ACCOUNTING STANDARDS OVERLOAD

An Honors Thesis (ID 499)

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Wide segments of the business community and the accounting profession have become increasingly concerned about, and critical of, the proliferation over the past several years of complex and detailed accounting standards. The mounting frustration with complicated measurement rules such as the standards on lease accounting, interperiod tax allocation, business combinations and interest capitalization indicates that many accounting standards users now believe that the situation has reached the point of accounting standards overload.

The accounting standards overload syndrome is apparent in businesses of all sizes, but the brunt of the burden falls on small businesses because they are least able to bear its cost.

In 1976, the American Institute of Certified Public Accountants (AICPA) committee on generally accepted accounting principles for small and/or closely held businesses recommended relief for small businesses from the increasing burden of financial statement disclosure requirements but concluded that the size of ownership of an entity should not result in the application of different measurement standards.¹ The AICPA established the Derieux committee in 1978 to study the viability and prospects of such firms. The report of that committee identified accounting standards overload as one of the many problems confronting such firms and recommended that the AICPA appoint a special committee to study alternate means of providing
additional relief from accounting standards that are not cost-effective for small businesses.²

In the spring of 1981, the AICPA board of directors established the special committee on accounting standards overload (the special committee) as recommended by the Derieux committee. On December 23, 1981, the special committee issued, for public comment through May 31, 1982, a discussion paper describing its deliberations and the evidence it considered and setting forth its tentative conclusions and recommendations.³

This paper discusses the means and prospects of providing relief from accounting standards overload against the background of those developments.

The Proportion of the Problem

The perception of accounting standards overload is but one aspect of the increasing complexity of the economic, social, cultural, scientific, and political environment in which all professions must function today. Regulations have multiplied in all areas of life including professional regulations and standards. The proliferation of accounting standards is only one facet of the explosion of regulations. Other facets include the burdens arising from governmental rules and regulations, detailed tax laws and involved procedures and routines created in the private sector to deal with the increasing complexity of business and the environment in which business operates.

CPAs who are general practitioners must keep up with technical standards and regulations in many areas. Sharing top billing with accounting and financial reporting is the whole
area of taxes—practitioners must deal with all the complexities of the income tax laws and the regulations that are constantly changing. To these must be added the area of information systems and the need for at least a working understanding of the problems in areas such as labor and pension laws. The owners and managers of those businesses look to CPAs for counsel. For practitioners to be able to serve clients adequately, they must keep up with developments in all of those areas.

The first step in finding a solution to a problem is to identify its size. To find a solution to the problem confronting the accounting profession, accounting standards overload should be viewed from two perspectives—that of small businesses and the users of their financial statements and that of the practitioners who serve those businesses.

Small Businesses and the Users of Their Financial Statements

The problems created for the business community by accounting standards overload should first be viewed apart from whatever problems practitioners may have in keeping up with those standards. In considering this issue, the concerns of small businesses and the users of their financial statements are paramount. Owners of small businesses perceive an accounting standards overload because of the cost of implementing increasingly complex standards and because they believe that the information that results from applying some of those standards does not make sense to them or to those who use their financial statements.

Accounting standards impose both direct and indirect costs on businesses. There are the direct costs of producing the
information required by accounting standards. There is also an opportunity cost: time and money spent on developing the information required by accounting standards are not available to develop other information that may be more useful to businesses and the users of their financial statements. Both of these costs are relatively bigger burdens on small businesses than on large businesses.

Current standards require all businesses to follow the same measurement rules when reporting to outside parties who require financial statements prepared in accordance with generally accepted accounting principles. However, the cost of producing information to meet some standards is a greater proportion of available resources for a small business than it is for a large business. If the benefits of the required information to the users of a small business's financial statements do not exceed their cost, the point of overload has been reached.

In addition, costs and benefits of financial statements used within a business or for other limited purposes differ from those of financial statements for outside parties. Large businesses with their own accounting staffs are free to prepare interim or special-purpose financial statements that omit disclosures required by GAAP or otherwise depart from GAAP. Small businesses, however, usually must rely on their outside accountants to prepare those types of financial statements, and the outside accountants are not free to simply ignore those standards that the accountant or the client believes are not relevant in the circumstances. The result is that the client incurs
the client also incurs an opportunity cost because the client cannot afford to pay for both the information necessary to comply with accounting standards and the other information believed to be more useful.

Thus, the accounting standards overload issue for small businesses can be addressed in two parts. The first relates to the question of whether certain standards are relevant to small businesses and produce general-purpose information useful to financial statement users. The second relates to the question of possible relief in situations when accounting principles are not significant in a particular situation, such as for interim financial statements, internal-information or special-purpose reports. In short, the second issue is whether GAAP financial statements—annual or interim—are needed by owners and management of small businesses and by the users of their financial statements.

The Practitioner

The practitioner is caught in the middle between the demands of professional standards and the discontent of small business clients with the burden those standards impose on them. Unquestionably, the world is more complicated today than it was twenty years ago and some degree of complexity in accounting standards is a natural outgrowth of our complex environment. It nevertheless is a burden on the practitioner to keep up with developments in accounting standards. That burden falls on practitioners in both large and small business units.
All practitioners need to have a working knowledge of the professional literature to be able to identify a problem, and to know where to look for the answer. However, they do not need to know the answers to every problem. The major difference between large and small practices is that large practices may assign individuals, on either a full-time or a part-time basis, to be available for consultation on various problems. Small practices may find it more difficult to support the kind of in-house capacity to deal with all the questions that can arise.

However, practitioners in small business units can and do avail themselves of equally acceptable alternatives to in-house capacities. Professional organizations have developed programs to provide small practices with consultation services similar to those available in-house in large practices. The largest such service is the AICPA Technical Information Service (TIS). An AICPA member may obtain the assistance of the TIS on any accounting or auditing problem by letter or by a toll free telephone call. TIS questions and answers on matters of wide interest are published in AICPA Technical Practice Aids available in loose-leaf and paperback form. The substantial increase in the use of the TIS over the past year suggests that there may have been, and may still be, a substantial number of members who are not aware of either the availability or the value of the TIS service.

Some state societies also sponsor consultation services, which afford practitioners the opportunity to discuss their accounting and auditing problems—and sometimes tax, management
consulting and management of accounting practice problems—with highly qualified consultants. Such consultation services have two attractive features. First, the consultant is a practitioner who usually has a good understanding of the problems addressed and may, in fact, have faced an identical situation with a client. Second, the consultant is located in the same state as the practitioner and is likely to be familiar with local laws, conditions or other factors that may be relevant to an appropriate resolution of the issues involved.

A Proposal for Relief

The discussion paper issued by the special committee takes a broad approach to identifying the issues and evaluates several possible solutions to accounting standards overload. The special committee recommends an approach for the Financial Accounting Standards Board (FASB) to pursue in providing a long-term solution and presents a proposal encouraging wider use of income tax basis accounting to provide immediate short-term relief. Each of these proposals is discussed in the following sections.

The special committee acknowledged in its tentative report that its proposal does not provide a final solution to the problem of accounting standards overload. The problem will not be fully and finally solved until consideration has been given to whether and to what extent the needs of users of financial statements of small or closely held businesses differ significantly from the needs of users of large, public companies and whether the costs of implementing some standards exceed the benefits from the information they produce. The special committee
acknowledged that the FASB is now spearheading and coordinating an effort to provide a long-term solution, which is ultimately its responsibility.

The FASB is recognized by the profession and by other concerned groups as the body having authority to issue binding accounting standards. For reasons outlined in the discussion paper, it is not realistic to withdraw recognition of the FASB or to take any action that would jeopardize the FASB. The special committee concluded that the profession should work on the accounting standards overload problem within the existing framework. Although the special committee took the position that the framework should not be changed, it recommends that the FASB reconsider accounting standards widely perceived as unnecessarily burdensome and costly.

The special committee recommends a comprehensive reconsideration by the FASB of several accounting standards identified in the discussion paper but also recommends immediate reexamination of four standards deemed to be most troublesome: (1) FASB Statement no. 13, Accounting for Leases, and its many amendments and interpretations; (2) APB Opinion no. 11, Accounting for Income Taxes, and its amendments and interpretations; (3) the pro forma disclosures mandated by APB Opinion no. 16, Business Combinations; and (4) FASB Statement no. 34, Capitalization of Interest Cost.

Wider Use of the Income Tax Basis of Accounting

In addition, the special committee encourages wider use of the income tax basis of accounting by business entities that for
whatever reasons do not need GAAP financial statements. The discussion paper presents tentative disclosure and measurement guidelines designed to increase the consistency among entities that choose to report on the income tax basis of accounting. Some of the early letters of comment, however, indicate confusion among some respondents about the nature and intent of the tentative recommendations.

The special committee does not recommend that the income tax basis of accounting supplant GAAP in any situation. The income tax basis is offered only as a potential alternative in situations in which GAAP financial statements are not necessary. A good example of such a situation is when a bank has a loan that is adequately collateralized by the assets of a business and the guarantees of its owners and the bank is interested in obtaining only a general idea of how business operations are progressing. In such situations, bankers often are satisfied with income tax basis financial statements. However, the option to use such financial statements does not mean that bankers will be required to accept non-GAAP statements from small business units. A bank, as a condition of making a loan, has the right to insist on GAAP financial statements at any time.

The idea of preparing financial statements on an income tax basis is not new. It was formally recognized in 1976 by Statement on Auditing Standards no. 14, Special Reports. The special committee's discussion paper provides measurement and disclosure guidance that would make the use of income tax basis financial statements more acceptable in situations in which GAAP
financial statements are not needed. Greater use of that basis of reporting would provide a means of relief from accounting standards overload for some companies and some practitioners because the income tax basis information must be developed in any event.

Despite its long history, some questions still are unresolved relating to financial statement presentation and disclosure in financial statements prepared on the income tax basis. Also, some perceive that current reporting standards for such statements are unduly negative. The tentative guidance in the discussion paper suggests answers to questions such as how to handle nontaxable revenue and nondeductible expense, how to account for Internal Revenue Service adjustments and what to do with accounting changes for tax purposes. In addition, suggestions are made for minimum disclosures and for a less negative form of report by accountants, including audit, review and compilation reports.

The issues relating to accounting standards overload are complex, controversial and threatening. A consensus on a comprehensive program to provide relief will be difficult to reach. The tentative conclusions and recommendations of the special committee touch only the tip of the iceberg. The ultimate responsibility for providing relief rests on a cooperative effort by the FASB and the AICPA.

Initiatives and Prospects

In response to the mounting concerns coming from many sources, the FASB already has taken some important steps and is continuing
to take significant initiatives toward relieving the accounting standards overload.

As a result of FASB action, small and closely held businesses have obtained some relief from certain financial statement disclosure requirements. In 1978, the FASB suspended the requirements to disclose earnings per share and segment information for companies whose securities are not publicly traded. The FASB has officially recognized that certain types of required financial information may be disclosed outside financial statements and is making progress in its project to distinguish between disclosures that should be required for all enterprises and disclosures that should be required for only certain designated types of enterprises. For example, only very large enterprises must present the supplementary information on the effects of changing prices required by FASB statement no. 33, Financial Reporting and Changing Prices, and related statements. FASB Statement no. 35, Accounting and Reporting by Defined Benefit Pension Plans, and FASB Statement no. 43, Accounting for Compensated Absences, issued in 1980, permit flexibility based on the relationship between costs and benefits considerations that may be helpful to small entities.

The FASB has established a permanent advisory committee to deal with issues relating to small businesses and the practitioners that serve them. More significantly, the FASB issued an invitation to comment seeking information on financial reporting by private and small public companies. That document asks managers of private and small public companies, users of
those companies' financial statements and public accountants providing services to those companies to complete detailed questionnaires tailored to the respective groups of respondents. The objective of the project is to learn more about the practices, experiences and views of the respondents concerning financial reporting by private and small public companies and about the financial information needs and practices of the primary users of the financial statements of such companies.

The current approach to setting standards results in standards that are too detailed. For example, accounting standards overload is made considerably worse by the tendency toward detailed, cookbook-type standards designed to curb every possible abuse. The objective of standards should be to provide general rules to guide accounting for transactions and events in accordance with their economic substance. Such standards should be flexible enough to admit considerably more judgment in their implementation than is now possible under many current standards.

CPAs in public practice bear a large share of the blame for the cookbook approach to setting standards. In our society, CPAs in public practice are primarily responsible for providing assurance that companies comply with accounting standards. The demand for detailed standards stems from public accountants' desire as auditors to have hard and fast rules against which to test the judgment of management in the application of accounting standards. However, not much progress can be made in providing relief from accounting standards overload until the pressure abates for standards that provide detailed tests against which audit judgments can be safely made.
As the FASB gets more and more of the building blocks of its conceptual framework in place, perhaps the pressure for detailed standards will abate and the FASB will pull back from the cookbook approach to setting standards and go forward with an approach that requires public accountants once more to exercise their professional judgment.26

A factor that has made it difficult to make greater progress in providing relief from the burdens imposed on small companies by GAAP has been the widely held view that GAAP constitutes a single body of rigid, inflexible and detailed measurement rules that must be applied precisely alike by all enterprises.

Evidence of the flaw in that view can be found in the differences that now exist in the application of GAAP in various circumstances. GAAP for governmental organizations differs from GAAP for business enterprises. GAAP for regulated business enterprises differs from GAAP for nonregulated business enterprises. GAAP for nonprofit organizations differs from GAAP for profit-making enterprises. GAAP for investment companies differs in significant detail from GAAP for banks. GAAP for some enterprises requires the use of market value for investments in securities, whereas GAAP for other enterprises requires the use of cost or the lower-of-cost-or-market convention.27

Such differences are based on differences in the underlying facts and circumstances. They are cited here to point up the flexibility of GAAP in dealing with those circumstances. However, efforts to make progress on simplifying GAAP to serve the needs of small business is hamstrung by the old fear, two sets of GAAP—one inferior to the other.
The special committee has issued its tentative conclusions and recommendations and the FASB has issued its invitation to comment on financial reporting by private and small public companies. They address essentially the same problem—accounting standards overload. However, to resolve that problem they need the help of accounting practitioners and the issuers, preparers and users of financial statements who can speak from the perspective of small or closely held businesses. The activities of the special committee, the FASB and others can be successful only with the participation of all who use accounting standards.
FOOTNOTES


6 W. T. Baxter, p. 5.


9 Brackney and Anderson, p. 27.

10 Hepp and McRae, p. 54.

11 Ibid, p. 54.


15 Thomas P. Kelley, p. 10.


18 Thomas P. Kelley, p. 16.


22 Hepp and McRae, p. 60.


24 Hepp and McRae, p. 60.

25 Ibid, p. 60.

26 Ibid, p. 60.


28 Hepp and McRae, p. 62.
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