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Another Look at GAAP Applied to Small Business

Some Suggested Cures

By Linda R. Jefcoat and Loudell Ellis Robinson

Application of generally accepted accounting principles, in their entirety, to the financial reporting of private and small public companies is controversial today. Since 1976 when the AICPA Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses issued its report, the financial community has repeatedly debated the ailments and possible cures related to such reporting. The purpose of this paper is to examine the basic issues surrounding a framework within which GAAP for small businesses can develop. The paper discusses problem areas of financial reporting of small business and presents possible remedies to alleviate the perceived burden of a standards overload.

Small Business Defined

A major problem in establishing GAAP for small business is defining the type of entity under study. In the past consistent parameters were not established to identify the "small business." Definitions varied, based

among other criteria on an amount of revenues or assets.

In January, 1982, the Securities and Exchange Commission formalized Rule 0-10 (Section 240) defining the phrases "small business" and "small organization":

...an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of \$3,000,000 or less;...

For purposes of the FASB's Invitation to Comment, Financial Reporting by Private and Small Public Companies, the terms small company, public company and private company were defined:

Small Company: *A company whose operations are relatively small, usually with total revenues of less than \$5 million. It typically (a) is owner-managed, (b) has few other owners, if any, (c) has all owners actively involved in the conduct of enterprise affairs except possibly for certain family members, (d) has infrequent transfers of ownership interests, and (e) has a simple capital structure.*

Public Company: *A company (a) whose securities trade in a public market on a stock exchange or in the over-the-counter market or (b) that is required to file financial statements with the Securities and Exchange Commission. A company also is considered a public company if its financial statements are issued in preparation for the sale of any class of securities in a public market.*

Private Company: *A company other than a public company.¹*

Since this paper deals with GAAP and since the SEC has authorized the FASB to promulgate standards comprising GAAP, the FASB's definitions are used.

A Two-Fold Problem Area: Cost Effectiveness and Relevancy to Users' Needs

Two major concerns surround financial reporting by small businesses. It is believed by some persons that, first, conformance with GAAP is not cost effective for such businesses and, secondly, certain information provided is irrelevant to their financial reporting needs.

Cost Effectiveness

FASB Concepts Statement Number 1 states that information provided by financial reporting involves a cost to provide and use. Generally, the benefits of information provided should be expected to at least equal the cost involved. Further, different persons will honestly disagree about whether the benefits of certain information justify its costs.

The cost of providing information that conforms to GAAP is perceived in some cases to be excessively high for small businesses. In a recent study of 2,000 corporations, it was found that entities with sales under \$50 million were paying their CPAs six times more (according to percent-to-sales) than larger firms. Also, 47 percent of the smaller entities thought that accountants' fees were unreasonable, whereas, only 17 percent of the large entities felt this way.² In another study conducted by Nair and Rittenberg it was found that CPAs and bankers strongly agreed that small businesses' accounting costs were disproportionately higher than those for large businesses, and that while most complex accounting pronouncements issued by the

FASB affected accounting costs, they did not improve the management of small business.³

Users' Needs

A basic objective of financial statements is to provide information useful to investors, creditors and other users in making rational investment, credit and similar decisions. One of the loudest outcries by critics of current FASB requirements applicable to small business is that the needs of users of small business' financial statements differ from the needs of users of the financial statements of large businesses. Typical remarks from critics are as follows:

The facts are that recent GAAP pronouncements are not relevant to small business financial reporting needs...

*Credit grantors to small business often have access to other, perhaps more significant, data than that contained in financial statements.*⁴

On the other hand, Nair and Rittenberg conclude from their study that bankers — the primary users of financial statements — perceive no difference in their needs regarding the financial statements of small and privately held businesses. Businessmen and CPAs appear to perceive a difference that is not perceived by bankers.

In the course of researching this paper, the writers considered it important to know the extent of reliance placed on financial statements by the banking community. If financial statements are not used for credit purposes, some of the urgency for compliance with GAAP is alleviated. Also, the writers wanted to determine if bankers in their local community felt that GAAP for small companies could appropriately differ from those of larger companies.

Questionnaires were sent to 10 banks in the community (Appendix A). Table 1 presents a summary of the seven usable responses received. Admittedly the sample is small for purposes of drawing universal conclusions. As shown, however, 86% of the respondents said that the financial statements of a small firm were of upmost importance as the basis for granting a loan. The degree of reliance placed on various types of statements was diverse, depending on whether

the statements were audited, reviewed, or compiled. Finally, seventy-one percent of the bankers surveyed felt that accounting rules should not differ for small businesses versus larger ones, a view consistent with the stand taken by Robert Morris Associates.⁵

This view is also consistent with findings from the FASB's Invitation to Comment mentioned earlier. While the FASB's work dealt with the area of private companies only it represents the issues addressed here. The majority of public accountants perceived a user-need difference between creditors of private as opposed to public companies, but the creditors themselves did not perceive this difference.⁶

Research findings reported above indicate a relatively great divergence in opinions about user needs, particularly creditors' needs in the small

business environment. As David Mosso states "there is very little hard evidence to identify the differences among small and large businesses that lead to different financial reporting needs."⁷

Nair and Rittenberg conclude that distinctions in GAAP should be based on substantiated, rather than asserted, differences in users' needs. Also, FASB Concepts Statement Number 1 states that financial reporting should not exclude relevant information merely because it is difficult for some to understand or because some investors or creditors choose not to use it.

Noncompliance with GAAP

From the two major issues of cost and relevancy to users' needs, another area of growing concern emerges — noncompliance with GAAP standards. "A potential consequence of the growing burden on small CPA firms is the

TABLE 1
Summary of Responses to Questionnaires
(expressed in both percentages and numbers answering)

	Of Upmost Importance	Of Medium Consideration	Of Little Consequence		
1. In your decision to grant a loan, do you consider the financial statement of a small business:	86% (6)	14% (1)			
2. Suppose a small business applied for a loan with your institution and presented its financial statements with the application. How much reliance would you place on the financial statements if those statements were:					
	Complete	High	Reliances Fair	Minimal	Reject
a) Audited with an unqualified opinion		86% (6)	14% (1)		
b) Audited with a qualified or negative opinion because of departure from GAAP			57% (4)	43% (3)	
c) Reviewed by a CPA			86% (6)	14% (1)	
d) Compiled by a CPA			43% (3)	57% (4)	
e) Unaudited and no association with a CPA				100% (7)	
				Yes	No
3. Do you feel that certain accounting rules should differ for small businesses vs. larger ones?				29% (2)	71% (5)

A two-tiered GAAP will reduce professional credibility and confuse statement users.

insidious creep of noncompliance with GAAP standards. This has serious implications for legal liabilities, erosion of professional ethics, loss of public support and dissonance within the accounting profession."⁸ CPAs appear to feel that moderate to significant non-compliance takes place in audited, reviewed, or compiled financial reports to outsiders in the following areas (in order of significance).

1. Leases
2. Deferred taxes
3. Pensions
4. Disclosure of related party transactions
5. Contingencies
6. Accounting changes
7. Capitalization of interest
8. Marketable equity securities
9. Business combinations
10. Statement of changes in financial position⁹

Possible Cures

Among the suggested possible cures for the illnesses affecting the financial reporting of small business is a two-tiered GAAP, that is, a set of accounting principles applicable to small business different from those applicable to other businesses. As noted by Mosso, all GAAP are based on two parts, the measurement process and disclosure regulations. Principles of measurement determine amounts, while disclosure principles determine the nature and extent of information provided in financial statements. The two-tiered GAAP could express differences by either measurements or disclosures, or both.

Mosso feels that a difference in GAAP based on disclosures does not appear to be meaningful. After removing disclosure requirements that seem

not to apply to small business, the burden probably will not be reduced very much. The measurement standards are where the burden is.

On the other hand, the AICPA Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses is opposed to a different measurement process. According to the committee, the measurement process should be independent of the nature of users and their interest in the resulting measurements. There should be a distinction in disclosures required by GAAP and those disclosures used for merely analytical or other purposes.

Much opposition exists to a two-tiered GAAP. This opposition is based on a concern for the possible lack of credence users would place on information resulting from a dual set of accounting principles. For example, Waterson warns that the FASB and the AICPA must avoid the temptations of creating two separate standards of accounting and auditing. Dual standards can only reduce professional credibility and confuse statement users.¹⁰ Kirk notes that he opposes a two-tier standard setting structure and quotes what Phillip L. Defliese told the Wheat study group: This sounds fine - but it won't work.¹¹

Views opposed to a two-tiered GAAP rest on the assumption that the term GAAP is referring to a singular body rather than a plurality comprised of many parts, each of which is specifically applicable under varying circumstances. GAAP can be a very flexible embodiment of rules as is shown by the differences that currently exist in the application of GAAP in varied circumstances. For example, GAAP for government organizations differ from GAAP for businesses, and companies in specialized industries follow practices peculiar to their industries. It has been suggested that any variations needed by users should be encompassed within GAAP without GAAP being two-tiered.¹²

Another suggested remedy to small businesses' financial reporting problems is an alternative comprehensive basis of accounting, such as the income tax basis or cash basis. However, Kirk has indicated that the AICPA Committee on Standards Overload will not endorse the income tax basis as the solution to the overload problem.

Increased acceptability of financial statement reviews and compilations is yet another potential solution. Currently, a stigma of unacceptability is attached to compilations and reviews because of the negative nature of the assurances provided by the accountants preparing the statements.

Progress To Date

Several changes in practice for small business are in effect now. In 1978 the FASB suspended the reporting of earnings per share and segment information by nonpublic enterprises. FASB Statement Number 33 (1979) requires supplementary disclosure of certain price-level-adjusted and current cost information from only relatively large publicly held companies. Finally, in 1980 the AICPA Committee on Small and Medium Sized Firms recommended that the FASB

All variations needed in GAAP should be incorporated within GAAP.

study the effects of standards on small business before their issuance and that they review GAAP, generally, to see if existing requirements really suit the needs of such businesses.

Yet to be released are two other research studies concerning private companies and small public companies. Both studies, one sponsored by the FASB and the other by the Financial Executives Research Foundation, are expected to be published sometime in 1983.¹³

Although some progress has been made to eliminate the standards overload on small business, there are still many areas of concern. Some of the current GAAP requirements cited as problem areas to small business are

as follows (listed in no particular order of importance):

APB Opinion No. 11, Accounting for Income Taxes
APB Opinion No. 16, Business Combinations (as related to the pro forma disclosure requirements)
APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock
APB Opinion No. 21, Interest on Receivables and Payables
FASB No. 12, Accounting for Certain Marketable Securities
FASB No. 13, Accounting for Leases
FASB No. 34, Capitalization of Interest Cost

Conclusion

That there is a problem in financial reporting for small business is not the issue; it is generally recognized that a problem exists. The concern lies in identifying the boundaries of the problem and finding feasible solutions.

The writers are opposed to a two-tiered GAAP. Things have a way of growing; a two-tiered GAAP might soon be a multi-tiered GAAP, with a different set of standards for different groups of entities. All variations needed in GAAP should be incorporated within GAAP, GAAP being a plurality comprised of many parts. The FASB follows this practice now (as in Statement 33 and specialized industries), though not to the extent it should. We encourage the FASB to conduct additional empirical research to better define the problem and, indeed, even the magnitude of the problem — both as to the number of companies involved and the extent of damage caused by noncompliance with GAAP. These issues have not been clearly defined. At the conclusion of the research, the FASB would be in a better position to review all existing GAAP and restructure them to the needs of small businesses. Ω

NOTES

¹Financial Accounting Standards Board, *Financial Reporting by Private and Small Public Companies*, Invitation to Comment, Stamford, Connecticut, 1981, November, 1981, pp. 3-4.

²Richard A. Epaves, "Alternative to Little GAAP", (Practitioners Forum) *Journal of Accountancy*, v. 146, November, 1978, p. 38.

³R.D. Nair and Larry E. Rittenberg, "Privately Held Businesses: Is There a Standards Overload?" (Professional Notes) *Journal of Accountancy*, February 1983, p. 92.

APPENDIX A QUESTIONNAIRE

1. In your decision to grant a loan, do you consider the financial statement of a small business:
(check one) _____ of utmost importance
_____ of medium consideration
_____ of little consequence
2. Suppose a small business applied for a loan with your institution and presented its financial statements with the application. How much reliance would you place on the financial statements if those statements were (a-e):
 - a. Audited with an unqualified ("clean") opinion
(check one) _____ complete reliance
_____ high reliance
_____ fair amount of reliance
_____ minimal reliance
_____ would completely reject financial statements and deem them unreliable
 - b. Audited with a "qualified" or "negative" opinion given because the financial statement departed from generally accepted accounting principles (GAAP)
(check one) _____ complete reliance
_____ high reliance
_____ fair amount of reliance
_____ minimal reliance
_____ would completely reject financial statements and deem them unreliable
 - c. "Reviewed" by a CPA (as used here, in a review the CPA states that he or she has no reason to believe that the statements are not in conformity with generally accepted accounting principles but no opinion on the financial statements is rendered nor is an audit performed)
(check one) _____ complete reliance
_____ high reliance
_____ fair amount of reliance
_____ minimal reliance
_____ would completely reject financial statements and deem them unreliable
 - d. "Compiled" by CPA (as used here, compiled means presenting in the form of financial statements information that is the representation of management [owners] without undertaking to express any assurance on the statements)
(check one) _____ complete reliance
_____ high reliance
_____ fair amount of reliance
_____ minimal reliance
_____ would completely reject financial statements and deem them unreliable
 - e. Unaudited and no association with a CPA
(check one) _____ complete reliance
_____ high reliance
_____ fair amount of reliance
_____ minimal reliance
_____ would completely reject financial statements and deem them unreliable

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APPENDIX A (Continued)

3. Do you feel that certain accounting rules should differ for small businesses vs. larger ones? (For example, some companies do not have to report earnings per share and segment data. Should there be other differences or exceptions?)

(check one) _____ yes
_____ no
_____ don't know

⁴"Big GAAP - Little GAAP" (Accounting and Auditing, Commentary on Current Developments in Accounting) *CPA Journal*, v. 52, January, 1982, p. 71.

⁵David Mosso, "Accounting for Small Business: Bridging a Widening GAAP", FASB Viewpoints, June 18, 1981, p. 5.

⁶Financial Accounting Standards Board, *Financial Reporting by Privately Owned Companies: Summary of Responses to FASB Invitation to Comment*, Special Report, Stamford, Connecticut, 1983, pp. 3-4.

⁷Mosso, "...Widening GAAP," p. 1.

⁸*Ibid.*, p.2.

⁹Nair and Rittenberg, "...Is there a Standards Overload?", p. 92.

¹⁰James Waterson, (past chairman of the Robert Morris Associates accounting policy committee), as quoted in Nair and Rittenberg, "...Is there a Standards Overload?", p. 86.

¹¹Donald Kirk, as quoted in Nair and Rittenberg, "...Is there a Standards Overload?", p. 78.

¹²Gerald W. Hepp and Thomas W. McRae, "Standards Overload: Relief is Needed", *Journal of Accountancy*, May, 1982, p. 60.

¹³FASB, Special Report, p. 29.



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