COST EFFECTIVE FINANCIAL REPORTING FOR SMALL BUSINESS*

For nearly two decades accountants have been researching and debating the merits of separate financial reporting standards for small private businesses. Research studies have included opinion surveys of accountants, auditors, owners, creditors, and other statement users, while apparently forgetting that although the benefits of increased information accrue to all financial statement users, the cost is borne solely by small private company owners. Financial statement information is, according to the American Institute of Certified Public Accountants (AICPA), provided "cost-free" to third-party financial statement users (AICPA 1983). Perhaps as a result, creditors and other third-party financial statement users tend to want more information rather than less, as well as to insist that financial statements of all firms (large and small, public and private) be prepared in full accordance with Generally Accepted Accounting Principles (GAAP).

The authors argue that the desire for more cost-free information should not be a factor in the accounting profession's cost-benefit analysis of financial reporting standards. Only the costs and benefits to owners (the cost bearers) should be considered in the application of reporting standards to small private companies.

Before applying accounting disclosure standards to small private companies, the query must be: who pays and who benefits? For private company owners, *increases* in the information content of financial statements may result in the following costs and benefits:

> Costs: Increased audit fees and/or greater involvement of internal auditors and/or staff accountants.
>
> Benefits: Reduced interest rates (no increase in financing costs resulting from inadequate information) and/or appropriate management decisions based on adequate data.

Likewise, *decreases* in the information content of financial statements may result in the following costs and benefits to private company owners:

> Costs: Inappropriate management decisisons based on inadequate data and/or higher interest rates or lost opportunities resulting from denied financing.
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> Benefits: Decreased audit fees and/or less involvement of internal auditors and/or staff accountants.

It also may be argued that the costs and benefits relating to management

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decision making are only theoretical and, in fact, do not exist. This is because small business owner-managers more frequently obtain information from sources inside the firms, not from audited statements. The involvement of an external auditor may lend assurance as to the adequacy of internal controls and the proper application of accrual accounting; but it is not necessary to generate full GAAP financial statements to obtain these benefits. Therefore, the true costs and benefits of changes in the information content of audited financial statements may, for the small business owner-manager, only be the increase or decrease in the cost of the audit and the effect on the cost of borrowed funds.

Regardless of the cost/benefits relationships, the Financial Accounting Standards Board (FASB) has maintained that it will not consider exemptions or free-choice alternatives in standards for recognition or measurement based solely on entity size or ownership characteristics.

BACKGROUND[1]

During the past two decades, several committees of the AICPA and the FASB have researched the wisdom of applying full GAAP to all companies. In general, these committees concluded that:

- The same accounting measurement rules should apply to both large and small public companies (AICPA 1976), but some GAAP were not justified for small private companies (AICPA 1980).
- Smaller companies were subject to too much disclosure (AICPA 1980).
- The income tax basis should be used as an acceptable financial reporting basis (AICPA 1981).
- When bankers deal with private companies' financial statements, they are more concerned with the reliability that external auditors give to the financial statements than the reliability provided by the reporting standards applied (FASB 1983).
- Many lenders accepted qualified audit opinions, provided the auditor disclosed the level of responsibility taken and the level of assurance provided (FASB 1983). This practice supports the notion that what statement users value most is not the application of specific accounting standards in the financial statements.

Officially, the FASB has responded by exempting small public companies from providing: (1) earnings per share and segment data (*FASB Statement No. 21* 1978), (2) data regarding defined benefit plans (*FASB Statement No. 35* 1980), (3) disclosures of oil and gas reserves (*FASB Statement No. 25* 1979), and (4) pro forma information following certain types of business combinations (*FASB Statement No. 79* 1984). In addition, only very large companies are required to make full disclosure relating to compensated employee absences (*FASB Statement No. 43* 1980).

USERS VERSUS PREPARERS

In all studies, financial statement users indicate that they want more rather than less disclosure. When information is cost-free to users, we may conclude that "more is better." In contrast, a different opinion is expressed by CPAs, who, through their audits, account for a major portion of the cost of preparing financial statements. CPAs do not feel disclosure requirements are equally important for all types and sizes of firms. When asked their opinion of the relative importance of different requirements, CPAs contended that disclosure is more

[1] The background provided is not intended to present an exhaustive review of the literature, but rather to survey those studies and publications that offer insights directly bearing on the authors' position. A more complete background review can be obtained by contacting the authors.

important for public than for privately held companies, and significantly more important for large publicly owned companies than for small publicly owned companies (Knutson and Wichmann 1984).

Interestingly, CPAs from small public accounting firms were more vocal in their criticism of the FASB than were small businesspersons. CPAs, as preparers, apparently realize that as accounting standards increase, so does pressure to increase fees. CPAs may thus be more sensitive than businesspersons to the balance between the disclosure needs of the user groups and the costs of providing information. Resistance to fee increases by the owner-managers of small private companies may result in resistance to increases in standards by small firm CPAs.

HIGHER PROPORTIONATE COSTS

The question of whether users' perceived information needs are different for large and small firms may not be the only issue. The promulgation of extensive and complex accounting standards puts a severe strain on the resources of a small business. For example, even though the AICPA has supported uniform standards (1982), it has also noted that the cost of CPA services was more than twice as high per dollar of sales for small businesses as for large businesses. Therefore, as accounting standards increase, so does the pressure placed on small firm CPAs. Because these firms are unable to reduce the pressure through specialization (as large firms do), accounting and audit fees generally rise. Additional auditor time may be spent ensuring that small firms are in compliance with complex pronouncements.

Small companies with limited staff and resources may incur substantial additional costs attempting to comply with accounting standards, while the cost of compliance may not be significant to larger companies. This would imply that a unique financial burden is placed on small business owner-managers because they must pay a proportionately higher cost for the same benefit (audited statements).

OUR PROPOSAL: A REPORTING CONTINUUM

We argue that financial reporting should not be a mutually exclusive choice between distinct alternatives, as the big GAAP/little GAAP approach implies. Financial reporting variations can be viewed as choices on a continuum, with each choice consisting of a level of reporting more advanced and complete than the last.

This approach is shown in table 1. Six levels are used to illustrate the potential of a reporting continuum.[2] Levels 1 (cash basis) and 2 (tax basis) are identified as acceptable applications of Other Comprehensive Bases of Accounting (OCBOA) that can be audited under *Statement on Auditing Standards No. 62, Special Reports* (AICPA 1989).[3] Levels 5 and 6 are full accrual statements that apply all GAAP for public and private companies. Levels 3 and 4 are basic full accrual presentations that lack incorporation of the more complex reporting and disclosure requirements. These levels (3 and 4) bridge the gap between OCBOA and GAAP and have no authoritative support.

COST/BENEFIT JUSTIFIED REPORTING

Given these choices, statement preparers could choose the least complex reporting level that would satisfy user needs. Liquidity and cash flow infor-

[2] The use of a reporting continuum was first proposed by the authors in G. Thomas Friedlob and Franklin J. Plewa, Jr. (1984). The proposed continuum was analyzed by Kenneth M. Hiltebeitel (1986) and was expanded in Franklin J. Plewa and G. Thomas Friedlob (1989).

[3] For an excellent discussion of the use of financial statements prepared according to other comprehensive bases of accounting, see Judith H. O'Dell and Jacob J. Cohen (1991).

Table 1
SMALL BUSINESS REPORTING CONTINUUM

Other Comprehensive Bases of Accounting (can be used to produce audited financial statements):

Level 1: The cash basis. [OCBOA]

Level 2: The federal income tax basis. Cash flows are reported with accruals for inventories, receivables, and depreciation. [OCBOA]

Hybrid Methods (could not receive an unqualified, that is, clean, audit opinion):

Level 3: Basic full accrual. [Neither OCBOA nor GAAP]

Level 4: Basic full accrual with footnote disclosure of departures from GAAP. All cost beneficial reporting standards are followed. The provisions of standards which are not cost beneficial, and the *directions* of their effects (increase or decrease) on amounts in the statements, are disclosed in the statement notes. [Neither OCBOA nor GAAP]

Full Compliance with All Accounting Standards:

Level 5: Full accrual GAAP statements for private companies. Financial statements with only currently allowable statement exclusions (FASB Statement Nos. 14, 21, and 33, for example) for private companies are prepared. [GAAP]

Level 6: Full accrual GAAP statements for public companies. [GAAP]

mation for debt repayment could perhaps be provided to lenders by level 1 or level 2 statements (cash or tax basis statements, respectively). Level 1 or 2 statements may be all that owner-managers of small private companies need to satisfy creditors. The information needs of private company owner-managers might be satisfied by financial reports from level 3. These show the basic full accrual profit and financial position of the company, but not the detail and additional accruals associated with requirements (such as for some pensions or tax accurals) that necessitate complex, costly calculations. Because of their reduced access to information from sources inside the company, private company owner-nonmanagers might, in contrast, want the more elaborate reports prepared at level 4, which would disclose the direction of the effect (as increase or decrease) of all reporting standards not followed.

The six reporting levels are fundamentally related so that additional procedures supply the detail to convert each level into the next. Many private companies already prepare level 2 statements for reporting federal taxes. Changes in the tax law have put pressure on small businesspersons to use their tax depreciation method for financial reporting, thereby avoiding generating a tax preference item under the alternative minimum tax calculations. This practice creates a report that is a hybrid of level 2 (tax basis), and level 3 (basic full accrual).

Owners of private companies could maximize their cost-to-benefit ratio by choosing the least complex reporting option needed to satisfy a particular user. If a user (perhaps a creditor) desires more detailed information (a higher level of reporting), private company owners could compare the potential benefits of providing additional information (for example, reduction in loan costs), with the additional costs of generating the information. Because there are no public policy considerations, owner-managers of private companies can limit financial reporting to providing only cost-justified information.

EMPHASIS OF MATTER PARAGRAPH

Generally accepted auditing standards require an audit opinion to be qualified or disclaimed, as necessary, to indicate the level of assurance given by the CPA. In the case of small, private companies, a separate paragraph for the emphasis of matter could describe the private company status and the cost-benefit justification for the reduced level of reporting. *Statement on Auditing Standards No. 58* discusses the emphasis of matter paragraph (AICPA 1990).

Levels 1 and 2

For levels 1 and 2 (both OCBOA), *Statement on Auditing Standards No. 62* specifies that the second paragraph of the audit opinion should identify the accounting basis used, describe how the basis differs from GAAP, and indicate that the statements are not intended to conform to GAAP. A qualification for lack of consistency could be required the first year that OCBOA statements are issued; but, despite the use of OCBOA, an auditor can express an unqualified opinion on level 1 and 2 financial statements issued after year 1.

Levels 3 and 4

For levels that are neither OCBOA nor GAAP, an AICPA *Statement of Position* and an SEC Financial Reporting Release would be helpful in structuring the emphasis of matter paragraph and in providing support for this approach. If the departure from GAAP is material, or of such significance as to cause a misstatement of the entire financial statements, *Statement on Auditing Standards No. 58* requires the auditor to either disclose the quantitative effects (i.e., make the calculations and bill the owner), or disclaim an opinion. In such a case, a review or compilation might offer a cost-effective response to user demands; both involve the CPA (thus providing assurance to some statement users), but neither requires an audit opinion.[4]

CONCLUSION

If auditing standards were changed so that auditors could qualify their opinion without disclosing the dollar impact of violating certain accounting standards, owners of private companies would be encouraged to select the most cost-beneficial level of financial reporting. With the approach outlined above, owners of private companies would determine the information content of company financial statements by examining the costs and benefits of supplying information. Statement content would be determined by owners who pay for information generated, rather than by third-party statement users who bear none of the costs.

As a result of suggestions from several sources, the forum final report (SEC 1991), published in June 1991, contained the following recommendation: "Reviewed financial statements should be acceptable for offerings of up to $1 million."

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[4]For a discussion of the varying levels of assurance that can be expressed regarding the six levels proposed by the authors, see Kenneth M. Hiltebeitel (1986).

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G. Thomas Friedlob
Clemson University
and
Franklin J. Plewa
Idaho State University