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Generally Accepted Accounting Standards: A Standards Overload for Small Business?

One of the most controversial issues in the accounting profession over the past few years has been labeled by some as the accounting standards overload and by others as the big GAAP / little GAAP debate. This controversy has arisen because, as a general rule, current accounting standards "apply to all companies with no distinction being made between small and large companies or publically held and closely held companies" (Williams, p.1294). It is possible that some accounting standards place an unnecessary burden on small and/or privately held companies. It is suggested that accounting standards and their required disclosures have been formulated with large, publicly held companies in mind and thus small and/or privately held businesses have had to incur costs in excess of the benefits received from complying with these standards. In addition, it is held by critics of current accounting standards that users of the financial statements of small and/or nonpublic companies are usually the owners of the business or bankers who are close to the business and who have alternative sources of information available to them; these users are not concerned with many of the complexities introduced by accounting standards.

Proponents of current standards disagree with the critics. Proponents hold that it is not at all evident that the costs of complying with accounting standards exceed the benefits of complying, nor is it clear that the needs of the users of the financial statements of small and/or privately held companies differ significantly from the needs of the users of the financial statements of large, publicly held companies. In fact, mixed messages have been received from the various studies and surveys conducted to examine the alledged standards overload problem. The controversy seems no more near resolution now than it did in 1974 when the AICPA formed the Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses.

Various accountants and other businessmen who believe that a standards overload problem does indeed exist have offered an array of possible solutions to the problem. These suggested solutions include the following: 1) simplifying Generally Accepted Accounting Principles for all companies, 2) providing additional disclosure relief for small and/or privately held companies, 3) providing accounting measurement relief for small and/or privately held companies, and 4) developing a simplified alternative basis of accounting for small and/or privately held companies.

The purpose of this paper is to explore the issue of the alledged standards overload problem. This exploration can be accomplished by breaking the topic down into several key areas of discussion. To fully comprehend the nature of the problem, it is necessary to have some background on current generally accepted accounting standards (GAAP): what is the nature of current accounting standards and where do they get their authority?; what is the purpose of current accounting standards, and is this purpose served for both small and/or privately held companies as well as for large, public companies? It is also necessary to have some background on the history of the controversy. The next logical step is to attempt to define the term "small business" -- a task not as easy as it would appear. The exploration of the problem continues with an analysis of both the users of the information found on the financial statements of small and/or nonpublic companies and the users of the information found on the financial statements of large, public companies: are the users different?; do their needs for information differ? Next, an analysis of the costs and benefits of complying with current accounting standards is necessary: does the cost/benefit ratio differ for small and/or nonpublic companies and for large, public companies? Assuming that a standards overload problem does exist, a discussion of possible solutions to the problem is the final step.

Generally accepted accounting standards (GAAP) are those standards that have substantial authoritative support; Carl E. Coles defines GAAP in the following manner:

> [GAAP is] a combination of definitions, concepts, methods, and procedures used in preparing financial statements ... [which] are established largely through the pronouncements issued by the Financial Accounting Standards Board (FASB), the Securities and Exchange commission and various other regulatory

> agencies (Coles, p.64)

GAAP has also been defined as:

> the consensus at any time as to which economic resources and obligations should be recorded as assets and liabilities, which changes in them should be recorded, when these changes should be recorded, how the recorded assets and liabilities and the changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared (Williams, p.12 quoting from AICPA Special Bullitan, Disclosures of Departures from Opinions of the Accounting Principles Board and APB Statement No. 4).

It is clear that the concepts of measurement and disclosure are important in the understanding of GAAP. In fact, accounting has been described as a measurement and disclosure discipline. "Measurement refers to the assignment of numbers to objects, such as inventories and plant assests, and events, such as purchases and sales" (Williams, p.78). Measurement allows the convenient use of numbers to convey certain objects and events to interested parties. After accountants measure the the elements of the financial statements, the results of the measurments are disclosed to the users of the financial information in order to help them make better decisions.

It is generally believed that the purpose of GAAP should be to fulfill the objectives of financial reporting. SFAC 1 defines these objectives which are not limited to financial statements; financial reporting encompasses the financial statements and other ways of communicating accounting information such as annual reports, prospectuses, etc. Three objectives of financial reporting are discussed in SFAC 1: 1) "to provide information that is useful in making business and economic decisions" to both internal and external users of the information; 2) "to provide understandable information which will aid investors and creditors in predicting the future cash flows of a firm"; and 3) "to provide information relative to an enterprise's economic resources, the claims to those resources (obligations), and the effects of transactions, events, and circumstances that change resources and claims to resources" (Delaney, p.19).

Since 1973, the FASB has been the official private sector in charge of establishing GAAP. The FASB took over responsibility from the Accounting Principles Board (APB) which had been charged with the responsibility of establishing accounting principles from 1959 to 1973. Although the FASB has the authority to set accounting standards, it is not a governmental agency; it is privately funded. However, its authority does depend a great deal on its endorsement by governmental bodies, especially the Securities and Exchange Commission (SEC), and state-level regulatory agencies. It gets additional authority from other non-governmental organizations: the AICPA, the major auditing firms, the Fianancial Executives Institute, and the National Association of Accountants, etc. (Miller and Redding, p.19).

A general understanding of GAAP and the sources of its authority facilitates in gaining an understanding of the history of the standards overload controversy. The history of the debate can probably be traced to the first GAAP, because businesses have never embraced the idea that an outside source should have the ability to dictate what a business should do or how it should do it. However, in discussing the question of whether or not different accounting standards should be established for small and/or privately held companies, it is only necessary to go back to 1974. This is the year that the American Institute of Certified Public Accountants formed the committee on Generally Accepted Principles for Smaller and/or Closely Held Businesses. For the committee, two areas were at issue: 1) measurement rules and 2) disclosure rules. The committee felt that measurement rules must apply "across the board" (Lippitt and Oliver, p.53). In other words, "measurement rules must be applied to the general-purpose financial statements of all entities because the measurement process should be independent of the nature of their users and their interest in resulting measures" (Knutson and Wichmann, p.54). However, the committee was more open to the possibility of a standards overload regarding disclosure rules; it decided that small and/or privately held businesses may be subject to unnecessarily extensive and financially burdonsome disclosure standards (Lippitt and Oliver, p.54). The committee suggested that those disclosures "required by GAAP in the financial statements of all companies should be distinguished from those merely providing additional or analytical data. These additional or analytical disclosures should be kept separate within the financial statements when they are presented" (Knutson and Wichmann, p.40).

In 1975, a committee of the Accounting Standards Division of the AICPA was formed to examine the standards overload issue. Its findings and suggestions generally correspond with those of the previous committee. In 1980, the Special Committee on Small and Medium Sized Firms was formed by the AICPA; it suggested the formation of "a special committee to study alternative means of providing relief from accounting standards which are not effective for small businesses" (Knutson and Wichmann, p.40). As a result, in 1981 the Special Committee on Accounting Standards was created; this committee was co-sponsored by the FASB. In 1984, the Special Committee issued its final report to the FASB. It recommended that the FASB: 1) "Immediately reconsider unnecessarily costly and burdomsome requirements, such as those that apply to leases and income tax," 2) "Make simplicity its goal in writing new rules and revising new ones," and 3) "Consider whether, in certain situations, different disclosure or measurement rules might be appropriate for privately-owned companies" (Knutson and Wichmann, p.40).

In addition to the special committees formed in 1981, the FASB offered an Invitation to Comment: Financial Reporting by Private and Small Public Companies on the subject of the alledged standards overload problem. This was a major research effort with the objective of discovering how the costs and benefits of complying with financial reporting requirements differ for small companies and the users of their financial information. This Invitation to Comment received an unusually large number of responses. Based on the consideration of the Invitation to Comment and other research by the AICPA and FEI, the FASB concluded that small businesses do incur different relative costs and benefits as a result of complying with financial accounting and reporting requirements in some areas (Wishon, p.101). Some areas had already been taken care of: earnings per share, business segment data, certain supplementary information about oil and gas producing activies, pro forma results of purchase business combinations. Small businesses did not have to disclose this information.

The FASB recommended that there should be one set of GAAP for all companies, but private or small public companies should be exempt from some disclosures based on cost/benefit analysis. Overall, the FASB recommended that the special circumstances of small business should be considered by the FASB on an issue-by-issue basis for each project on the FASB's agenda.

As has been stated, it is generally held that the purpose of GAAP should be able to fulfill the objectives of financial reporting. Is this purpose served for both small and/or privately held companies and for large companies? To answer this question, a definition of "small" and/or privately held company must be developed. Williams defines a public company as one whose securities are traded in a public market or one that is required to file with the securities and exchange commission (p. 1298). A privately held company is defined as one that is not a public company. However, the definition of "small" is not so easy. The FASB has found that size and ownership tests are not all that helpful in evaluating whether small business is affected by accounting standards or in determining the consequences of standards in small business financial statements (Upton and Ostergaard, p.95). These tests are often too restrictive or too broad. The tests also fail to discriminate between companies of the same size, one of which is stable, for example, the other of which is new and unstable. These tests may also fail to discriminate between the norms of a particular industry: for example, a 100 employee manufacturer is considered small by its industry standards while a 100 employee computer software developer is considered large by its industry standards (Upton and Ostergaard, p.95).

Rather than trying to define "small" as many researchers have done, the FASB has focused on how specific issues in accounting affect different businesses. This approach, says Wayne S. Upton, a practice fellow at the FASB, is more difficult but is also more consistant with the board's intention to set standards for general purpose accounting (Upton and Ostergaard, p.5). From this point onward in the paper, The term "small" will refer to both small public companies and privately held companies.

Some critics disagree with the FASB's approach and feel that the elusive definition of "small" business in not necessary. Generally speaking, these critics maintain, small businesses differ from large public companies in the users of their respective financial statements, the information necessary to be communicated to these users, the their cost/benefit ratios of complying with GAAP.

The critics of the FASB's approach to the standards overload problem conclude that the major users of the financial information generated by a small business are its owners, its managers, and its creditors. As oppposed to a large public company, the owners of a small business are usually also its managers. It has been suggested that because smaller firms tend to be less diversified than larger firms, the owner-managers of a smaller firm are more interested in business risk than in the systematic risk or market risk that interests the more diversified owners of a large business. In other words, the owner-manager of a small business has more of his/her capital invested in a single enterprise. "The resulting concentration of ownership suggests a relatively smaller capital market and the lack of large numbers of buyers and sellers" (Plewa and Friedlob, p.56). Thus, there tend to be fewer changes in ownership in a smaller business than in a larger business.

As has already been mentioned, the management of a small business tends to consist of only a few people who are also owners. These owner-managers tend to be knowledgeable of all parts of the business, because these individuals perform multiple management roles.

Because of the limited access of small business to capital markets, the role of bankers and other short-term creditors is often very important. A survey about small business was conducted by R.D. Nair and Larry E. Rettenburg in 1983. These researchers asked businessmen and CPA's to rank "five reasons why [small] businessess receive audit, review or compilation services" (p. 84). The rankings indicated that both groups believe that the main use of financial statements is for bank loan and credit arrangements (Nair and Rettenberg, p.84). Thus in the eyes of the businessmen surveyed, bankers are the primary users of the financial statements of a small business.

The major users of the of the financial statements of a small business, as seen by the critics of current accounting standards and the FASB, have been identified. Do the financial information needs of these users differ from the needs of the users of the financial statements of a large business? When it comes to the owner-manager of the small business, there is evidence that suggests the answer to this question is yes. Because the owners and the management of a small business tend to be the same individuals, they tend to receive good information internally and on a timely basis. Therefore, they are not so dependent upon formal financial statements like the owners (shareholders) of a large business who are far removed from management. It could be argued that formal financial statements may have little or no value to the owner-manager of a small business.

Many of the people on both sides of the standards overload controversy might agree that, if the owner-managers were the only potental users of the financial information generated by a small business, there would be no need for compliance with GAAP on the part of small business. However, owner-managers are not the only users, and there is much disagreement as to whether or not the financial information needs of the creditors of a small business differ from the financial information needs of the creditors of a large business. Many critics of current GAAP believe that the needs of the creditors, usually bankers, of a small business <u>do</u> differ. This difference stems from the fact that small businesses often have limited access to capital markets.

> Short-term creditors often require systematic financial reporting information. A case can thus be made for making the focus of small business financial reporting the liquidity information needs of their short-term creditors, not general purpose GAAP, which focuses more upon income measurement" (Lippitt and Oliver, p.55).

In other words, creditors need a different type of financial reporting that focuses on their specific needs rather than that which is supplied in multi-purpose financial statements. The focus, say supporters of this contention, should be on liquidity -- the ability to repay debt, rather than on the periodic measurement of income.

Advocates of current GAAP tend to expand the notion of "financial information user" and find fault with the narrow definition of "user" that critics of current GAAP often employ -- owner-manager and creditor. These advocates of current GAAP hold that <u>all</u> the possible users of a small business's financial statements should be considered. Thus, in addition to owner-manager and creditor of a small business, the litigation claimant, limited partner, bonding agent, absentee owner, government regulators, and others must be taken into account (Upton and Ostergaard, p.95). The financial statements and their accompanying notes are often the only sources of information for these users.

> External users take it for granted that published financial reports are presented in accordance with GAAP. They want financial data to be reliable, relevant, consistant, and in a form that facilitates comparisons, and they rely on GAAP for providing an accurate financial picture of a particular business (Korn, p.16).

Thus, these proponants of current GAAP refute the idea that abbreviated financial statements, such as those focusing on short-term liquidity for the benefit of creditors, would be sufficient for all the users of the financial information of a small business.

Advocates of current GAAP also refute the idea that financial statements focusing on stort-term liquidity would be sufficient even for bankers alone. For example, the ASC studied the standard analysis sheets of the major clearing banks. The study indicated that the analysis sheets were no more that a re-ordering and summary of information found on standard financial statements conforming with GAAP. "There was no indication that the typical bank manager needed any more information than was already contained in the financial statements" (Lawson, p.21).

Because there is obviously no consensus on the definition of "small business" or how exactly a small business differs from large business in terms of its users and the needs of its users, it may be necessary to perform some sort of cost/benefit analysis to see if certain standards are an unnecessary burdon on small business. The costs incurred by a small business as a result of complying with GAAP may be relatively higher than those costs incurred by a larger company. This inequality results because a small firm with limited staff and resources will probably need to hire an outside CPA to do the work; a large firm could just re-assign one of its salaried internal accountants. Another reason for the relatively higher costs of complying with GAAP is that the cost of CPA services for a small business is greater than twice as much per dollar of sale revenue as compared to a larger business (Plewa and Friedlob, p.55). The greater the number of or the more complex the accounting standards, the greater is the pressure put on a small business's CPA; because the usually small CPA firm cannot reduce the pressure via specialization, fees are higher. Another cost of complying with GAAP, although difficult to quantify, is the opportunity cost borne by a small business: money that could be spent to improve the business is instead spent on financial statements. Thus, "small business owners pay proportionately much higher costs for the same benefit -- audited financial statements" (Plewa and Friedlob, p.55).

Complying with GAAP results in the benefits provided by unqualified audited financial statements. Advocates of current GAAP believe that the value of audited financial statements cannot be overemphasized. Plewa and Friedlob identify these benefits: 1) lower interest rates or "no increase in financing costs from inadequate information; 2) "the ability to take advantage of investment opportunities when financing is readily available," and 3) "availablility of adequate data to make better management decisions" (p. 55). Plewa and Friedlob may face some disagreement about their third point, but there would be little disagreement with their first two points.

Although there are benefits received from complying with GAAP, critics of current GAAP maintain that full GAAP financial statements are not, or should not be, necessary for small businesses to receive these benefits. This fact has already been recognized to a certain extent say researchers Lippitt and Oliver :

> Where substantial differences have been recognized, different GAAP's have evolved ... If there is room for different reporting standards based on specialized industry practices, isn't there also room for those bases on size? (p. 56).

With this quote, Lippitt and Oliver refer to SFAC 2.

Small businesses are already exempt from reporting earnings per share information, segment information, supplimental inflation disclosures, and interim information. Some critics of current GAAP maintain that small business should also be relieved of the burden of reporting on some or all of the following: the equity method of accounting for investing in common stock, capitalization of interest, imputed interest on receivables and payables, leases, interperiod tax allocation, markerable securities, and other items (Williams, p.1299). Many researchers have suggested as a solution to the alledged standards overload problem alternatives to current GAAP. These various alternatives fall under four general categories: 1) simplfying GAAP for all companies, 2)providing additional disclosure relief for small companies, 3)providing accounting measurement relief for small companies, and 4) developing a simplified alternative basis of accounting for small companies.

The first suggested solution to the alledged problem is to simplify GAAP for all companies. The argument here is that current GAAP is not only a standards overload for small busines but for large business as well. Upton and Ostergaard believe that this is "the ideal answer ... but more often than not, however, universal simplification is impossible when complex issues and transactions are involved" (p. 98). The second suggested solution is to provide additional disclosure relief for small companies; this solution entails relieving small companies of the burdon of disclosing information about leases, capitalization of interest, etc. just as small companies are currently exempt from reporting earnings per share information, segment information, etc. The next suggested solution is to provide differential measurement for small companies. The implementation of this solution would allow small companies "to apply simplified measurement techniques to certain assets or liabilities" (Upton and Ostergaard, p.98). The final suggested solution is to develop a simplied alternative basis of accounting for small companies. There are many possible variations of this solution. For example, Plewa and Friedlob recommend a reporting continuum of small business. There are six increasingly simplified levels to their continuum: level six requires full accrual GAAP; level five requires full accrual GAAP with only currently allowable statement exclusions; level four requires full accrual with footnote disclosures of GAAP departures; level three requires only full accrual; level two requires federal income tax basis; level one requires cash basis (p. 56). A small business would be able to choose the least complex of continuum choices that would fulfill its needs and its users needs, and it would still be able to receive an unqualified audit report. It must be stressed that any of these suggested solutions would render the financial statements of different companies inconsistant with one another and thus reduce comparability between different companies.

There are many groups interested in financial accounting and the nature of the interests of these groups differ. Governmental regulators are interested because of their objective to promote the public welfare via protecting the capital markets from inefficient allocation of capital resources; they favor reliable, consistant, comparable measurements and greater disclosure of information to prevent the publication of false or misleading information which could lead to poor decisions by the public and thus inefficient allocation of capital resources.

Current and potential investors and creditors, the providers of the capital resources used by a business are also interested in financial accounting and financial statements. By using the information in the financial statements, they will be able to make better informed decisions to reduce their risks and increase their rates of return. Therefore, these users, especially creditors, also tend to favor reliable, consistant, comparable measurements and increased disclosure of financial information.

The management of a business is obviously interested in financial accounting and the financial statements. The information conveyed to the public affects the business's share of the allocation of capital resources. The more "in control" management is regarding the measurement of data and the disclosure of information, the easier it is to manipulate the conversion of the data into positive information. Even management that does not consciously try to manipulate data has a tendancy to be overly optimistic about the performance of the business. Therefore, management tends to favor less stringent measurement and disclosure requirements that will allow it to present the financial information of the business as favorably as possible.

Independent auditors are also interested in the standards setting process and the measurement and disclosure of financial information. It is the responsibility of the independent auditor to add credibility to the financial statements of a business by issuing an opinion on them as an objective and independent outsider. Because an independent auditor risks her reputation with every opinion, she would prefer "the standards setting process ... directed toward producing more auditable information" (Miller and Redding, p.24).

The differences among these groups, the governmental regulators, current and potential investors and creditors, management, and independent auditors, must be resolved. The way this is accomplished is by Generally Accepted Accounting Principles.

An important argument of those who do not endorse the standards overload theory is the assertion that "uniformity in the practices used by all companies is generally preferable to diversity" (Miller and Redding, p.15). This idea has its roots in the idea that "valid, and thus useful, comparisons among alternative investments can be made only if the financial information is comparable (Miller and Redding, p.15). If material, real economic differences exist but are not disclosed in the financial statements, the the users of the financial statements will not be able to make the correct decisions. Uniformity in practices also helps to protect the users of the financial statements from unethical or overly enthusiastic managers manipulating the information to show their company in a better light. Uniformity helps to protect independent auditors also, because "the rules provide an external basis for their judgements. Auditors are able to express an opinion that the financial statements are in compliance with GAAP rather than that the financial statements present the "truth" (Miller and Redding, p.16).

In conclusion, it seems that despite claims to the contrary, current GAAP, by requiring with a few exeptions the same measurement and disclosure rules for all companies, is balancing the various needs and desires of those groups interested in financial accounting and financial statements of all companies, large and small alike.

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