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Business forms:

Understanding the issues

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About this report

Business activities are an essential part of every society. Their success, especially when first starting up, depends on many social and economic variables, but one of the most important things is what legal form the business adopts. Sympathetic and pragmatic advice from experienced experts in the field can make a real difference to the success of the venture. Previous ACCA research has shown that the value ascribed to an accountant's advice to a small business comes not simply from the professional qualification but also from the client's perception of the adviser as a peer, who has faced the same challenges and decisions in establishing their own business (Spence et al. 2012).

Nonetheless, it is unavoidable that over time the development of practice expertise will affect the perspective of the adviser, potentially colouring the importance they attach to particular factors. In order to help bridge the understanding gap and aid both sides in deriving more value from their conversations, this report incorporates findings from a survey of 345 advisers and entrepreneurs across 60 jurisdictions. It is designed to identify the areas perceived as the most important by each group.

Introduction

For every small business founder, the success of their venture will be at the centre of their life. While their goals and visions may differ, every new business founder will be characterised by a desire to achieve those aspirations. Whatever the nature of these aspirations, it is a fundamental element of a business that it has to interact with the outside world.

Relations with customers, investors, regulators and suppliers cannot be avoided, but the ease with which those relationships can be established, the effectiveness with which they can be managed and, ultimately, the manner in which any disputes can be resolved will be determined by the legal form that the business assumes. The freedom of the owner to choose the legal form of their business may be constrained by external factors. In most jurisdictions, entities with charitable purposes are required to assume specific regulated forms. In some sectors the use of an incorporated entity with its own legal personality is a practical requirement of business partners managing their own exposure to other regulatory requirements. Sophisticated investors may have particular preferences for the business forms to which they will contribute.

> **Advisers should keep the form of their clients' existing business under review. It will be necessary to consider where the business is in its life cycle and where it is expected to go.**

The pressures can be softer or, indeed, simply traditional. The general partnership has long been a feature of professional practices, but increasingly the attractions of limited liability and ease of operation are seeing other forms adopted (Payne and Silkin 2017). It may be assumed that having letters after the business name will confer some respectability upon the undertaking in any marketplace (IPSOS MORI Social Research Institute 2014). Traditionally, 'going limited' may have been seen as a way of making a business look bigger and more official than a sole trader, perhaps alongside moving into business premises rather than working from home. It can constitute a way of saving money in taxes, but it is important to remember that taxes are only paid on the profits left after the business has met all its operating expenses – and with a company those are very often higher than for other business forms.

The legal form adopted for any business venture will affect what it can do and how it can do it. As well as the rights and responsibilities set out in law, the form of the business can also affect how customers, suppliers and investors behave towards it. It is important that the choice of form is based on the appropriate factors, and it is equally important to recognise that those factors can change over time.

Advisers should also keep the form of their clients' existing businesses under review. While it is unlikely that there will be a need to revise a business's legal status as a matter of routine, significant changes in the circumstances or intentions of the business or its owner may indicate that the existing format is no longer the most appropriate. It will be necessary to consider where the business is in its life cycle and where it is expected to go.

Unless the business has recourse to its own funds, a requirement for rapid expansion is likely to call for a format attractive to external investors. Typically this will be a company limited by share capital, a format which is linked with closer regulation and a greater level of formality for aspects such as transparency and the accountability of the business owners (Davies 2013). If the aim is to build a business to sell, then some form of separate legal personality is likely to be the most attractive to purchasers, even if they simply purchase the trade and assets from that entity.

Conversely, if the aim is to build for the long term and create an asset to hand down to children then it will be essential to consider local inheritance rules and provisions, and with them the tax position. While it should never be the determinative factor, it will be instructive to consider what is the normal model in the sector, and the reasons for this. The adviser should consider whether this particular model is relevant to the client, or is their business unusual in some way that suggests a different approach?

THE CHARACTERISTICS OF DIFFERENT BUSINESS FORMS

In order to help structure the analysis and conversations with clients, the characteristics of business forms have been split into four broad chapters, considering in turn:

- Realising the returns
- Investing into the business
- Legal characteristics, and
- Administrative requirements.

While there is inevitably some overlap and interaction between those broad headings, and a number of further considerations must be taken into account, results from the survey confirm that addressing these factors and identifying the correct balance between them will be essential to ensuring that the business is operating through the format best suited to its current needs.

1. Realising the returns

Most businesses are run with a view to creating a profit for the investors (whether owners, managers or lenders), but there can be other motivations, such as providing community services or wider public benefits, which might restrict the range of business vehicles available. The long-term goal may be financial security for the founder and their family or partners, or it could be to maximise profitability with a view to sale.

Establishing what form 'value' takes for the business, and then how best to ensure that the value ends up where it is supposed to be, is perhaps the most important consideration when deciding on form. In order to offer appropriate advice, it will be important for the adviser to understand the owners/founders' goals, their approach to achieving those goals, and any compromises they may be prepared to make along the way.

Some structures favour regular extraction of accrued profits; others allow for the sale of a share, and future returns on that share, to a third party. A number of cooperative and charitable forms, by contrast, deliver their value entirely in the form of returns to society or indirectly to the members, and do not allow for any cumulative return on capital invested. Understanding the founders' intentions, and exploring how they can best be reflected by the outcomes available from the form chosen is an essential element in good advice.

> 68% of survey respondents without an advisory background believe business legal forms should exist that explicitly recognise non-financial aims as a measure of success (compared to just 46% of advisers who have set up their own business).

Although the emphasis on capital maintenance provisions and enhanced liability in proximity to insolvency might imply an apparent assumption in government policy and legislative and regulatory regimes that businesses, especially incorporated ones, exist purely for financial gain, this does not always reflect the actual intentions of business owners and operators (Gerner-Beuerle et al. 2013). It will be worth bearing in mind that those who have not previously run a business but are looking at setting one up are around twice as likely as advisers to believe that business legal forms should exist that explicitly recognise that non-financial aims are part of measuring the success of a small business.

Advisers should be sure to have familiarised themselves with the options available in their jurisdiction for such undertakings, and to have a good understanding of any restrictions on their use, or limitations on their activities. While it is usually the case that specific vehicles exist for purely charitable undertakings, these may not be suitable or available for ventures with mixed goals. Being ready to explain the differences between them, and to explore whether a nominally 'purely financial' enterprise might still meet the founders' aims, will help to distinguish the valuable adviser. In many cases it will be possible to use a standard commercial format combined with specific adopted terms to meet the owners' goals while allowing for greater flexibility should it be needed.

The local social and economic environment can play a significant role in shaping the sorts of vehicle needed to enable economic activity. In several of the markets surveyed as part of the initial desktop research for this report, farming and business cooperatives exist as a significant and important part of the economic infrastructure. While the adoption of the cooperative form is driven by financial imperatives, the goal is not so much a financial profit as simply facilitating access to marketplaces in the first instance. The collective bargaining power of the cooperatives allows those involved to negotiate commercial deals with counterparties on terms that would not otherwise be possible, and while a direct individual financial return on the membership share is typically not available, the members benefit indirectly through being able to deal on those terms in respect of their own transactions (Sabir et al., 2012; Trebbin and Hassler 2012). The choice of such a vehicle will often be a foregone conclusion based upon the founders' circumstances and goals, but the professional adviser should still be aware of the key features, advantages and potential shortcomings of the format.

Whenever money is realised there are likely to be tax consequences. While it is rarely, if ever, a good idea to allow business form to be driven exclusively by tax, it is nonetheless a factor which must be considered. As shown below, there was a strong preference across all groups surveyed for governments to use the tax system to support small businesses, through mechanisms such as reduced tax burdens on profits, or exemption from specific charges.

Those looking to set up their first business were the group most in favour of tax incentives, with 45% believing that tax measures should be the primary incentive for small businesses, compared with just 30% of those who have already set up a

The Certified B-Corporation

The B-Corp movement of businesses, focusing on social value, started in 2007. Described as 'a new kind of business that balances purpose and profit', such a company has to undergo self-assessment and have its social and environmental credentials independently verified. There is a growing community of more than 2,650 Certified B-Corps from 60 countries and 150 industries. (B Corps 2019). A majority of US States' now allow a legally binding opt-in for companies, which sees the directors' fiduciary duties expanded and the purpose of the corporation updated to require creation of a material positive impact on society and environment taken as a whole (Tomorrow's Company 2013: 37 note 5). ■

Advisers should be careful to ensure that entrepreneurs recognise that the rules governing realised profits and losses can be complicated and may need expert advice from an accountant.

business, and only 18% of advisers who have set up their own business. While not directly explored in the survey, it is quite possible that the comparatively low importance attached to tax incentives by those who have run their own business is just relative: they simply give other factors more weight, rather than regarding tax as unimportant. In fact, it is notable that every group considered that some tax incentives should be offered, with only a handful of respondents actually classing them as 'unimportant'. The vast majority of business taxes paid by small and medium-sized enterprises (SMEs) are levied only on profits, and typically after some considerable time lag, as the business will not make a return until some time after a profits period or local fiscal deadline has passed. Welcome though the reduced liability will be at that time, if the business has not yet made a profit at all then the question of taxes is unlikely even to arise, making other incentives and aids to business success more important in the earliest days of the venture.

HOW EASY IS IT TO WITHDRAW MONEY FROM THE BUSINESS?

A sole trader is typically free to use the funds of the business as he or she sees fit. There are no restrictions on how much of the firm's profits can be taken, or how often withdrawals may be made. The proprietor will be restricted only by the practical need to ensure that the business retains enough money to keep operating. In the case of a partnership, the rules governing withdrawal of profits and funds will be dealt with by each individual firm's in-house partnership agreement.

Where the business is a separate legal entity, and its assets belong to it and not to its individual members, there are likely to be, at the very least, legal restrictions on how funds may be distributed back to investors. In practice these may well be a mere formality, especially in the case of a single shareholder-director company (where these are allowed under local legislation) but otherwise companies are restricted in the ways in which they may distribute funds to their directors and shareholders. The UK Companies Act contains rules that reinforce the company's special status and restrict the ways money can be taken out to just two situations: distributions of profits and loans.

As noted above, many cooperatives and charitable structures impose significant restrictions on the distribution of cash from the enterprise. It is common for the statutory provisions setting up farming cooperatives and the like to have conditions that not only restrict the venture's scope for making cash returns to members, but also require it build up cash reserves out of each year's operating surplus in order to fund future capital investment by the cooperative, for example in improved machinery or storage facilities.[1]

Similarly, the constitution of a charitable enterprise, in addition to restrictions on distributing returns during the life of the enterprise, will often include a stipulation that any funds held by the body on a winding-up may only be distributed to another charitable body pursuing similar aims to its own.[2] It will be important for founders to recognise any such limitations inherent in the structure chosen, and consider carefully how much they might invest and whether it is realistic for them to pursue such a course.

DISTRIBUTION OF PROFITS

A common type of profit distribution from companies is a dividend, where the directors authorise a payment out of profits to the shareholders. In making any decision on dividends, the directors should assess, by reference to the most recent accounts, whether the company has a surplus of accumulated 'realised' profits over accumulated 'realised' losses before thinking about making a distribution. If directors/shareholders make a distribution to themselves, when their company does not have net realised profits, they will typically be liable to repay the amount of the dividend to their company (Cheffins and Black 2006) Advisers should be careful to ensure that entrepreneurs recognise that the rules governing realised profits and losses can be complicated and may need expert advice from an accountant.

1 For example, Indian Cooperatives and Nidhi and Producer Companies. For general information see <http://www.indiancooperative.com/>, accessed 25 February 2019.

2 For example, the Singapore Public Company Limited by Guarantee, Indian cooperatives, Irish Guarantee Companies and the UK CIO/SCIO models.

2. Investing into the business

One of the most fundamental considerations is whether or not the owners need to raise money beyond their own resources to develop the business. If the founders need more start-up funding than they personally have available then the simplest way to introduce money to the business is often to borrow it, which will involve paying interest. Typically, the cost will be based on how much is borrowed, regardless of the predicted proportional return on that sum.

For a corporate body, however, there is also often scope for raising money as equity, so that the investor receives a return only if the business actually returns a profit on the investment. Furthermore, whether a company raises money as debt or equity, lenders/investors are typically more ready to put funds into a company than into a sole trader or partnership – either lending more, or at lower rates of return (OECD 2015).

One aspect of investing to develop the business that can be hard to assess is the time and effort needed to establish networks of customers and suppliers.

Corporations are perceived as having a degree of stability and permanence which unincorporated businesses do not – although for many small businesses the owners will have to give a personal guarantee anyway, diluting any potential benefits of the separate legal personality (OECD 2015; Davies 2013).

There may be other sources of funding, such as government grants, which are often targeted at smaller firms, and again, as with realising returns, it is important to understand the tax impacts of different funding models. For all groups of survey respondents, the attractiveness of grants was lower than that of tax incentives, with a clear majority (62%) seeing them as part of a balanced package of measures to assist small business. Nevertheless, it will be important for advisers to be aware of the grants available, and of the sources of information that should be consulted to stay up to date on sector-specific and local incentives.

One aspect of investing to develop the business that can be hard to assess is the time and effort needed to establish networks of customers and suppliers. The difficulties faced were captured by a comment from one survey respondent:

'Two of the biggest problems for any new SME are: 1) where to find clients; 2) where to find capital. Hence, if government wants to engage in meaningful support activities, I would see them concentrate efforts on promoting TRULY WORKING [capitals original] business exchanges, trade associations' membership support, making government contracts more accessible, etc. and supporting funding efforts through some sort of [government] guarantees for qualifying business projects that would allow the owners to draw credit from commercial banks.'

While access to business exchanges and support networks is rarely dependent on the legal form of the enterprise, it can nevertheless be an absolutely crucial factor in the success of a new business (ACCA 2019). Advisers should again be sure to have a working knowledge of local initiatives and groupings that can help clients achieve their business aims. As technology moves on, such networks can increasingly be found online, and the power of social media and an internet presence should not be underestimated. The investment required to curate an online brand will in the first instance need to come from within the business but in certain sectors and particular markets it will be more important to long-term success than cash investment, and should be given the appropriate level of prominence in the business plan (OECD 2018).

3. Legal characteristics

The defining legal characteristic of a business form will be whether the business has a separate legal identity from its owner(s). Deciding whether the enterprise will need its own identity, and the capacity to own things in its own right, or can simply exist as an extension of the legal name(s) of the owner(s) goes to the heart of its relationships with the outside world, and where liability will fall for any issues that arise.

Companies and other 'bodies corporate' exist as independent legal entities, able to enter into contracts and enforce (or be subject to) rights and liabilities. That contrasts with the sole trader's position, where everything is done directly in the name of the individual responsible. In addition, use of a separate legal personality can greatly simplify selling, or transferring, part or all of the business. At the same time, it will impose restrictions on the legal power of the owners and/or managers to deal with the assets of the business, or enter into contracts on its behalf.

Respondents across the whole survey population viewed separate legal personality as an important factor when choosing a business form, with 75% rating it as an important or very important consideration. Closely linked to the issue of separate legal personality is the matter of liability for the debts of the business. This was an even more significant factor to consider in the minds of respondents, with fully 80% classing it as important or very important.

Nonetheless, while it is understandable that the direct risk to the founders' personal financial security ranks highly as a consideration, what complicates the situation is that, where a business enjoys limited liability status, the individuals behind that business are generally able to take shelter from the consequences in the event of their own poor or reckless decisions and initiatives, while those third parties who deal with

them, including trade creditors, employees and government departments, are left to count the cost. Invariably, jurisdictions will impose conditions on the conduct of business by limited liability companies so as to deter abuse of the system and to compensate third parties for the risk they run in doing business with companies (Davies 2013).

It is worth bearing in mind that courts might sometimes look behind the company identity (sometimes known as looking behind the 'corporate veil') to hold owners or directors personally liable, usually where there has been criminal activity. On the other hand, in many jurisdictions there are personal bankruptcy safeguards that protect the entrepreneur from total ruin in the event that unexpected liabilities arise (Davies 2013).

In addition to the above, the law will typically lay down a large number of criminal offences for breach of statutory responsibilities, which can be viewed as highly persuasive incentives for companies to respect the interests of their shareholders in particular, and in some cases their creditors as well. For example, directors may commit criminal offences if they approve annual accounts that do not comply with legal requirements, make solvency statements that are not supportable, fail to keep minutes of their meetings, or fail to provide information to a company auditor on request. In some circumstances, a company's shareholders may be able to bring legal proceedings, in the name of the company, against their directors(Gerner-Beuerle et al. 2013; Cheffins and Black 2006).

A stakeholder protection of a wider character is represented by the fact that accountants who are appointed to provide business support services to businesses will typically have legal responsibilities under financial crimes legislation such as the EU Anti-Money Laundering and Counter Terrorist Financing framework and in line with local implementation of Financial Action Task Force (FATF) guidelines, including anti-money-laundering, anti-bribery and counter-terrorist-financing measures and initiatives, as well as under any ethical codes of conduct by which they are bound through membership of a professional body. While the picture varies internationally, a significant proportion of small companies are believed to consult an external accountant for accounting or business advice, meaning that the great majority of companies will be covered by these provisions (ACCA 2019).

Any regulatory regime for limited companies is likely to comprise a system of interrelated checks and balances. Where rules on accounting and disclosures exist, they will form part of such a system, and where they do not, compensating measures are likely to be present (Davies 2013). The optimum regime for a given enterprise cannot therefore be considered in isolation from consideration of how the regulatory framework overall provides appropriate safeguards for investors, creditors and the public interest. While small companies in Australia, for example, are not bound to prepare or publish annual accounts, the financial interests of their stakeholders are addressed by requirements for directors to make an annual declaration of solvency and for decisions on distributions to take stakeholders' interests expressly into account.[3]

In countries that have more extensive and standardised requirements governing accounting and public disclosure, such as the UK, those measures may be seen as a substitute for the more stringent rules on personal liability that exist in other company law regimes. The particular contribution that accounting and disclosure can make to the goal of protecting stakeholder interests and the

Personal liability in the US

When a limited liability company (LLC), the most popular form of incorporation for small businesses in the US, becomes insolvent and enters into the standard liquidation procedure, creditors' rights will generally be classified as either secured claims, priority unsecured claims (these include employee wage and benefit claims and debts incurred by the firm between the filing of a creditor petition and the granting of the bankruptcy order), and general unsecured claims (which have lowest priority). Under federal law, trade creditors enjoy a special privilege in that unpaid invoices issued in the 20 days preceding the entry into bankruptcy are regarded as being administrative expenses and should thus be repaid as of priority by the trustee (although where no assets are available to the trustee, creditors are not likely to receive anything).

Members of an insolvent LLC will technically owe no obligations in insolvency because of their limited personal liability. However, LLC managers and members may be required to repay monies which have been distributed illegally – that is, if a distribution has been made when the company would not be able to pay its debts as they fall due, or if the company's total assets would be less than the sum of its liabilities plus the amount that would be needed, should the company have to be wound up, to pay those creditors who would have preferential rights superior to those of the members receiving the distribution.

The US criminal code also contains a number of offences of concealment of assets and embezzlement, which are punishable by fines or imprisonment. It should be noted, however, that there is a lack of certainty in the LLC regulatory framework as regards how the corporate character of the LLC is to be accommodated in insolvency. The courts will normally treat an LLC like a corporation, but where it is owned by one individual – as is the case with the majority of LLCs – they can treat the LLC bankruptcy as a sole proprietorship bankruptcy, depending on the merits of the case. When the corporate veil is pierced in this way by the bankruptcy courts, the assets of the business owner may be treated as business assets and sold, with the proceeds used to pay off the creditors (Davies 2013). ■

3 For a comprehensive account of the relevant Australian regulation see the ASIC (Australian Securities and investments Commission) Guidance at https://asic.gov.au/for-business/running-a-company/company-officeholder-duties/your-company-and-the-law/, accessed 25 February 2019.

The assumption of a business form with its own separate legal personality has important practical consequences which should be discussed with the owners.

public interest in any individual company law regime will accordingly be a function of the wider regulatory framework within which companies exist.

Determining where the optimal balance lies in relation to any given entrepreneur's circumstances and capabilities will invariably involve an assessment, not only of the costs and the benefits of meeting standardised accounting and disclosure practices, but also of how those obligations coexist and interact with other measures that provide necessary protections for stakeholder interests.

When considering a separate legal personality for the business, advisers will typically need to recommend a variant on one of the following broad types.

THE TYPES OF SEPARATE LEGAL PERSONALITY

i) Private company limited by shares

This is by far the most numerous form of company across almost all jurisdictions (DG Just 2017). Although requirements do vary, it may well require little in the way of capital commitment, enable present and future shareholders to dispose of their interests as they wish, and restrict the liability of each shareholder to the amount owing on their shares at the time of the company's liquidation. The word 'private' in the name simply means that shares in such a company may not be put on open sale to the public, meaning that equity injections will need to be negotiated separately and specifically with individual investors. Despite this restriction on raising funds through the issue of shares, a private company, like other types of company, can often provide valuable security for loans by granting a floating charge[4] over its assets – something unincorporated entities are less frequently able to do.

ii) Private company limited by guarantee

'Guarantee' companies are found widely across common law tradition jurisdictions and are typically popular with non-profit-making entities, such as clubs and charities, and in many jurisdictions it is the required legal structure for dedicated public interest enterprises. The format allows the entity concerned to take advantage of limited liability, separate legal personality and perpetual existence but restricts the power of the company to distribute its profits to its members. The 'members' in a guarantee company are members in the generally understood sense of the word, and their liability for the company's debts is invariably restricted to the amount, usually a very nominal amount, that they agree to pay in the event of the company's liquidation. Conversely, the members' ability to withdraw funds from the company will be similarly limited, as the underlying rationale is that the enterprise exists not for the benefit of its members, but for the wider benefit of society.

iii) Unlimited companies

These are corporate bodies, and thus enjoy separate legal personality, but as the name implies, their members have unlimited liability for their company's debts in the event of the company's liquidation. The main advantage of the unlimited company is usually a reduced administrative burden, especially around disclosure. Nonetheless, it must be recognised that in an increasingly transparent corporate world, unlimited companies are viewed with suspicion in international transactions as they are often the vehicle of choice for those seeking to disguise their activities or cover their tracks. From the perspective of a new business founder, the sole advantage of an unlimited company is likely to be the day-to-day administrative separation of their personal and business affairs. While some commentators have argued that the lack of liability protection is in fact an incentive to prudent management by the owner, the same would hold true of the sole trader or common partnership formats.[5]

The assumption of a business form with its own separate legal personality has three important practical consequences which should be discussed with the owners.

4 A 'floating charge' is the security for a loan granted against whatever assets the borrower owns at the time, as opposed to a 'fixed charge', which will be secured against specific named assets.

5 For details of the advantages and disadvantages of the unlimited company model see <https://www.companywizard.co.uk/blog/what-is-an-unlimited-company>, accessed 26 February 2019.

THE PRACTICAL CONSEQUENCES OF SEPARATE LEGAL PERSONALITY

First, from the moment of incorporation, the company is treated as an entity separate from both the individuals who own the company as its shareholders and those who manage it as its directors. The assets and liabilities of the company are, as a rule, the responsibility of the company itself and not of the individual shareholders or directors, even where the company has just one shareholder/director who is plainly the guiding force behind the company's activities. Although the position varies between and within jurisdictions, any legal action by an aggrieved customer or client of the company, or a third party, will typically need to be taken against the company rather than against its shareholders or directors unless there is a clear breach of specific personal duties by an individual, such as knowingly criminal behaviour by a director (Gerner-Beuerle et al. 2013).

The second main consequence of incorporation is that the company's existence continues independently of the identity of its shareholders and directors. Where a person carries on a business in his or her own name, then the retirement or death of that person brings the business to an end. Similarly, with most partnership models each change of partner, for whatever reason, technically brings the partnership to an end, and the re-constituted partnership survives only until the next change of partner (although, in practice, for larger partnerships there are usually measures that blunt the impact of this). In the case of a company, shareholders are usually free to sell their shares if they wish to do so. Even when there is a complete change of ownership, for example where the company is taken over by another business or where a sole shareholder dies and his interest is passed on, the company survives and continues in existence. Therefore, the company format allows a business to be planned for the long term.

The third main consequence of incorporation is that the law invariably treats shareholders and directors differently. If one individual is involved as both a shareholder and a director then there will be different rules (and potentially liabilities) to be considered, depending on whether the individual is acting as a director or as a shareholder. It is vitally important that advisers are able to explain clearly to clients the difference between the two roles, and the very real additional legal responsibilities that directors assume (and that cannot as a rule be delegated to others).

The shareholders in a limited company enjoy limited personal liability for the debts of their company. Shareholders, as such, have no personal responsibility for the debts incurred by their company in the normal course of trading. In the case of a company limited by shares, the liability of each member is limited to the amount of share capital subscribed. Where, as will often be the case, the full value of the shares has been paid into the company, then there is no further liability to meet. If a company goes into liquidation because it cannot pay its debts, its shareholders will be required, at most, to pay to the liquidator any amounts remaining unpaid on their shares – where shares are 'fully paid', that amount will be nil.

Against this, shareholders bear the ultimate risk in a company, in the sense that, if their company fails, they stand to lose whatever amounts they have invested in their company. In any winding up, shareholders will only see a return if there are still assets available after all the creditors have been paid. Accordingly, if a company is wound up on an insolvent basis, shareholders can expect to lose the entire value of their investment.

A company's directors, on the other hand, are entrusted with controlling the affairs of their company. The law will require them to do this in a disciplined way that takes account of the need to protect the interests not only of the company's shareholders but also of some third parties. In the case of small companies, the shareholders and directors are usually the same people. There is nothing untoward in this but individuals in this situation need always to remember the technical distinction that exists between the ownership rights that they have as shareholders and the management responsibilities they have as directors.

This distinction is very often demonstrated, in the case of small companies in particular, by the fact that banks and other lenders of finance will usually insist, as a condition of agreeing to lend funds to a small company, that its director or directors give personal guarantees that the loan will be repaid (Davies 2013). Thus, while as shareholders they have limited personal liability for their company's debts, as directors they may take on personal responsibilities for those same debts. Any company whose directors expect to have to borrow substantial funds in its early years should be aware of this, as it may dilute the value of limited liability for the director/shareholders.

> Advisers should know all the duties and responsibilities of directors and ensure clients are fully aware of the personal liability implications of taking them on.

WHAT DOES IT MEAN TO BE A DIRECTOR?

Directors are the officers who control and manage the company's affairs on behalf of the shareholders. Requirements vary around the world, and there may be maximum or minimum numbers of directors required, alongside restrictions as to who can fulfil the role. Full legal capacity is almost invariably a requirement, but conditions may also apply to the residence or nationality of directors, and whether they must be natural persons or if the role can be held by another body corporate.

The directors usually have the power to take all or most of the important decisions about the running of their companies. The overriding principle is typically that directors owe their duty to the company, and not to any third party (including themselves). They must follow the company's rules, and must act in the way that is most likely to promote the success of their company. A prudent director should also be ready to consider a number of other factors. The UK Companies Act 2006 sets out a range of factors that directors in the UK must consider, including:

- the likely long-term consequences of their decisions
- the interests of the company's employees
- the need to foster the company's relationships with suppliers, customers and others
- the impact of the company's operations on the environment
- the desirability of maintaining a reputation for high standards of business conduct
- the need to act fairly as between members
- the need to exercise independent judgement
- the need to exercise reasonable care, skill and diligence
- the need to avoid conflicts of duty
- the need to avoid accepting benefits from third parties that could give rise to conflicts of interest
- the need to declare any interest they have in transactions being considered by their company.

While local requirements will vary, the list above nevertheless sets out a useful checklist of issues that advisers should discuss with clients when considering the adoption of corporate form, and indeed the conduct of any business enterprise. Even where the specific item is not a legal requirement of the local market, or final form adopted, adherence to those principles will help build a responsible and sustainable business model which (all other things being equal) is more likely to succeed at its chosen tasks.

Local regulation will also typically impose a number of specific obligations on company directors, such as responsibilities for keeping accounting records and preparing annual accounts or solvency statements. These statutory obligations all derive from the fiduciary responsibilities that directors owe to their company. Failure to comply very often means that both the company and the individual directors commit an offence and are liable to prosecution. You should also note that, while directors' duties are usually owed to their company, they are also often required to take into account the interests of certain third parties. At the point where a company becomes insolvent, the directors become accountable not to the shareholders but to the company's creditors. Directors may be made personally liable for their company's debts if they fail to take appropriate action to protect creditors' interests when the company faces insolvency.

Anyone contemplating becoming a director by incorporating their business should take the time to familiarise themselves with the range of duties for which they would be responsible. A failure to understand or appreciate those responsibilities properly could have significant consequences, and hence it is incumbent on a professional adviser to ensure that these matters are fully discussed and understood before any legally binding steps are taken.

4. Administrative requirements

These are often driven by the legal characteristics and tend to fall into two categories – occasional requirements, such as the formalities governing the initial start-up or major transactions such as a sale of the business, and regular requirements such as preparing and filing or publishing accounting information, or observing certain formalities around transactions, for example dealings between the investors and other stakeholders, such as managers or employees.

There is often a trade-off between the level of administrative requirements and the degree of autonomy which the business can have, linked with the related fields of transparency and accountability.

Starting the business is something that happens only once. The legal form adopted by the business should be based on long-term factors, not just the ease of the start-up process. It is important, nonetheless, to understand what needs to be done, how long it will take and what it might cost. This is particularly the case in those jurisdictions where the formalities of the incorporation process are more burdensome. Although there is a widespread shift to adopting modern technological methods, with central registers maintained in digital format and registration processes accordingly moving online, the change is by no means universal. Even though around the world the time taken to incorporate a business has fallen on average from 47 days in 2006 to 20 days in 2018, this still masks a wide range of variation, from 2.5 days in Australia to 40 in South Africa and 70 in Somalia (World Bank 2019).

The initial registration of the business is often the moment that offers the best opportunity for the authorities to assess the good standing and good faith of those behind it.

While the convenience of online filing and information sharing offers real productivity gains for both the administrators and users of business information and records, the ease of online incorporation and business transactions has also been linked to a shift in patterns of criminal behaviour (ICLEG 2016). National registries are faced with a trade-off between ease of business registration and the need to combat criminal and fraudulent behaviour. Although the digital exchange of business information between authorities, regulators and crime fighting agencies can aid them in the fight to protect the public, the usefulness of the exchange will depend on the reliability of the information contained in their registers, so it is increasingly important that steps are taken to ensure confidence in the accuracy and completeness of that information.

The initial registration of the business is often the moment that offers the best opportunity for the authorities to assess the good standing and good faith of those behind it. The greater the powers of the business to contract with third parties and create liabilities on its own behalf, the more important it is that the authorities are able to maintain confidence in the business form that justifies those powers.

Just under 70% of all survey respondents considered that all new businesses should be subject to compulsory registration or regulation, with only a slight variance between groups. Professional advisers who do not run their own business were the most likely to advocate compulsory formalities, at 73%, while those who were considering a new venture were least likely to support such a measure. Nonetheless, nearly two-thirds (64%) of the latter agreed that all new businesses should be subject to some degree of official monitoring.

There was, however, considerable variation between the populations over the factors that they argued should trigger regulation. Some 40% of aspiring business owners stated that the limitation of owners' liability was a high-risk area requiring additional regulation, nearly twice the proportion from among non-business-owning advisers. Similarly, while most respondents considered that the size of the business was a factor which should be taken into account, with additional regulation desirable above a certain (unspecified) size, the degree of importance was again subject to differing opinions. Advisers who had set up their own business were only half as likely to consider it a high-risk area (21%) as those advisers who had not set up a business themselves (42%), although 50% of owner-advisers did consider some additional regulation desirable (against 30% of 'non-owner-advisers').

When asked about crowdfunding, however, 61% of respondents rated this a high-risk area, justifying additional regulation such as third-party oversight. Just one respondent considered direct calls on public funds to be a low-risk factor requiring no regulation at all. Those looking to set up a business were the most concerned about this area, with 83% seeing it as an activity justifying additional regulation, indicating a widespread recognition of the possible risks, and an acceptance of the corresponding administrative burdens to be expected.

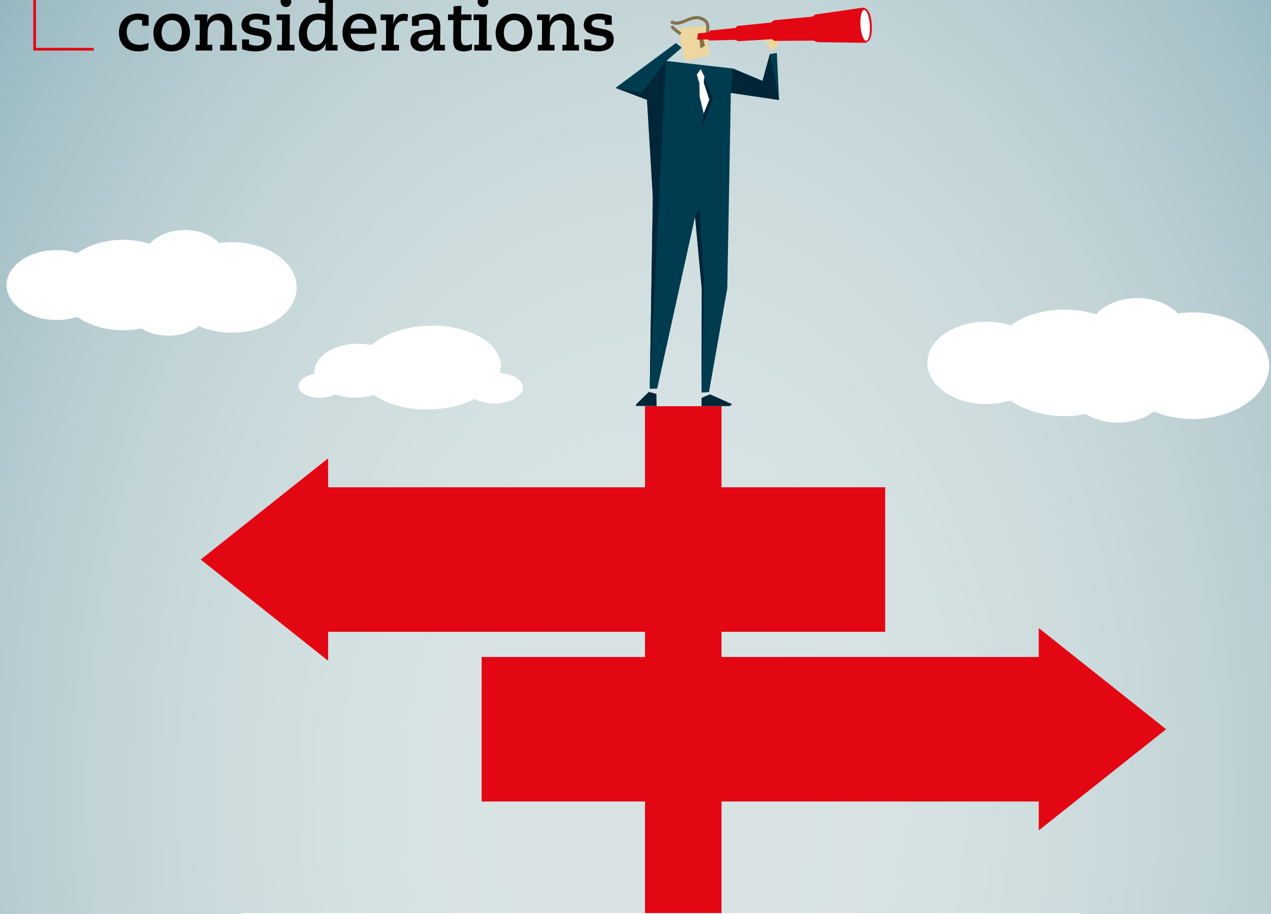
With that background in mind, advisers should be prepared to explain clearly to their clients what administrative burdens exist for a particular business form, and why. The majority of aspiring business owners recognise the need for some regulation and appear comfortable with the concept that limited liability will come with additional administrative responsibilities, so advisers can introduce the topic accordingly.

Companies' legislation typically requires companies, via their directors, to abide by a number of rules for their internal administration.

Companies' legislation typically requires companies, via their directors, to abide by a number of rules for their internal administration. For example, under UK and Australian law they may have to keep minutes of all their board and general meetings, to keep up-to-date registers of members and directors, and to observe standard procedures when carrying out share transfers. There is usually an obligation to ensure that certain information is displayed on their business stationery or outside their business premises so as to inform all customers, prospective customers and the general public of their corporate status, and failure to comply with those obligations can be a criminal offence.

Overall, though, there is a general pattern across jurisdictions that the formalities with which directors have to comply to keep shareholders informed have fallen since the turn of the century while the ease with which those obligations that survive can be discharged has in many cases been enhanced through the availability of digital communications, with many jurisdictions now allowing electronic communications and share transfers, and even the holding of general meetings online or through video-conferencing (ICLEG 2016; Collis et al. 2018). This often reflects the very widespread reality that, in small private companies, directors and shareholders are often one and the same. For example, since the Companies Act 2006 came into force, private companies in the UK no longer have to hold an annual general meeting (AGM) or to present their accounts for review by shareholders at a general meeting. They can also pass company resolutions in writing, rather than going to the trouble of holding a general meeting to do so. Given pressures on regulator funding and resources since the financial crisis of 2008-9 and resultant incentives towards focusing compliance resources on identified risks rather than blanket monitoring, it seems likely that this trend in favour of the lighter routine administrative regulation of private companies will continue, although some trade-off of enhanced monitoring of high risk events, such as large individual transactions and initial registrations might reasonably be expected.

Some broader considerations



TRANSPARENCY AND ACCOUNTABILITY

There is often a trade-off between the level of rights or freedoms a business vehicle has and the amount of information about itself that it has to make public (Davies 2013). The link is sensible – for example, where companies can raise money from the general public through 'listed' securities they have to publish considerable amounts of legal and financial information so that investors can make an informed decision and, as noted above, this is a risk recognised by all those surveyed.

Likewise, entities that enjoy limited liability are usually required to report or publish financial information so that potential creditors can understand what limits there might be to recovery if they do enter into a financial relationship with the business. The disadvantage is that there can be concerns about divulging commercially sensitive information, or even personal details about owners or managers.

The rationale for imposing accounting and disclosure requirements on companies has always been that it is in the public interest for companies to be subject to standardised regulation in these matters by way of compensation for the special legal privileges that flow from the award of limited personal liability to company owners.

> 85% of all survey respondents think it is important that creditors can easily find out information about any business's financial health.

The rationale can be explained in these terms:

- a company should be required to manage its financial affairs in specified ways that respect and reinforce its separate legal personality
- given the separation, under company law, of ownership and management, rules are needed to protect the interests of the former and to clarify the responsibilities of the latter
- since the persons who own and control a company will not be personally responsible for their company's debts, rules are necessary to reduce the risk that third parties assume when doing business with them.

Studies have found that avoidance of public disclosure of potentially sensitive business information is one of the principal reasons why SMEs choose where possible to file abbreviated accounts (Collis 2012; Allee and Yohn 2007). Many companies that file abbreviated accounts are likely to do so in order to avoid disclosing information that might be used to their disadvantage: for example, they may fear that suppliers might raise prices, employees might seek higher salaries and customers might seek discounts if they believed that the company was successful.

The consequence of filing modified information, however, is that there is a reduction of transparency on the public record. Where only abbreviated information is made available, prospective lenders may act more cautiously, and be encouraged to require additional information before making a decision on a loan, credit rating or insurance policy (Davies 2013: 28). This is an indirect argument for making available the full financial statements rather than a modified version.

Another argument that is frequently presented to justify mandatory accounting rules (and associated legal requirements to keep adequate accounting records) is that they encourage financial discipline, which in turn acts as an indirect safeguard for companies' shareholders and creditors. Deadlines imposed for filing a set of accounts or making a public solvency declaration are seen as another strong incentive for ensuring correct financial management in that they act as a spur to companies to prepare their accounts in good time: failure to file annual accounts or prepare solvency statements on time is often seen as a warning sign of internal problems, in particular that the company has not been able to agree its accounts (Davies 2013).

Were companies to be freed from any obligation to report on their financial affairs on a regular basis, then there could be a risk that those companies would find it more difficult to win and retain business and to access finance, because the risks associated with doing business with them would increase. It may also be that poor behaviour on the part of some small companies would translate into a reduction in confidence in smaller companies more generally, to the detriment of the wider business community.

The rights that a business has, for example to protect its name or enter into contracts, are usually reflected in the responsibilities it has for filing accounts or maintaining reserves for its creditors. Such responsibilities will be reflected in running costs and earning opportunities, as well as the obligations the business has for paying taxes.

The mechanisms that society has to hold a business to account for its actions, whether in respect of investors, creditors, employees or customers, may vary depending on the business form. Culpability of the decision maker may influence whether remedies are based in civil law or criminal sanctions, while holders of formal defined offices, such as director, may benefit from legal protections or even indemnity (Gerner-Beuerle et al. 2013; Zurich 2017).

The assumption of corporate status is not a totally pain-free option. Once the business owner assumes control of a limited company or other separate legal entity they will have responsibilities that do not fall upon a sole trader or a partner. These responsibilities should not be treated lightly: breaches of directors' duties can lead to permanent consequences such as being disqualified from holding office in the future or being made personally liable for their company's debts.

The answers to those questions will help client and adviser come to a considered conclusion on the features of its business form that will be the most important.

Questions to discuss with advisers

The areas discussed above suggest some questions that individuals who are considering incorporating their businesses should discuss with their advisers.

- Where do you see the business in ten years' time?
- What are the risks in the business, and how much do you need to be insulated from them?
- Are you likely to want to raise funds for their business and if so, who from?
- Do you want the affairs of your business to remain private or are you prepared to file information on them on a publicly available register?
- Are you prepared to assume the responsibilities of acting as a company director?
- Do you think that becoming a company would enhance the status of your business?
- Are you prepared to be restricted in the way that you can make personal use of the funds in your business?

The answers to those questions will help client and adviser come to a considered conclusion on the features of its business form that will be the most important, and accordingly to decide which of the locally available models is most suitable for the business at this time. ■

Sources and methodology

This report builds on ACCA's existing body of guidance for members. In addition to previous publications, a desktop survey of available business forms in nine jurisdictions was undertaken (UK, Ireland, India, Pakistan, China, Singapore, Malaysia, Nigeria and Hong Kong) analysing the key features under four main themes: Realising the returns, Investing into the business, Legal characteristics and administrative requirements.

Building on the results of that work, a survey of interested parties was undertaken. The survey targeted professional advisers in practice (50%), existing small business owners (48%) and, finally, those actively considering the founding of a small business (23%) and garnered 345 respondents from 60 jurisdictions, 49% of individual responses from Western Europe, 19% Africa, 13% Asia-Pacific, 6% Caribbean and the balance from other regions.

Questions were designed to identify those features of the business model that were considered to be most important by each group, with a view to helping advisers recognise which aspects of the business format are likely to be most important or attractive to clients and prospective clients.

The survey results identified four main populations:

- entrepreneurs with practical experience of small business operation but no related professional advisory experience (32%)
- professional advisers who had practical experience of small business operation(16%)
- professional advisers with no practical experience of small business operation (30%), and
- entrepreneurs with no previous experience who were actively considering setting up a business (19%).

A comparison of responses between the populations indicates areas that are universally seen as important, and those where an adviser's focus might differ from that of their client. Awareness of those differing perspectives will allow advisers to tailor their approach to the type of client and their situation.

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ACCA The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom / +44 (0)20 7059 5000 / www.accaglobal.com