Federation of European Accountants

VIEWS

Simplified prospectus for SMEs

An investor-oriented and business-driven proposal

BRIEFING PAPER

HIGHLIGHTS

With this briefing paper, we aim to add a concrete proposal to the European Commission's efforts to establish a simplified prospectus regime for small- and medium-sized enterprises (SMEs) under the Capital Markets Union (CMU). Therefore, we suggest what information investors should find in a SME prospectus (section 4, further elaborated in the Annex), as well as how it could be presented (section 5). Our proposal makes prospectuses shorter, simpler, and less costly to produce for SMEs, whilst increasing their relevance for investors.

The European accountancy profession actively contributes to boost financing for SMEs, also in relation to further integrating EU capital markets. Professional accountants combine a thorough understanding of SMEs and their capital needs with knowledge of the Initial Public Offering (IPO) process. We want to use this expertise to progress the European Commission's CMU initiative and actions to foster growth and jobs in Europe.

The paper is a joint effort of the Federation of European Accountants, European Contact Group (ECG) – an informal grouping of the six largest accounting networks in the EU, and the European Group of International Accounting Networks and Associations (EGIAN) – an informal forum of 22 leading middle-sized accounting networks and associations.

1. Introduction

On 30 September 2015, the European Commission launched an **Action Plan** setting out over thirty key measures to achieve a true single market for capital in Europe – the CMU.

The Commission envisages that "deeper and more integrated capital markets will lower the cost of funding and make the financial system more resilient. All 28 Member States of the EU will benefit from building a true single market for capital."

The purpose of the CMU is to mobilise capital in Europe and channel it to all companies – including SMEs – that need funding to expand and create jobs. Facilitating **SME access to capital** would increase the investment opportunities of investors with smaller sums to invest, thus enabling them to further diversify their investment portfolios. In turn, SMEs would rely less on bank financing whilst having greater access to financing that enables them to grow and prosper.

One of the first steps towards building a CMU is the proposal to amend the Prospectus Directive. The proposed **Prospectus regulation** puts forward, amongst other things, a differential disclosure regime for SMEs:

"SMEs should likewise be offered the option to draw up a distinct, tailor-made prospectus when they offer securities to the public, focusing on information that is material and relevant for companies of such size. (…). In addition, a new optional 'question and answer' format is expected to help SMEs in drawing up their own prospectus, thus saving considerable legal fees."

Furthermore, the Commission proposes to enlarge the scope of documents whose information may be **incorporated by reference** in a prospectus, provided that the information is published electronically. This would greatly reduce the current volume of a prospectus, and this paper builds further on this proposal in Section 4 below.

The **European Parliament** is also considering changes to the current EU prospectus regime. The leading Member of the European Parliament (MEP) on the issue, Philippe De Backer (ALDE, Belgium) and his successor, Petr Jezek (ALDE, Czech Republic), have proposed the option of a **EU Growth prospectus**[1] intended for offers of securities to the public with a total consideration up to €20 million. The proposed EU Growth Prospectus should be proportionate, take into account the need for reducing the costs of drawing up a prospectus for SMEs, and entail key information that is relevant and useful for the investors whilst providing appropriate investor protection.

Finally, the **European Securities and Markets Authority (ESMA)** has been tasked by the Commission to work on the technical details of the new prospectus regime. This will include ESMA guidance and proposals on the format and information requirements of the SME prospectus regime.

The **European accountancy profession** supports these proposals, and would like to contribute to the institutions' efforts to reform the EU prospectus regime. This document has drawn inspiration from the work and thinking of the EU institutions outlined above, and has been prepared to provide a complementing perspective on the information that should be provided to investors under a SME prospectus regime, as well as the ways in which this could be done in practice.

This briefing paper provides a complementing perspective on the information that should be provided to investors under a SME prospectus regime

[1] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE578.833+01+DOC+PDF+V0//EN&language=EN

This paper is the product of the cooperation between three European accountancy organisations – the Federation of European Accountants (FEE), the European Contact Group (ECG) and the European Group of International Accounting Networks and Associations (EGIAN).

Specific challenges and solutions for SMEs

While many SMEs may have issued financial statements before going public, a prospectus is usually the **first broad public communication** of an SME to a wider audience. The purpose is to actively seek interaction and funds from the market. The accountancy profession, based on its deep understanding of SMEs and their capital needs combined with its knowledge of the **Initial Public Offering (IPO)** process, is well placed to share its views and perspective on the issue. The European representatives of the profession have done so in order to contribute in a constructive manner to the overall CMU initiative and the EU's efforts to foster growth and jobs.

A balance needs to be struck between providing information that is material and relevant to investors, whilst ensuring the protection of investors and the company

SMEs are often deterred from entering the capital markets because of the amount of information, the cost of preparing that information and ongoing obligations related to funding. The proposals presented in this paper have been developed on the basis of a balance that needs to be struck between providing information that is material and relevant to investors, whilst ensuring the protection of investors and the company. The balance between protection, simplicity, costs, and relevance is particularly important when it comes to SMEs.

In considering solutions for a **simplified SME prospectus**, this paper pays particular attention to the challenges that SMEs face when raising equity capital by reference to the **information that investors use** in making an investment decision and the way in which investors assess whether or not to invest.

The purpose of this paper is to:

- reflect on the elements of the IPO process that are not readily available to investors in SMEs, such as investor presentations and analysts' research, while eliminating information with limited relevance to an investor
- make the information relevant to investors, and available in more accessible and user friendly formats
- reduce the cost of preparing a prospectus

It is not however the purpose to define here what constitutes a SME. Market and business sizes vary across Europe, and hence the focus is on the challenges faced by SMEs as a group, regardless of their respective size in their markets.

2. Information that investors use in making an investment decision

In a typical IPO, information relevant to investors is currently provided in a number of ways, including:

1. presentations by management to investors on the so-called 'road show' during which asset managers can make enquiries to the management
2. various research documents[2]
3. the prospectus

From an investor perspective, the first two of these – management presentations and research documents – carry much greater weight than the prospectus, and provide highly relevant information to investors. A prospectus that provides added-value to investors should strive to incorporate elements from both.

A prospectus should incorporate elements from both management presentations and independent research

Management presentations: in support of the SMEs' request for capital in the IPO, managements' presentations focus on the business and its financial performance, the risks it faces, how it operates, the market in which it operates including suppliers, customers and competitors, and how that market might develop by reference to external indicators. Information is often presented in pictorial form to facilitate comprehension. Whilst this information is included in a prospectus as well, the way in which the information is presented and the relative importance given to each section may significantly differ. For example, an issuer might summarise its historical financial track record, that can form one-third of a prospectus, onto a few slides in the presentation.

A company delivers management presentations to investors and asset managers who are in a position to make reasonable investments in it. In addition, these presentations enable investors the opportunity to form a view as to the credibility of the company's management – to 'see the whites of their eyes', their passion for the company, as well as the company's unique characteristics that make it a potentially good investment opportunity.

Research documents: the other key contributor to investors' decision making in an IPO context is the research produced by independent analysts. Independent research is generally greatly sought after by investors, whereas paid studies suffer from obvious biases. This research provides the analysts' view on the company's prospects, such as forecasts of the company's earnings for the next few years. The research also indicates the likely valuation of the company.

This paper will focus on the type of material and relevant information that investors need and the form in which it should be presented

Prospectus: it is regrettable to note that the prospectus has in many ways become a shield to protect management from potential litigation, rather than an investor-focused document. Therefore, investors refer less and less to the prospectus. This paper will consequently focus on the type of material and relevant information that investors need and the form in which it should be presented, so that future SME prospectuses are more useful whilst less costly to produce.

[2] For example, buy-side research sponsored by professional investors for their own needs on the basis of presentations and discussions with the management; Independent research by sell side analysts giving their view of a company's prospects and valuation and founded on presentations by management and meetings with management; as well as paid studies on market trends, sponsored by the company.

3. The added challenge for SMEs

Further to the general comments on prospectuses and information needs made above, SMEs face **additional challenges**. Due to SMEs' smaller size, institutional investors such as the asset management community often have no appetite to invest or investigate properly the SME as an investment opportunity. This is for example due to the fact that the amounts involved are below the level at which the asset managers can meaningfully invest without them becoming the sole investor. As a consequence, SMEs have a larger proportion of retail investors who, in general, invest smaller sums to those of institutional investors.

Although **retail investors** do invest in larger companies as well, they are unable to participate in the management presentations or access the independent analyst's research. They can, however, take indirect comfort from the fact that the management has been challenged as to the investment proposition. This is less likely to be the case when investing in an SME, as for example SMEs often find it harder to get analysts to write research on them.

So, is there information that is important for an investor's decision-making process and not typically made available in a prospectus? A prospectus contains a lot of information, but this is often presented in an impenetrable manner that is difficult to digest. What is usually not included in a prospectus, but may form part of managements' presentations to analysts and investors, is **non-company specific information** about the prospects of the industry in which a company operates – for example through external market studies. What is almost never provided by the company is its own view of its prospects.

Companies may not wish to provide a quantitative view of their future prospects in the form of prospective financial information for the next three to five years. However, they should be encouraged to at least provide their views about how their eco-system should transform and how they will tackle the challenges, the key assumptions that underpin their internal forecasts (such as anticipated growth in their markets), their expectations as to their market share, and their expectations as to cost pressures and/or cost management exercises through which investors can build a picture of the company's prospects.

The prospectus should strive to create sustainable trust and give management confidence to be protected from litigation

Solving this requires a **multi-faceted and integrated approach** to increase the relevance of prospectuses for SMEs by identifying the information that investors actually need, and presenting it in a concise and clear manner, whilst reducing costs by ensuring that 'boiler plate' or general information is not included. In doing so, it is necessary to ensure that appropriate and sufficient information is disclosed in both a transparent and accessible manner to protect investors from less transparent investment environments. The prospectus should strive to create sustainable trust, as well as to give the management confidence that they will be protected from unwarranted litigation.

4. Information that investors need to find in a simplified prospectus

For the future prospectus to be more relevant to investors, the current practice of lengthy, 'contract like documents' should be transformed in favour of more concise and business focused data. Such information is often already available to all companies, and would be less costly to reproduce especially for SMEs.

The elements for the prospectus listed below (Category 1.) are considered as most relevant for investors to consider when making their investment decisions. Each of these core information topics are further commented on in this document's Annex.

In order to achieve an **investor-oriented and business-driven approach**, business owners and managers can best describe and comment on the these core elements, possibly aided by in-house business controllers and investor relationship managers. It will most likely reduce (outside) costs and result in concise and meaningful explanations that resonate with, and meet, the needs of investors.

The reduction of the **amount of information** in a prospectus is another key objective. Much of this information is either 'boiler plate' or could be made available elsewhere. This information can be posted on a company's website with links being provided in the prospectus (Category 2. below). This would have the additional effect of extending, to IPO candidates, the benefits of being able to incorporate information by reference, which is already available to existing issuers. A realistic objective should be to reduce the volume of a prospectus by at least half of what it is today.

Being concise, relevant, and forward-looking, the simplified prospectus should address the conditions under which the strategy, governance, performance, and prospects of the organization will allow it to create value in the short, medium and long term. The focus of a prospectus should therefore be on presenting the most important features of the company.

A clear objective must be the reduction of the amount of information that is set out in a prospectus

The **three categories** indicate below which sets of information should be found in the prospectus itself, made available on the company's website, or placed on publicly available information platforms. In this way, the actual amount of information in a prospectus can be significantly reduced.

Category 1. Core information that investors need to find in a new simplified SME prospectus[3]

- insight into the key market features, including a description of the competitive landscape and third party forecasts with drivers for growth
- description of the business model as it is the core driver of value creation[4]
- explanation of the strategy, strategic objectives and milestones, describing how the company will engage with competitors, identify and segment customers, and respond to the actual market environment
- identification of the key risk factors specific to the company and explain how it plans to mitigate them

[3] Each of these items are further explained and elaborated on in the Annex.

[4] Without spreading the information over pages, the description could consist in a simple diagram focusing on explaining how a company is structured and its methods for maximizing revenues and profits over time. In particular, it should emphasise on how the revenue is generated, identify the key customers and suppliers, explain how the organization differentiates itself from competitors, disclose the relationships with related parties and explain how the organization is agile and able to innovate.

- outline of the governance and ownership structure, including the track record of selected key managers as well as the top management compensation and how it is aligned with long-term value creation
- overview of performance, preferably pictured through a couple of financial and non-financial key performance indicators (KPIs) and summary historical financial information
- overall indication of management's view on market trends as well as the company's related forecasts, as and when available
- reasons for offering and use of proceeds linked to the company's proposal

Materiality should be considered for all of the topics above, in order to ensure their relevance and reduce the overall length of the prospectus. For the small businesses in the SME market, and in particular for those that combine small offering sizes with small par value securities per (retail) investor, some information such as governance and forecasts, even if qualitative only, may not always be available or of most relevance. In the end, markets may still – whilst allowing for lower costs of capital for more transparent issuers – provide capital for small companies that are not expected to deliver mature financial data in all instances.

Category 2. Core information that should be placed on the issuer's website

Issuers should place core information on their website to reduce the length of prospectuses

Much of the elements listed here take up a large volume in any prospectus:

- audited historical financial statements[5]
- overview of the most significant transactions and relationships with related parties
- where and when available, more extensive descriptions of the business, its markets and customers, and its strategy[6]
- extended CVs and resumes of all management
- constitution(s) of the company
- extracts or summaries of key agreements
- lock up data, type of shares, voting rights and the likes
- any other risk factors

Category 3. More generic information to be included on publicly available information platforms

There is also an opportunity to consider the extent to which standard information which applies to any company or offer can be made available elsewhere, so the prospectus disclosure can be limited to a link to where the information can be found. This information could be set out on a website maintained by an external party such as the market operator, securities regulator, or an independent IPO platform.

[5] This information is often several tens if not hundreds of pages of an existing prospectus. Such information could reside on the company's website and only summarized information be included in the prospectus.
[6] A company should include, if applicable, additional data on its website that goes beyond the concise description sought after in the actual Prospectus. In many cases, these already exist and can thus be shared without significant additional costs

Such information could include:

- generic risk factors[7]
- investor's taxation position across the EU member states and those of other countries where investors may reside
- known differences between a country's accounting framework and the International Financial Reporting Standards (IFRS) to enable investors achieve greater comparability in cases where IFRS financial statements are not available

[7] Such as "There is no currently a trading market for the Ordinary Shares", "The trading price of the Ordinary Shares may fluctuate in response to various factors, many of which are outside the Group's control" and "Pre-emption rights for US and other non-UK holders of Ordinary Shares may be unavailable"

5. How information should be made available in a prospectus

As a principle, and based on current practice, issuers of prospectuses are encouraged to look at all presentations and media formats in order to find solutions as to how the information outlined in the above section (Category 1.) can be made available. The current lengthy and contract-like documents are costly, especially for SMEs, and by their format alone often discourage active use by potential investors.

We encourage issuers of prospectuses to look at all presentations and media formats in order to find solutions as to how the information can be made available

Various **web-based platforms and tools** allow the management to 'speak directly' to all types of potential investors in ways that were previously only available in close-knit road shows and investor or analysts' gatherings. These new tools often allow the production of information at a fraction of the printing cost. Not only should these previously limited audience dialogues be made available in the prospectus to enhance the relevance for investors, but current technologies can bring down costs.

Issuers should be encouraged to make available to investors the management's presentation of the business as part of the new prospectus. Where and when traditional investor road shows are held, the company should strive to make these available and, if possible, offer the opportunity for questions to be raised via these online platforms perhaps hosted by an independent person. The presentations, questions, and answers should be recorded and made available for subsequent viewing on the company's website or on an independent IPO platform. Where and when additional due diligence and studies are made as part of the IPO process, thought should also be given to making these available to investors so that more valuable information is shared transparently to all potential investors.

The time is right to make such changes to meet the investor-oriented and business-driven objective set forth. Many listed companies' annual reports already illustrate what can be done without the straight jacket that is imposed on a prospectus.

6. A role for credible and relevant communication

Investors benefit from the knowledge that an issuer and its management have been challenged in the process leading up to an IPO through the involvement of bankers, lawyers, and accountants as well as the securities regulator. This process is currently kept private, with investors implicitly taking confidence from the involvement of others that due process has been undertaken.

Transparency on all due diligence or other activities performed by any expert will enhance the investment environment

Therefore, investors may benefit from more **transparent information** on the various types of conducted due diligence. Amongst other things, the following are of potential interest:

- a description of the **experts and advisors** that performed some form of due diligence or supported the company or advisors in that due diligence
- a brief description of the **nature of the type of services or procedures** they have performed. Transparency on all due diligence or other activities performed by any expert will enhance the investment environment and allow companies, in particular SMEs, to leverage more on conducted work. In order for this to be cost-effective, any disclosures of private work delivered as part of the issuance of the prospectus should be reported upon as stated in this section – without expanding the liability regime of those involved. Not doing so would risk resulting in increased costs, which is counterproductive. Even without direct liability coverage, greater knowledge of what services were provided by which experts can only increase investment opportunities at no extra cost, and respectively increase usage and leverage of costs that were incurred
- a reference or link to **corporate governance structure** and information of these experts and advisors. Transparent data in general, and in this case on all advisors and experts, will almost certainly allow investors to better gauge the quality of the advisors and experts used in the prospectuses, whether those are niche experts, firms specializing in SMEs, certain industries, or larger service provider firms. For instance, currently **Transparency Reports** are defined and requested for registered accountants serving Public Interest Companies. The EU and the market as a whole have come to expect and rely on such transparency. Such or similar information should be made available transparently for all advisors and experts involved.

Annex: Further commentary on suggested prospectus disclosure[8]

Companies, and in particular SMEs, may be daunted by the information needs that result from a going public process. This section therefore provides examples and guidance of what more specifically investors may seek to find in a prospectus.

This should not be seen as a checklist of data to incorporate, but rather an aide to consider the relevance and applicability to the company preparing a prospectus. As made clear in the main body of this paper, preparers of new prospectuses should aim to present data concisely and with a business focus, thereby using all current technology-based distribution formats.

There is no 'one size fits all model' to describe what should be included in a prospectus, given the variety of businesses that exist and investors they may attract. Businesses – from early stage growth companies to mature businesses offering stable dividends – should each consider these elements with an investor-oriented and business-driven focus. Those that are involved in drawing up prospectuses should avoid redundancies and overlap, and instead build on an executive summary (*Description of the business model*) in a manner that provides additional and more detailed insights, in the captions thereafter.

The following examples of data may, where and when applicable, be provided:

Insight into the key market features

- short description of the overall market(s) in which the company operates and how trends of that market may create value for investors

Description of the business model – descriptions should be concise and clear

- description of the company's business including how and where it creates (or plans to create) value for investors
- describe where the company is situated in the value chain of its industry, its product and geographical footprint. Identification of competitors/peers that operate partially or wholly in the same target market(s)
- concise analysis of past performances focusing on the key drivers of prior periods and how such drivers may evolve in the upcoming periods
- description of opportunities that may allow the company to meet or surpass market trends described above
- the business case for seeking funding from investors including how and where the expected proceeds will be used and how these will create an opportunity for investors

Explanation of the strategy

- a concise description of the company's long-term strategy and how it expects to create value for investors
- describe how the company has met or exceeded its past strategic plans

[8] Category 1. in Section 4

- a comment on how the Business Case fits into the strategic plan
- value creation model
    - building on the initial descriptions made in the above section, provide additional clarifications on how the company seeks to create value in its market or industry
    - describe how the proceeds will be used to support the strategy of the company
    - provide additional comments on the past value creation, including its key drivers and the company's ability to influence and manage these drivers
    - explain, using the above drivers and market trends, how the value chain may change and what that means for the company

Identification of the key risk factors specific to the company and explain how it plans to mitigate them

- explanatory comments on the key risks affecting the business model that may affect the above drivers and how these could influence future results
- identification of key customers and suppliers, briefly comment on key suppliers, including their relative importance to the supply chain or the value chain as a whole. Comment on how such suppliers may impact the risks and opportunities described above
- description of barriers to entry, intellectual property, patents etc. Describe existing legal, technological and other hurdles that may both create more stability in certain markets and/or stymie growth and opportunities in others

Outline of the governance and ownership structure, including the track record of selected key managers as well as the top management compensation and how it is aligned to long-term value creation

- describe the key features of the existing or planned corporate governance structure and process
- explain past and current experiences, including relationships with existing management team members and key shareholders, of those in charge of corporate governance
- comment briefly on the type of oversight activities or procedures performed by the corporate governance structure, including nature and frequency. Comment on key findings and resulting suggestions it has initiated
- track record of selected key management
    - provide an overview of selected key management members (more information on all management and board members could be shown on the website)
    - comment specifically on their past track record in this or similar value chains, markets and/or industries
    - where and when new management team members have joined the company, explain how these new management members are expected to contribute to the company's business

- describe the key drivers in the compensation package of any of the above key management members

Overview of performance, preferably pictured through a couple of financial and non-financial KPI’s and summary historical financial information

- provide an overview with key historical financial information including, where applicable, operational and financial KPIs
- explain why these KPIs are appropriate to measure performance in view of the key drivers in the value chain described above
- comment on trends noted both in historical financial information and KPIs. Explain such trends in relation to the drivers, products and markets described above
- comment on the quality of the historical financial information and KPIs, i.e. how these have been impacted by risk and opportunities that materialized in the past years, and how this historical data correlated with past forecasts by management
- describe key elements of past historical performance such as:
  - revenues: price and volume trends, internal and external growth, new or terminated products or markets
  - costs: describe how costs relate to the revenues outlined above. Describe both key recurring costs and past none-recurring costs distinctly
  - comment on historical working capital strengths or weaknesses; debt ratios and capex trends
  - describe existing covenants, guarantees, pledges that may be affecting the quality of the assets and liabilities
  - describe prior key off-balance sheet commitments and how these have affected past performance
  - comment on cash flows, drivers for increases, and decreases and the historic quality of management’s predictive vs actual cash flows
  - provide quantitative and qualitative explanations on events (acquisitions, disposals, restructuring, major capex, carve outs) in a manner that allows investor to understand how these have contributed to the achieved historical financial information and KPIs

Overall indication of management’s view on market trends as well as the companies’ related forecasts

- explain the key assumptions and how these compare to the actual trends described in the historical data and the expected market trends also described above
- explain key sensitivity data indicating the relative impacts of changes of these assumptions on the forecast
- explain how the proceeds described in the business case will impact the forecasts

Reasons for offering and use of proceeds

- summarise why the company is seeking funds, as opposed to alternative financing opportunities
- summarise, using data developed and explained above, how the funds will contribute to value creation for the investor
- summarise the key risks and opportunities investors should consider in relation to the above
- summarise why an investor might find this particular investment an appropriate addition to his/her investment portfolio and risk/reward appetite

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Federation of European Accountants

WHO WE ARE

The Federation of European Accountants represents 50 professional institutes of accountants and auditors from 37 European countries, with a combined membership of over 875,000 professional accountants working in different capacities. As the voice of the European profession, the Federation recognises the public interest.

The Federation is in the EU Transparency Register (No 4713568401-18).