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ARE SMALL BUSINESSES FALLING THROUGH THE GAAP?

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ABSTRACT

Professional accountants have long recognized the need for a change in the reporting requirements for small businesses because standard setting agencies focus on large firms and promulgate GAAPs which ignore special problems of small firms. We propose a procedure which may correct the problem in the United States and which could provide a model for use in other countries.

INTRODUCTION

Discussions questioning the universality of accounting pronouncements have been common in the United States, England, Australia and other countries for a number of years (i.e. 1, 2, 5). The issue has been whether generally accepted accounting principles (GAAP) as established by accounting regulatory agencies can or should recognize differences between businesses based on firm size. No clear answers have emerged. Consequently, accounting regulatory bodies have been uncertain about the desirability of differentiated reporting requirements.

The response of the Financial Accounting Standards Board (FASB) in the United States has been to consider explicitly the impact of proposed reporting standards on smaller companies. Although it has been opposed to differences in recognition standards or measurement principles, the FASB has distinguished between supplementary disclosure requirements for small and large firms in several instances (9, 10). It is our position that such steps on the part of the FASB represent an inadequate response to the needs of small business. We believe that a similar situation exists in other countries; however, for purposes of this paper we will focus on the FASB and its impact on United States small businesses. Should the approach outlined in this paper prove successful in the United States, it may serve as a model for use in other countries.

PROFESSIONAL DISSATISFACTION WITH THE FASB

The accounting profession has demonstrated a great dissatisfaction with the FASB and its refusal to mitigate reporting requirements for small firms. Louis Harris and Associates conducted opinion surveys with CPAs in 1980 and again in 1985. The focus of the surveys was whether respondents felt the needs of small business were being met by FASB pronouncements. The results of the first survey were so negative that the FASB responded by taking several steps to rectify the problem. As a result of their efforts, the follow up survey reflected a somewhat higher level of satisfaction but still displayed significant concerns. In the 1985 survey only 28% of the responding CPAs felt that the needs of small business were being adequately addressed in FASB pronouncements and the body of GAAP (9). Those CPAs in small practices were the most negative in their views. These practitioners were those who performed few attest engagements, although it would be reasonable to posit that these small CPA firms have the largest contact with small businesses.

The FASB responded to the criticism inherent in the survey by pointing to its recently formed Small Business Advisory Group. That group was intended to improve the Board's knowledge of small business concerns regarding proposed accounting standards so that future promulgations might better reflect their needs. Nevertheless, the FASB maintains that it is still opposed to differentiation in reporting requirements except for supplementary disclosures. Furthermore, the Board discussed the lack of data on areas where separate accounting standards might be beneficial and reaffirmed its position that financial statements must be focused to meet the general information needs of outside users (11). Apparently the Board felt that such requirements forestall any effort to differentiate the treatment of small firms.

PROBLEMS IN FASB RESPONSE TO SMALL BUSINESS NEEDS

Several factors make it difficult for the FASB to respond to the small business problem. One major limitation is the composition and outlook of the Board itself. The membership of the FASB consists of individuals from public accounting, academe, government and finance and is drawn mainly from large firms and institutions. The source of Board membership is designed to allow for a greater breadth of experience regarding financial issues. Nevertheless, the background of Board members and the process of selection of their replacements reduce the likelihood that any members will have recent or extensive contact with small businesses. Consequently, Board members have a lessened appreciation for the special problems which FASB pronouncements can create for small firms.

There are additional problems in responding to small business needs. The accounting standard-setting environment is highly political (7). The Board is under constant pressure to emphasize the reporting needs of large companies. The current climate of increased accountability and the visibility and notoriety of claims of audit failure in major firms contribute to the pressure. Such pressure may be understandable from both an economic and social viewpoint, but it complicates prospects for small firms. Clearly, the FASB's creation of the Small Business Advisory Group is a positive move and indicates a willingness to consider the impact of any resulting standards on small business. Nevertheless, the realities of the political environment make remote any probability that the regulators will be able to devote much of their time to reporting areas which are of concern mainly to small companies.

The FASB has little energy to devote to the specific reporting needs of small business because it clearly believes that accounting problems are universal across all types and sizes of business. If one accepts a focus on the needs of external users of financial statements, the orientation of the FASB may seem understandable. However, such a focus may fail to consider the impact of reporting requirements on small firms and the development of data which small business owners need for internal decision making.

SPECIAL NEEDS OF SMALL BUSINESSES

Small businesses have similar information needs as those of larger firms. However, large companies usually have an accounting staff and a professional management team, while most small businesses have little expertise or staff time to gather or utilize accounting information. Furthermore, small firms do not have large numbers of shareholders who require protection of their investments and reports on financial status of their firms. Consequently, the Board's focus solely on external users of accounting information may not be appropriate.

The financial statements of small firms are likely to be used by three groups of people: owners, creditors, and tax authorities. Tax authorities are self serving in that they have their own reporting requirements separate from those established by accounting regulators. Compliance with these requirements is a separate issue from GAAP.

Study results have shown that the information required by creditors may not be significantly different for companies of various sizes (8). From that perspective a uniform treatment may seem justifiable. However, lenders involved in small business credit are accustomed to the frequent absence of acceptable financial statements and are able to compensate with the use of internally prepared reports and schedules. Such users are clearly competent to protect themselves, absent any regulatory requirements. Furthermore, creditors of small firms tend to be short term lenders which would imply better service from financial statements which emphasized liquidity rather than income generation as is presently the case (5).

The owners of small companies are generally also managers of the business. Their information needs are not limited to the data normally provided to external users (6). Consequently, this group of users is under-served by existing regulations. Furthermore, their lack of accounting expertise and the absence of internal accounting staffs make the probability of internal development of valuable accounting information unlikely.

Small firms need accounting pronouncements which are simple, clear and understandable. This is perhaps the greatest failing of the FASB from a small firm perspective. One single pronouncement of the FASB, rules concerning leases, filled more pages than all of the pronouncements of its predecessor body, which existed from 1939 through 1959 (5). This is particularly relevant when one considers the importance which leases have to capital-poor small firms. The direction of GAAP development is not toward conciseness or simplicity.

Finally, the expense of compliance with accounting regulations may not be significant for large firms with internal accounting staffs but is clearly a problem for many small firms. In fact, the present regulatory environment encourages small firms not to use external accountants because of the expense and the perceived lack of value of the resulting information. One survey indicated that small firms paid outside CPA fees of $3,300 per $1 million in sales compared to $1,500 per $1 million in sales paid by large firms (4). This imbalance may well result from the presence of internal accounting professionals in large firms, but it represents a tremendous burden which most small firms cannot support.

The failure of regulators of the accounting profession to adequately address the reporting needs of small firm owner/managers may be partially responsible for the high failure rate of small businesses, in that the regulatory environment clearly does not provide them significant assistance. While it may appear that impact on small firms should not concern the FASB since their stated domain of concern is external users, if the accounting profession is to be of value to the entirety of the business population, that domain of concern must be broadened to include the special needs and problems of small businesses.

RECOMMENDATIONS

In an attempt to increase the amount of relevant data provided to the owners of small firms, the American Institute of CPAs (AICPA) should consider the establishment of a permanent, separate Small Bsuiness Accounting Section to explicitly address the information needs of the owner/managers of such businesses. The AICPA is a more appropriate entity for developing a small business appreciation because it is outside the political environment in which the FASB must function.

By studying the specific areas vital to the continued viability of the small firm, the Section could design recommended supplemental reports for use by accountants serving small business clients and educational materials explaining the relevance of the additional data. For example, since cash management is especially critical for small companies, expanded cash flow reporting for such firms may be beneficial. Additionally, with the high failure rate of small business, it may be helpful to do more research with bankruptcy prediction models based specifically on small companies to determine factors which may be useful to the owner/manager in assessing business risk (3). Such information may also be useful to creditors in their small business loan decisions. The models currently available are based mainly on financial information pertaining to medium or large companies which may not be valid for small business (12).

Finally, should the research of the Small Business Section identify a potential reporting improvement or needed additional external disclosure for small businesses, it could draft a recommendation for consideration by the FASB. This would explicitly address the stated lack of data on small business needs, which has apparently limited the responsivness of the FASB to date. Such an arrangement would appear to be beneficial to the accounting profession by responding to the information needs of small businesses, reducing the burden on the Board and researching the need for differential reporting.

Clearly the FASB must be responsive to reports from the AICPA Small Bsuiness Section in order to make this recommendation effective. The AICPA has previously formed temporary bodies whose charges were to examine small business needs. Committees were formed in 1974, 1978 and 1981. All of these committees recommended changes in regulations for the benefit of small firms (5). The Board did respond somewhat by modifying supplementary disclosure requirements. However, the FASB has not made significant changes in disclosure requirements for small firms, despite the fact that it has long recognized the need for specialized reporting requirements for individual industries. Nevertheless, the recent actions of the Board in establishment of a Small Business Advisory Group may be an indication that it is now more willing to react favorably to specific recommendations from the AICPA.

This approach would capitalize on existing agencies and avoid the inherent difficulties of legislative involvement. It can also serve as a model for other countries. Furthermore, the AICPA has historically strived to serve the needs of its members CPAs and the accounting profession. We believe that establishment of a permanent Small Business Section has potential for success and we encourage the AICPA to consider this action. Should the FASB continue to prove uncooperative in adopting AICPA recommendations, it may well become appropriate to establish the Small Business Section as a standard setting body for small business. Potential conflicts between AICPA and FASB promulgations could then be handled in the same negotiating manner as legislative differences, i.e., through the work of a joint committee of the two agencies. Before such a dramatic step is taken, however, the FASB should be afforded the opportunity to establish itself as the single authority on GAAP standards for all businesses regardless of size. Should the Board prove recalcitrant, stronger steps will be required to close the GAAP for small business reporting.

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