Foire Internationale
B.P. 1604
L-1016 Luxembourg
Phone: +352 426 767 257
Fax: +352 426 787
Email: norry.dondelinger@cdm.lu

Malta

Mrs. Sharon Zammit
Quality Assurance Unit
Accountancy Board
Small Enterprise Centre,
Marsa Industrial Estate,
Marsa MRS 3000 - Malta
Phone: +356 21228670
Fax: +356 21228671
Email: sharon.zammit@gov.mt

The Netherlands

Mr. Hugo van den Ende
Partner
PricewaterhouseCoopers
PO Box 90357
1006 BJ Amsterdam
Phone: +31 6 53 645 109
Fax: +31 20 568 4501
Email: hugo.van.den.ende@nl.pwc.com

Poland

Mrs. Malgorzata Szewc
Chief Specialist
Ministry of Finance
Ul. Swietokrzyska 12
PL-00-916 Warsaw
Phone: +48 22 694 38 08
Fax: +48 22 694 32 60
Email: malgorzata.szewc@mofnet.gov.pl

Portugal

Mr. Antonio Almeida
Director

IAPMEI
Rua Rodrigo da Fonseca 73
P-1269-158 Lisboa
Phone: +351 21 383 60 60
Email: antonio.almeida@iapmei.pt

Ms. Isabel Cristina Ramos Gonçalves
Member of the Board
Commission de Normalisation Comptable (CNC)
Rua Sotto Mayor n° 16 Esq.
P-8000 Faro
Phone: +351 96 625 19 85
Email: c.jesus@ualg.pt

Romania

Ms. Monica Bizon
Expert
Ministry of Public Finance
Bd. Libertatii, No 12, sector 5
RO-Bucharest
Phone: +40 21 319 9306
Fax: +40 21 311 1886
Email: monica.bizon@mfinante.ro

Slovakia

Ms. Anna Jencova
Euros
Kozmonautov 6
SK-040 12 Kosice
Phone: +421 90 464 7788
Email: ajencova@netkosice.sk

Spain

Mr. Enrique Ortega
Playa del la Lanzada 20
E-Las Rozas 28290
Phone: +34 916 301 725
Email: eortega@padrol.com

United Kingdom

Mr. David Tyrrall
Director Accounting Policy
Department for Business, Enterprise and Regulatory Reform
1, Victoria Street
London, SW1H 0ET
Phone: +44 20 7215 3341
Fax: +44 20 7215 0235

Email: david.tyrrall@berr.gsi.gov.uk

Business organisations

Cooperatives Europe asbl
Mr. Marc Spyker
Square Ambiorix, 32
B-1000 Brussels
Belgium
Phone: +32 (0)2 280 16 09
Fax: +32 (0)2 235 28 69
Email: a.mathis@coopseurope.coop

EFAA (European Federation of Accountants and Auditors for SMEs)
President Mr. Federico Diomeda
Secretary General Ms. Agnieszka Ostaszewicz
Rue Jacques de Lalaing, 4
B-1040 Brussels
Phone: +32 (0)2 736 88 86
Fax: +32 (0)2 736 29 64

Email: info@efaa.com

Eurochambers
Ms. Typhaine Beauperin-Holvoet
Policy Advisor, EU Affairs
Avenue des Arts, 19 A/D
B-1000 Brussels,
Belgium
Phone: +32 2 282 08 80
Fax: +32 2 280 01 91
Email: beauperin@eurochambres.eu

UEAPME (European Association of Craft Small and Medium-sized Enterprises)
Mr. Luc Hendrickx
Director Enterprise Policy and External Relations
Rue Jacques de Lalaingstraat 4
B-1040 Brussels
Belgium
Phone: +32 2 230.75.99
Fax: +32 2 230.78.61
Email l.hendrickx@ueapme.com

ZDH (Zentralverband des Deutschen Handwerks e.V.)
Handwerkskammer Niederbayern·Oberpfalz
Mr. Toni Hinterdobler
CEO of the Chamber of Skilled Crafts of Lower Bavaria and Upper Palatinate
Nikolastraße 10
D-94032 Passau
Germany
Phone: +49 851 53 01 102
Fax: +49 941 79 65 103
Email: toni.hinterdobler@hwkno.de

Mr. Dirk Palige
Director of the Law Department of ZDH-Berlin
Mohrenstraße 20/21
D-10117 Berlin
Germany
Phone: +49(0)30 206 19 350
Fax: +49 (0)30 206 19 -59 350
Email: palige@zdh.de

European Commission

Mr. Mikael Lindroos
Directorate-General for Enterprise and Industry
B-1049 Brussels
Phone: +32 2 2969367
Fax: +32 2 2998110
Email: mikael.lindroos@ec.europa.eu

Mr. Reinhard Biebel
Directorate-General for Internal Market and Services
B-1049 Brussels
Phone: +32 2 2955480
Fax: +32 2 2921749
Email: reinhard.biebel@ec.europa.eu