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Report of the Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses

American Institute of Certified Public Accountants. Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses

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Preface

During 1974, the accounting standards division of the American Institute of Certified Public Accountants began a study of the application of generally accepted accounting principles to smaller and/or closely held businesses. On March 31, 1975, the division issued over 20,000 copies of a discussion paper on this subject for public comment. That paper identified four basic questions and a number of related alternatives, possibilities, and problems. The division received 138 responses from individuals, firms, and state society groups and other associations (not always official). In addition, the discussion paper was the subject of member forums held in various locations in Pennsylvania, and the division received a number of responses to a questionnaire distributed at those forums.

The letters of comment vary significantly in both qualitative and quantitative respects. In some cases the responses were the result of extensive discussion sessions. For example, the letter submitted by the California Society of CPAs was based on 32 discussion sessions with over 1,200 CPAs throughout the state. However, some respondents presented their conclusions but not their rationale, or answered only the questions in which they have a special interest. In view of these differences, the committee believes that a statistical summary of the letters of comment would not be helpful.

The members of the committee have studied each letter of comment carefully and have also discussed the issues before a number of groups of practicing CPAs. Each member has thereby developed impressions about the views held within the profession on this subject. It is the belief of the committee that there is strong support within the profession as a whole for reconsideration of present practices with respect to the application of generally accepted accounting principles to the financial statements of smaller and/or closely held businesses and with respect to standards for reports of CPAs on such statements. Further, the committee has concluded that certain changes in present practices are necessary and that those changes should be implemented expeditiously. Although the changes the committee suggests will have an impact on the financial statements of *all* entities, the committee believes that implementation of its recommendations will alleviate the problems smaller and/or closely held businesses are perceived to have with respect to both financial accounting practices and reports of CPAs.

The objective of this report is to influence the development of standards for accounting and for reporting by CPAs in directions the committee believes are in the public interest. To that end, the committee proposes to discuss its recommendations with representatives of bodies having authority to issue pronouncements on the subject and to perform such additional work as will facilitate the consideration and implementation of its recommendations by those authoritative bodies.

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General Background

A number of different identifiable groups use financial statements. These groups include owners, creditors and suppliers (both present and potential), management, taxing authorities, employees, customers, financial analysts and advisors, stock exchanges, lawyers, regulatory or registration authorities, financial press and reporting agencies, trade associations, and labor unions. Accountants have attempted to satisfy the needs of these various groups with general-purpose financial statements. General-purpose financial statements are required to be presented in conformity with generally accepted accounting principles (GAAP). When a CPA is associated with such statements, he is currently required to disclose departures from GAAP in his report, although special provisions apply to financial statements restricted to internal use.

A smaller business often relies on a CPA to provide the accounting services that a larger business obtains from its own staff. Many CPAs who provide such services disagree with certain aspects of present GAAP as they apply to financial statements of smaller and/or closely held businesses and object to present standards for reports of CPAs (reporting standards) on such statements. First, they believe that such financial statements prepared in conformity with GAAP are often unnecessarily costly because they include information required by GAAP that is not useful in meeting the needs of users of these statements. In addition, even with this excess information, such statements do not satisfy the needs of users of financial statements of smaller and/or closely held businesses, who have a management perspective and often desire information not required by GAAP and not ordinarily included in general-purpose financial statements. Second, they believe that present reporting standards for CPAs are *not* responsive to the needs of those users and, in fact, tend to discriminate against smaller and/or closely held businesses. Others strongly oppose these views. The different views are presented in the "Discussion" section of this report.

Agreement on the answers to a few key questions is vital to the resolution of these problems. To what extent should GAAP comprehend measurement principles and disclosure principles? Should all such principles be applied to the financial statements of all businesses? Should standard-setting and regulatory bodies limit the applicability of their pronouncements? Should present reporting standards, including those that establish when a CPA is deemed to be associated with unaudited financial statements, be reconsidered?

The committee's major recommendations follow. The reasons for these recommendations are discussed later in this report.

Summary of Major Recommendations

The committee believes that the same measurement principles should be applied in the general-purpose financial statements of all entities, because the measurement process should be independent of the nature of users and their interest in the resulting measurements. However, the nature of the information disclosed and the extent of detail necessary for any particular disclosure may well vary depending on the needs of users. Disclosures required by pronouncements of standard-setting or regulatory bodies may be applicable only to certain entities and should not necessarily be an integral part of generally accepted accounting principles. Therefore, the committee has concluded that disclosures that should be required by GAAP in the financial statements of all entities should be distinguished from those that merely provide additional or analytical data. The committee also believes that the AICPA auditing standards division should address the reporting problems discussed herein.

The committee was established to consider the application of generally accepted accounting principles to the financial statements of smaller and/or closely held businesses. However, the committee has concluded that there should be a distinction between disclosures required by GAAP and additional or analytical disclosures in the financial statements of *all* entities. Therefore, it has not been necessary to develop criteria to identify smaller and/or closely held businesses for purposes of implementing the recommendations contained herein, and this report does not suggest such criteria. Although most of the recommendations in this report are applicable, in general, to all entities, the committee believes that their implementation will prove of particular benefit to the smaller and/or closely held business.

In summary, the committee urges prompt action on the following general recommendations:

- The Financial Accounting Standards Board should develop criteria to distinguish disclosures that should be required by GAAP, which is applicable to the financial statements of all entities, from disclosures that merely provide additional or analytical data. (Some of these latter disclosures may, however, still be required in certain circumstances for certain types of entities.) The criteria should then be used in a formal review of disclosures presently considered to be required by GAAP and should also be considered by the Board in any new pronouncements. The committee has suggested possible criteria on pages 17 and 18 of this report.

- Disclosures are required by the Securities and Exchange Commission on the basis of its review of information available to it and in accordance with the authority granted by Congress with respect to financial statements of issuers whose securities are publicly traded. Accordingly, the commission should avoid in its pronouncements any implicit or explicit language that may be interpreted as establishing GAAP.

- The AICPA auditing standards division should reconsider pronouncements concerning a CPA's report on (a) unaudited financial statements, including those accompanied by an "internal use only" disclaimer, (b) financial information presented on prescribed forms, and (c) interim financial statements of smaller and/or closely held businesses.

The committee also believes that the Financial Accounting Standards Board should amend APB Opinion No. 15 to require only publicly traded companies, as that term is defined in APB Opinion No. 28, to disclose earnings-per-share data. This disclosure is clearly not relevant to most companies whose shares are not publicly traded, and this recommendation does not, in the committee's view, require substantial research before it can be implemented.

Discussion

The Perceived Problems With Present Practices

The letters received on the March 31, 1975, discussion paper and the comments made to members of the committee at numerous meetings with CPAs indicate that a number of problems with present practices are perceived to exist. These perceived problems have been summarized by the committee as follows:

- Financial statements prepared in conformity with GAAP in many cases do not satisfy the needs of the principal users of financial statements of smaller and/or closely held businesses. These users are generally owners, owner-managers, and principal bankers, and they often have little interest in or understanding of information that is principally aimed at financial analysts or public stockholders. The information in general-purpose financial statements often has little relevance to these users. They do have a need for information *not* ordinarily included in general-purpose financial statements, information with a management perspective. However, the cost associated with the irrelevant information often effectively precludes presentation of other, more relevant, data. Promulgated standards effectively mandate that information required by GAAP be presented or the company will receive a modified report from its CPA, which may have negative implications for some users. (The term "modified report" as used herein includes qualified opinions, adverse opinions, and disclaimers of opinion containing language of the type described in sections 516.06 and .08 of Statement on Auditing Standards No. 1.)

- The problem is particularly acute when a CPA assists in the preparation of unaudited interim financial statements or financial information submitted on prescribed forms or is otherwise deemed to be associated with such information. Larger businesses prepare abbreviated financial statements and present financial information on prescribed forms and release such information to third parties without restriction. Smaller and/or closely held businesses that engage a CPA to perform accounting services are required to comply with promulgated standards that preclude issuing similar information without modifications that result in additional expense. Otherwise, the CPA's report that must be attached will contain language which some users may view as impugning the integrity of the information presented.

- The provisions in promulgated standards for reports of CPAs relative to financial statements that are restricted to internal use by the client do not solve the problems cited above. Further, in practice, the restriction on use is ineffective.

- The CPA risks being perceived by his client as requiring the presentation of information that is costly to obtain and/or report and yet is neither desired by nor relevant to the user.

Statement No. 4 of the Accounting Principles Board took the position that "the basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making economic decisions."[1] This objective is echoed in the "Report of the Study Group on the Objectives of Financial Statements," which observed:

> The qualitative characteristics of financial statements, like objectives, should be based largely upon the needs of users of the statements. Information is useless unless it is relevant and material to a user's decision. . . . In all cases, information is more useful if it stresses economic substance rather than technical form.[2]

APB Statement No. 4, which is primarily a document describing practices and ideas accepted at the time of its issuance, identified the following different user groups: owners, creditors and suppliers (both present and potential), management, taxing authorities, employees, customers, financial analysts and advisors, stock exchanges, lawyers, regulatory or registration authorities, financial press and reporting agencies, trade associations, and labor unions. Although it acknowledged that these different groups have different needs, the statement observed that "the problem of ascertaining specialized needs of a large number of users, the cost of attempting to serve those needs on an individual basis, and the confusion that might result from disseminating more than one set of information about the financial results of an enterprise's operation militate against attempting to serve all needs of users with special-purpose reports." It later identified one of the basic features of financial accounting as the presentation of "general-purpose financial information that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the needs of present and potential owners and creditors." This basic feature of financial accounting is based on the presumption that "a significant number of users need similar information."[3]

Although it can be inferred from the APB statement that general-purpose financial statements serve at least some of the informational needs of all user groups, it has been noted that "the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise."[4] Many believe that this has led, often at the implicit or explicit behest of the Securities and Exchange Commission, to the development of official pronouncements that are directed to the problems of the *public* investor. Some of these

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[1] AICPA, APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (New York: AICPA, 1970), par. 21.

[2] AICPA, Study Group on Objectives of Financial Statements, *Objectives of Financial Statements* (New York: AICPA, 1973), p. 60.

[3] AICPA, APB Statement No. 4, pars. 44–47 and 125.

[4] AICPA, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (New York: AICPA, 1953), "Introduction," par. 3.

pronouncements, in their view, require the presentation of data that have little relevance to users of the financial statements of the smaller and/or closely held business.[5]

These data are often lengthy or complex disclosures oriented principally to financial analysts and public stockholder interests. (APB Opinion No. 15, dealing with the computation and reporting of earnings per share, is often cited as a prime example.) Frequently, they entail extensive and costly assistance to the smaller and/or closely held business by its CPA. The cost of this assistance effectively precludes preparation of other analytical data that primary users who have a management perspective would find more relevant to their needs. For example, such users may be interested in operating information and statistics and explanations of variances from planned or budgeted results; this type of information is not ordinarily included in general-purpose financial statements. Also, certain measurement principles not permitted by GAAP may be relevant in the case of some smaller and/or closely held businesses. For example, direct costing may be useful in analyzing the results of such an entity's operations, but direct costing is not an acceptable alternative accounting method.[6] Finally, some believe that disclosures mandated by GAAP can reach a point of volume and detail that is confusing to the reader.

However, a CPA's judgment about the relevance of a particular accountting principle to the users of the financial statements of an entity is of no practical significance. The CPA is bound by the first standard of reporting and by Rule 203 of the AICPA Rules of Professional Conduct to state in his report whether the financial statements are presented in accordance with generally accepted accounting principles and is required to accept as GAAP pronouncements of bodies (FASB, APB) designated by the AICPA Council to establish such principles.

These requirements have been imposed on the CPA even though it has been acknowledged that "present generally accepted accounting principles have not been formally derived from the environment, objectives, and basic features of financial accounting"; rather, they "have developed on the basis of experience, reason, *custom, usage, and, to a significant extent, practical necessity*" (emphasis supplied).[7] It has been further acknowledged that "financial accounting and reporting are not grounded in natural laws as are the physical sciences, but must rest on a set of conventions or standards designed to achieve what are perceived to be the desired objectives of financial accounting and reporting."[8]

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[5] See AICPA, Study on Establishment of Accounting Principles, *Establishing Financial Accounting Standards* (New York: AICPA, 1972), pp. 18–19.

[6] See, for example, John C. Burton, "The Organization of the Public Accounting Profession," *The National Public Accountant*, November 1974, pp. 9–10.

[7] AICPA, APB Statement No. 4, pars. 3 and 139.

[8] AICPA, *Establishing Financial Accounting Standards*, p. 19.

These requirements, it should be noted, are not restricted to audited financial statements. Statement on Auditing Standards No. 1, section 516.06, requires that "if the certified public accountant concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure . . . [his] disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements."

This requirement usually means that a CPA will recommend that measurements and disclosures be made in conformity with GAAP in all financial statements with which he is associated, including those of smaller and/or closely held businesses. Thus, although a larger business with its own accounting staff is free to prepare financial statements that meet its needs, a smaller business that relies on its CPA for accounting services is required to conform its financial statements with GAAP or to accept a modified CPA's report that may raise questions from some users as to the integrity of those financial statements.

Statement on Auditing Standards No. 1, section 516.05, explicitly permits a CPA rendering accounting services on a monthly or quarterly basis merely to note in his disclaimer of opinion that the financial statements do not necessarily include all disclosures that might be required for a fair presentation in conformity with GAAP if such financial statements are restricted to internal use by the client. However, the CPA cannot control the distribution of "restricted use" financial statements and, in fact, they are sometimes distributed to bankers and others outside of the business. In practice, the business that abides by the requirements relative to financial statements that are not restricted to internal use may be effectively penalized because, to avoid the possibly adverse consequences of a modified CPA's report, it must incur additional costs to conform those financial statements with GAAP. The key issue is whether the additional costs bear a reasonable relationship to the benefits obtained. In this connection, it is noted that although APB Opinion No. 28 recognized that publicly traded companies report summarized interim financial information and established guides as to *minimum* disclosures, such guides have not been established for businesses, large or small, that are not publicly traded.

Also, businesses often must submit financial information in a prescribed format developed by a user for its own purposes. This poses no problem for the larger business, whose accounting staff prepares and issues the financial information. However, the prescribed formats may not be adequate for a fair presentation in conformity with GAAP. In such a situation, the smaller business that relies on its CPA for accounting services is required to submit with the prescribed information (unless additional, augmenting information is also submitted) a CPA's report containing modifications that are perceived to be unnecessary and confusing. Many believe this to be an inequitable and unreasonable situation.

In the view of some CPAs, the problems described above damage the accounting profession since the CPA may be perceived as requiring for his own economic benefit the presentation of information that is not desired by and is not relevant to the user.

On the other hand, many do not agree that there are significant problems and disagree strongly with any proposal for differences in the application of GAAP in the financial statements of smaller and/or closely held businesses. They cite, among other sources, this view expressed in an FASB exposure draft ("Financial Reporting for Segments of a Business Enterprise," September 30, 1975, par. 73) and would apply it to other measurement and disclosure principles:

> The Board believes, however, that there is no fundamental difference in the types of decisions and the decision-making processes of those who use the financial statements of smaller or privately held enterprises. . . . Information of the type required to be disclosed by this Statement is as important to users of the financial statements of those enterprises as it is to users of the financial statements of a large or publicly-held enterprise. Accordingly, this Statement applies to all financial statements that present financial position or results of operations in conformity with generally accepted accounting principles.

Still others, although believing that there should be no differences in the application of GAAP, advocate, or at least would agree to, changes in standards for reports by CPAs to minimize some of the problems discussed above.

The Reasons for the Major Recommendations

Problems related to the application of GAAP in the financial statements of smaller and/or closely held businesses have become more apparent as a result of the increasing codification in recent years of a number of accounting principles, coupled with the detailed disclosures mandated by those pronouncements and by the SEC. APB Statement No. 4 noted in paragraph 32 that because "principles are conventional and have been developed in relation to a specific environment and with assumptions about needed financial information, they are all subject to review, evaluation, and possible change." However, for the most part, there have been no reviews, no evaluations, and no changes, and the burden of these steadily increasing rules is particularly heavy on smaller and/or closely held businesses. In addition, the expansion of disclosure requirements is making it difficult for many users to understand the essential financial facts about *any* business. Some streamlining of disclosure requirements is clearly necessary, not only for smaller and/or closely held businesses, but for all companies reporting in accordance with GAAP.

The committee believes that the accounting and disclosure principles followed in the financial statements of all entities should be in conformity with GAAP; indeed, to do otherwise would be directly contrary to the efforts of the accounting profession to narrow the range of acceptable alternative practices and would be inconsistent with the concept of professional service. However, because "understanding the objectives of financial accounting and financial statements . . . is vital in evaluating and improving generally accepted accounting principles," and because those "general objectives [should] relate the content of financial accounting information to the interests and needs of users," it seems equally evident that the needs of different user groups should not be disregarded in formulating GAAP. Further, the committee agrees that "relevance is the primary qualitative objective because information that does not bear on the decisions for which it is used is useless, regardless of the extent to which it satisfies the other objectives," and "generally accepted accounting principles should therefore be evaluated to determine the degree to which the objectives are met. . . ."[9]

The issue is not, therefore, whether to permit large numbers of specialized—and thereby different—financial statements and reports in similar circumstances. The issue is whether it is possible to identify financial accounting practices that, when tested against the concept of relevance to the user, do not merit inclusion in every set of financial statements.

One role of accounting involves the measurement of the economic effects of events and transactions; measurement principles are applicable, generally speaking, to the determination of the amounts reflected in a final, adjusted trial balance. The committee believes that these measurements should not be affected by the size of the business or the number of its shareholders. The measurement process should be independent of the nature of users and their interest in the resulting measurements. Only the measurement of similar transactions and other economic events on a consistent basis will prevent users from being hopelessly confused by the resulting information.

A second role of accounting is to develop informative vehicles for the presentation of the measurements made and, in some cases, of the related circumstances and peculiarities of the transactions or other events. The committee believes that the nature of the information disclosed and the extent of detail necessary for any particular disclosure may well vary depending on the needs of users or other factors. As the number of users increases and the diversity of their interests becomes greater, additional information may be desirable or even necessary to provide a more complete analysis of the transactions involved. However, the standard for disclosures required by GAAP should not be the presentation of all the information that any conceivable user might desire. Rather, disclosures that

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[9] AICPA, APB Statement No. 4, pars. 88 and 213.

provide additional or analytical information should be encouraged in particular circumstances but not required in all circumstances.

GAAP, whether codified or not, has developed in large part on the basis of custom, usage, and practical necessity. When a certain type of information has been reported frequently, that disclosure, through usage, often has become a part of GAAP. However, the committee believes that certain disclosures (for example, some of those related to lease transactions) may be helpful to an investor in analyzing an enterprise's current position, past operations, and expected future results, but are simply additional or analytical data. They should not be considered a part of GAAP, no matter how often they are reported in financial statements. Although some types of financial information may at times be considered necessary to meet the needs of certain user groups, this fact *by itself* should no longer be considered to create a presumption that the reporting of such information has become an integral part of GAAP to be applied to *all* business enterprises.

Paragraphs 5 and 6 of Statement on Auditing Standards No. 5 state that GAAP can be established by the body designated by the AICPA Council to establish such principles and, in the absence of such promulgations, by a number of other sources. In practice, pronouncements of regulatory and standard-setting bodies have often been developed for companies whose securities are publicly traded. It is time to identify the disclosures required by these pronouncements that may be applicable only to certain entities and that should not always be generally accepted accounting principles.

The committee believes that standard-setting bodies should attempt to develop criteria to distinguish disclosures that merely provide additional or analytical data from those that should be required by GAAP. The criteria should then be applied in a formal review of disclosures presently considered to be required by GAAP and should also be considered in any new pronouncements.

Although the committee believes that all accounting transactions should be measured according to the same set of measurement principles, the appropriateness of existing measurement principles should also be evaluated periodically by those having authority to establish accounting standards.

The committee was established to consider the application of GAAP to the financial statements of smaller and/or closely held businesses. The March 31, 1975, discussion paper listed a number of possible criteria for identifying such businesses. These were size; ownership characteristics; a combination of size and ownership characteristics; audited vs. unaudited; and the nature and needs of users. Commentators on the discussion paper raised a number of objections to the use of each of these criteria. Since the committee's final conclusions are applicable to the financial statements of *all* entities, it has not been necessary to develop criteria to identity smaller and/or closely held businesses for purposes of implementing those conclusions. However, it is important to note that the committee's final conclusions were not influenced to a significant degree by the acknowledged difficulty of developing acceptable criteria. Rather, the committee's conclusions reflect its unanimous belief that measurement principles are equally applicable to all entities; that the disclosures required by GAAP should be streamlined for all entities; that certain disclosures required by pronouncements of regulatory and standard-setting bodies should not always become GAAP; and that implementation of its recommendations, which it believes are sound from both a theoretical and a practical viewpoint, will alleviate the problems related to smaller and/or closely held businesses described earlier in this report.

Some members of the committee believe that the present use of the term "generally accepted accounting principles" should be reconsidered. The term now encompasses accounting principles derived from a number of sources, ranging from FASB Statements and pronouncements of the Securities and Exchange Commission to accounting text books and articles (see Statement on Auditing Standards No. 5). In particular contexts, these members believe, the use of other words, such as "promulgated," "required," or "established," may more accurately describe the principles referred to and may thereby clarify thought on the concepts underlying those principles.

Suggested Criteria for Disclosures to be Required by GAAP

The committee suggests that the following might be workable criteria for disclosures that should be required by GAAP.

(1) Disclosures necessary to an understanding of the availability of an asset for use in the business, the payment requirements of a liability, and the legal characteristics of equity securities.

(2) Disclosures with respect to (a) a selection from existing acceptable alternatives, (b) principles and methods peculiar to the industry in which the reporting entity operates, and (c) unusual or innovative applications of generally accepted accounting principles. (See APB Opinion No. 22, paragraph 12.)

(3) Disclosures of significant contingencies and commitments.

(4) Disclosures with respect to (a) material events or transactions that are unusual in nature or occur infrequently (see APB Opinion No. 30, paragraph 26), and (b) material subsequent events of the type discussed in Statement on Auditing Standards No. 1, sections 560.05–.06.

(5) Disclosures with respect to (a) significant changes in accounting principles or estimates, and (b) effects of restatements of prior-period financial statements.

(6) Disclosures with respect to related party transactions that are material, individually or in the aggregate (see Statement on Auditing Standards No. 6).

Reporting on Additional or Analytical Disclosures

Some disclosures not required by GAAP under the criteria developed may, nevertheless, still be required by regulatory or standard-setting bodies in certain circumstances, or may be voluntarily made by companies not subject to the requirements. Such additional or analytical disclosures should be kept separate within the financial statements from other disclosures. The AICPA auditing standards division should consider the reporting standards appropriate for such disclosures.

This distinction between disclosures required by GAAP and other disclosures is necessary to prevent additional or analytical disclosures from inappropriately becoming part of GAAP. Very often, requirements of regulatory bodies have become GAAP through custom and usage because a large number of entities were subject to those requirements. Regulatory bodies, therefore, should be encouraged to identify disclosures required by their pronouncements as additional or analytical disclosures. Standard-setting bodies should distinguish in their pronouncements between disclosures that are required by GAAP in the financial statements of all entities and those that are merely additional or analytical.

Other Reporting Suggestions

The accounting and review services subcommittee of the AICPA auditing standards division is reviewing standards for a CPA's report on unaudited financial statements, on unaudited "internal use only" financial statements, and on financial information on prescribed forms. The problems described in this report merit careful attention by that subcommittee. This should include a reconsideration of the concept of a CPA's "association" with the unaudited financial statements of his client. The committee also believes that a more informative CPA's report, one which refers to the accounting services rendered and distinguishes them from auditing procedures, should be considered. Finally, the "internal use only" disclaimer should be reevaluated and consideration should be given to allowing the CPA to be associated with financial statements where some or all footnote disclosures have been omitted if the CPA's report includes an appropriate notice to the reader about such omissions without necessarily identifying them in detail.