AN APPROPRIATE FINANCIAL REPORTING FRAMEWORK
FOR SMALL COMPANIES

A THESIS SUBMITTED TO THE FACULTY OF ECONOMICS AND COMMERCE
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The purpose of this thesis is to examine the implications of the Australian financial reporting framework for small companies operating in Australia, and to consider whether the framework is appropriate for these companies.

The study necessarily contains discussion of Australian companies legislation and accounting standards. As far as possible, recently issued accounting standards and legislative changes have been considered. However, the revisions to Schedule 7 of the Regulations to the Companies Act 1981, which are effective from October 1986, are not discussed. Although a draft of the proposed revisions was released in December 1985, at the time of writing the substantive part of this thesis it was not apparent that the revisions would be introduced. Accordingly, it was considered inappropriate to review the proposals in detail, and brief mention only is made of the "draft revised Schedule 7" in Chapter Seven.
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CHAPTER ONE: INTRODUCTION

The purpose of this study is to determine whether small companies in Australia are "overburdened" in terms of the amount and type of financial information they are required to disclose in their financial statements and, if this is the case, to recommend an appropriate reporting framework for them.

The regulation of accounting and financial reporting has increased substantially since the 1960's. The growth in the number of regulations affecting financial reporting has led to concern that there are too many reporting requirements. The literature has focused particularly on the burden of existing measurement and disclosure standards for small companies. The issue has been widely discussed in the United States of America and in the United Kingdom, addressed as "accounting standards overload" or the "differential reporting problem". Until very recently, the issue has been the subject of little discussion in Australia.

Consideration of whether small companies in Australia are overburdened necessarily involves an identification of what is meant by the term "small company". Although many
definitions have been proposed\textsuperscript{1}, a particular definition is not regarded as appropriate universally. It is evident from the available definitions that certain features which are prescribed as essential characteristics of small businesses are similar among the definitions. These are:

1. that the firm is not dominant in its field of operations;
2. that the firm is independently owned; and
3. that the firm is independently operated, to the extent that it is managed by a few people.

For practical purposes, government departments and other researchers have used statistical measures based on these characteristics. A statistical definition will not always capture the type of business situation that is envisaged in the descriptive definitions. However, from the viewpoint of applying a definition to serve a classificatory purpose, it is necessary to establish some criteria against which businesses can be effectively measured.

For the purposes of this study, a company is distinguished as "small" if it meets the definition of exempt proprietary company contained in Australian companies legislation (refer Section 2.3.1). The size limits implicit in that definition

\textsuperscript{1} See, for example, those definitions of small firms proposed in the following reports: Bolton Committee Report, \textit{Small Firms: Report of the Committee of Inquiry on Small Firms}, Cmd 4811, HMSO, London, United Kingdom, 1972; and Wiltshire Committee Report, \textit{Report of the Committee on Small Business}, Department of Trade and Industry, Canberra, Australia, 1971.
are inevitably arbitrary. The intention is that the companies categorised as small by the definition are those most likely to have the ownership, economic, and management characteristics contained in the more descriptive definitions.

The burden of reporting for small companies is claimed to exist as the result of particular characteristics of those companies.

The first of these characteristics is that small companies usually have relatively few owners, and the owners are usually family members\(^2\). The ownership interests lack the marketability characteristics inherent in a publicly owned company. Compared with the owners of a public company, there is less diversity in their investment objectives and consequently, in their information needs. The claim is made therefore, that much simpler financial reports could satisfy the information needs of small-company owners.

Secondly, the management group is usually very small and the same few people would normally have responsibilities in the areas of supervision of the production processes or services offered, costing, internal control, accounting procedures, purchasing of materials and labour, marketing, and pricing. Because this small group is also responsible for the

\(^2\) Surveys completed at the University of Newcastle indicated that more than 80% of small businesses had as their chief executive either the original founder of the firm or a member of the founder's family. Refer Johns B.L., Dunlop W.C., and Sheehan W.J., *Small Business in Australia: Problems and Prospects*, George, Allen & Unwin, Sydney, Australia, 1978.
preparation of financial reports, the time involved for them in that process is considered excessive as it reduces the time available for the activities considered more productive as far as progress of the business is concerned. Finally, some companies lack the skills and knowledge required to produce detailed financial reports, and are obliged to employ a public accountant to prepare the reports. Thus, as well as involving an indirect cost in terms of productive time lost, the reporting function imposes a direct cost, the purchase of the skills of a public accountant. This cost is of particular concern to owners whose accounting knowledge is weak, because they do not understand the detail of the reports prepared by the accountant. In their view, a considerable cost is incurred for no value to themselves.

These characteristics may be summarised into the following arguments which support the need for reducing the reporting burden for small companies:

1. the cost of adhering to measurement standards and disclosure rules is borne disproportionately by small companies;
2. interested users of their financial reports differ from those interested in large companies' reports and their knowledge of the enterprise is more intimate; and
3. the users possess more authority or some other ability to obtain the information they need for
decision-making purposes from the management of the company rather than the financial reports.

The issue as to whether or not small companies in Australia are overburdened by financial reporting requirements is examined in the following way. Reviews are completed of the existing financial reporting framework, and the body of literature which seeks to establish the case for overburdenment and to make recommendations as to appropriate reporting practices for small companies. From these reviews, hypotheses regarding the overburdenment issue are established on a priori grounds. The hypotheses are examined by completing a field study involving interviews with the managements of small companies that operate in Victoria.

Arising from the field study and associated reviews, recommendations for improvement to the existing financial reporting framework in Australia, in order to lessen the burden of reporting for small companies, are made.

The study does not examine the issue of overburdenment as far as it may affect reporting entities other than "small companies".
The subject matter of this thesis is whether small companies in Australia are "overburdened" in terms of the amount and type of financial information they are required to disclose in their financial statements. The existing reporting framework for small companies is reviewed to determine whether it is ideal. The justification for consideration of these issues is presented in this chapter.

SECTION 2.1 A BRIEF REVIEW OF THE JUSTIFICATION

Support for the need for review of financial reporting requirements as they affect small companies derives firstly from consideration of the objective of accounting and financial reporting. Barton3 outlines this as

"The fundamental objective of accounting systems and financial reports should be to satisfy the needs of users for financial information on the economic affairs of a firm."

For a large company, the users of financial reports are many and varied. Presently, financial reporting requirements are directed towards large companies and, accordingly, concentrate on general purpose reports that are made publicly available. The users of the financial information

3 Barton A.D., Objectives and Basic Concepts of Accounting, Accounting Theory Monograph No 2, Australian Accounting Research Foundation, Melbourne, Australia, 1982, Page 6.
from small companies may differ from the users of the reports of large companies. It is not clear that the present financial reporting requirements are ideal for both groups of users. Indeed, the users of small companies' reports might be better served if these companies presented information different from that which they currently provide.

This support is referred to as the "users' needs" argument.

The need for review of financial reporting requirements as they affect small companies in Australia, specifically, derives from the considerable concern expressed at the general burden of regulation on small companies in Australia.

The Australian Government has directed the Companies Law Review Committee to consider the following issues in relation to proprietary companies:

1. the suitability of the provisions of the Companies Act 1981 in relation to the regulation of proprietary companies; and
2. the obligations of proprietary companies to make public disclosure, particularly in the light of their limited liability.

4 These are two of a number of issues with which the Committee has been requested to deal. Refer Companies and Securities Law Review Committee, Forms of Legal Organisations for Small Business Enterprises, Discussion Paper No 1, Sydney, Australia, 1984.
The National Companies and Securities Commission has also considered the concerns that have been expressed by the public regarding the regulation of proprietary companies. Recent amendments to the Companies Act to reduce the amount of public disclosure required from proprietary companies reflect the result of those considerations. While these amendments had not been drafted prior to the commencement of this research, the investigations which prompted them have served to support the research in a retroactive sense. This support is referred to as the "legislative burden" argument.

SECTION 2.2 THE USERS' NEEDS ARGUMENT

Central to the users' needs argument is identification of the users of the reports of small companies. The users of the financial information reported by companies are set out below.

1. Equity investors.
2. Capital market institutions.
3. Management.
4. Lenders.
5. Trade creditors.
6. Employees.
7. Customers.
9. The public.
It is unlikely that all of these users are interested in the financial statements of all companies. In particular, it is probable that some of the users identified above are not interested in the financial statements of small companies. The following analysis of the users' interests and information needs presents a view of whom might be expected to be the users of the financial statements of small companies.

1. Equity investors
The primary aim of an investor in purchasing shares in a company is to earn a return which is sufficiently high to compensate him for the risk of investment and the period of time which elapses between his initial investment and recoupment of the investment and return. The investor is concerned with the company's solvency, financial position, and earning power. He requires information with which he can evaluate whether the company's operations are sufficiently effective to ensure an adequate rate of return. This information is provided by the company's financial statements.

Owners of large and small companies have essentially the same interests, with the exception that, because they are typically quite a separate group from the managers, the owners of a large company require information to indicate that the company's funds have been properly used by the managers.
2. Capital market institutions

The capital market exists to provide a link between investment opportunities in public companies and investors. The information required by capital market institutions is similar to the needs of investors in public companies because the institutions often effectively act in an agency capacity for those investors.

In order that the institutions can advise investors on the relative merits of opportunities they must have information regarding profit performance and financial position such as that normally included in a company's financial statements.

Although some capital market institutions may be interested in the affairs of small companies, the capital market exists to facilitate investment in public companies only, and it should be regarded as having no interest in the financial reports of small companies.

3. Management

Management is concerned to plan the company's operations effectively and to control them appropriately in order that adequate profit is earned for the owners. Accounting information must be provided to facilitate these functions.

Management uses financial statements as the basis for planning and budgeting, as well as for analysing the
company's liquidity, solvency, earning power, and financial position.

In large companies, various internal reports may be prepared in addition to the statutory financial statements to assist the management process. Small companies, however, usually lack resources adequate to support multiple reporting procedures and therefore could be expected to place greater emphasis on the formally prepared year-end accounting reports, or reports prepared in the same format as these throughout the year.

4. Lenders

Companies commonly obtain finance from lenders such as trading banks. The discussion herein is framed specifically in terms of the trading banks, but it applies equally to all lenders.

In making loans to companies, banks are concerned to ensure that the principal is repaid, and that the company makes regular interest payments of an amount and frequency that makes the bank's investment worthwhile. They are concerned with the ability of the company to generate cash flows that will enable the relevant amounts to be repaid, and with the economic stability of the company. As the period of the loan varies from short-, to long-term, so will the bank's primary concern change from liquidity to stability. The company's financial statements may be reviewed by
bank officers to guide their assessments of liquidity and solvency. However, the statements can be no more than rough guidance because the information contained therein is likely to be out-dated by the time the statements are prepared, and cash flow information is not highlighted.

For these reasons, additional information would normally be obtained by the bank officers directly from management either in the form of specially prepared reports, or orally, before lending decisions are made. Because of the strong bargaining power of the banks, i.e., their power to withhold loans until requested information is obtained, they are well placed to obtain any information they require. In the case of small companies, it may be that the banks place emphasis on their knowledge of management and the companies' operations because these companies may not be able to provide the same degree of security and backing as their larger counterparts.

5. Trade creditors

Trade creditors are concerned with the prospects of payment by the end of the credit period. It could be argued that a creditor making a decision to give credit, for the first time, to a company might consult the company's financial statements to assess its short-term liquidity. However, the financial statements are unlikely to be an adequate guide, having been prepared
some time earlier. The relevant information is more appropriately obtained from business contacts or a trade reference. A creditor who supplies the company regularly assesses the prospects of payment on the basis of the company's past paying record, without the need for consulting the financial statements. It is suggested, therefore, that creditors make very limited use of the financial statements of either small companies or large companies.

6. Employees

Employees are concerned with information regarding the stability and financial position of their employer as they see their remuneration and prospects within the organisation as being related to these aspects. This information is normally best understood by the group if it is expressed in qualitative terms, and for this reason large companies often provide it in narrative form in the annual report or in a special employees' report issued as an addendum to the financial statements. In a small company, this information is normally communicated through personal contact between the employees and the owner/managers. Employees are unlikely to have any real interest in the financial statements of small companies.

7. Customers

Customers entering into long-term contracts for supply
require information regarding the company's reliability to produce, productive capacity, and warranty considerations.

It is unlikely that financial statements are the main source of this information. Rather, previous contacts with the company, knowledge of the industry within which the company operates, economic conditions, and trade references may be the most relevant indicators of operating performance.

8. Government

Often companies' financial data are required for analysis purposes by government departments and instrumentalities. This information is usually obtained directly from the companies through, for example, Bureau of Statistics forms, rather than from financial statements.

"In practice, financial statements lodged by companies with their annual returns are rarely consulted by governments - and only then principally for fiscal (e.g. taxation) and similar purposes. The information which they disclose is neither aggregated nor analysed for economic management purposes." ¹⁵

9. The public

"The public's right to information about companies arises from the special legal and economic privileges granted to companies."6

It is claimed that companies have a social responsibility to uphold the community's expectations of their behaviour.

Although the public is concerned with such financial factors as the general levels of prices charged and wages paid by the corporate sector, the public's primary area of interest is knowledge that companies adhere to various social standards, e.g., environmental controls, safety standards, etc. Information regarding these aspects of companies' operations may be contained in the financial statements of some large companies, and is rarely contained in the financial statements of small companies. Thus, the most appropriate source of information for the public is direct communication with the companies.

The discussion above asserts that the primary users of financial reports of small companies are equity investors and management; indeed in many small companies these will be an identical group. While some information of interest to lenders and other users may be obtained from financial

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statements, more relevant and up-to-date information is obtained from the companies directly.

Once investors and management are identified as the primary users, the imposition of some reporting burdens must be questioned because:

1. the range of users of small companies' financial reports differs from those interested in large companies' reports and their knowledge of the enterprise is more intimate; and
2. these users possess authority or some other ability to obtain the information they need from the management of the company rather than the company's financial reports.

The users' needs argument proceeds as follows. Information which is useful for the users of the financial reports of small companies should be disclosed in those reports. Attempts should be made to identify the information found useful, and reporting requirements should be amended to require disclosure of this information.

At this stage it is appropriate to recognise that the assertions regarding the users of reports cannot be supported unequivocally by the literature or previous empirical research. Many studies have considered the general issue of the users of financial statements.
However, few have considered, specifically, the users of the financial statements of small companies. It is difficult to interpret the results of the studies because they necessarily reflect the perspective of the individual researchers.

Even though support for the claim that investors and management (owner/managers) are the primary users of the reports of small companies is not unequivocal, it is contended that sufficient evidence exists to support a review of financial reporting requirements following the users' needs argument.

SECTION 2.3 THE LEGISLATIVE BURDEN ARGUMENT

The framework for financial reporting in Australia was established from rules developed by various sources: the legislature, the accounting profession, and the stock exchanges. The framework is disjointed to the extent that the rules developed from each source exist independently of the others; an individual company preparing its annual accounts must consult the body of rules from each source to ensure compliance with reporting requirements.

A summary of the framework is presented in this section, together with an outline of the equivalent frameworks in the United States of America (USA) and the United Kingdom (UK). Each framework is similar to the extent that reporting rules developed by the private accounting bodies and the
governments and stock exchanges exist independently of one another. However, each differs in the degree of its application to various classes of companies.

2.3.1 The Australian Reporting Framework

The National Companies and Securities Commission is responsible for administering legislation relating to companies enacted by the Australian Government. Financial reporting by companies in Australia is governed in the first instance by the Companies Act 1981 (the Act) of the Australian Government. This Act has been adopted by each state of Australia as the Companies Code for that state. The Act distinguishes three classes of company limited by shares. These classes are explained below.

1. Proprietary company - one whose memorandum and articles:
   - restrict the right to transfer its shares;
   - limit the number of members to not more than 50;
   and
   - prohibit any invitation to the public to subscribe for shares or deposit money.

2. Exempt proprietary company - a proprietary company in which membership is not held by a public company.

3. Public company - a company other than a proprietary
Reporting requirements for each of these classes are outlined in the course of the discussion that follows.

Division 2 of Part VI of the Act prescribes that the following information be presented at each general meeting of the company:

- a balance sheet;
- a profit and loss statement; and
- a directors' report.

The accounts, comprising the balance sheet and profit and loss statement and notes thereto, must give a true and fair view of the results and state of affairs of the company, must have been prepared in accordance with applicable approved accounting standards, and must comply with "such of the prescribed requirements as are relevant to those accounts". The prescribed requirements are listed in Schedule 7 of the Regulations to the Act.

The contents of the directors' report are outlined within the division, and basically give further narrative explanation of the company's accounts and activities for the year. In that it expands on the accounts themselves, the directors' report is not of concern to this study.

Division 2 also includes a requirement that companies' accounts be audited. Section 3 of Part VI offers relief
from this requirement to exempt proprietary companies.\(^7\)

As well as being presented at the Annual General Meeting, the accounts of companies, other than exempt proprietary companies, must be lodged with the Corporate Affairs Commission (CAC), being agent for the National Companies and Securities Commission, as part of the company's annual return. Most companies, including unaudited exempt proprietary companies, must record on their annual return forms seven specified items of key financial data.\(^8\) The specified items are the amounts disclosed in the company's financial statements for: current assets; other assets; current liabilities; other liabilities; share capital and reserves; net tangible assets; and operating profit and extraordinary items.

As outlined earlier, a company's annual accounts must give a true and fair view of the results and state of affairs of the company. The interpretation of "true and fair" has been the subject of much conjecture. However, it is usual to

\(^7\) Prior to June 1986, the Companies Act prescribed that the accounts of exempt proprietary companies should be lodged with annual return forms to facilitate public inspection of those accounts. Exemption from public lodgement was given if the accounts had been audited. For this reason, the accounts of many exempt proprietary companies were audited. The Companies Amendment Act 1985, effective from July 1986, relieves all exempt proprietary companies from the requirement to lodge accounts.

\(^8\) Those exempt proprietary companies which elect to be audited are exempted from the requirement to disclose the seven specified items of financial information in their annual return forms.
consider that a true and fair view will be presented only if the accounts are prepared following generally accepted accounting principles. In Australia, these principles are formally presented in the accounting standards promulgated by the professional accounting bodies. The concept of truth and fairness is effectively the link between the legal requirements and the accounting standards. This is recognised by the accounting profession. For example, paragraph 1 of APS 1, Conformity with Statements of Accounting Standards states:

"The National Councils also believe that application of the Statements of Accounting Standards is necessary for those entities whose financial statements are required by Statute or otherwise to give a 'true and fair view'."

There are presently 21 standards:

AAS 1 Profit and Loss Statements.
AAS 2 Valuation and Presentation of Inventories in the Context of the Historical Cost System.
AAS 3 Accounting for Company Income Tax (Tax-effect Accounting).
AAS 4 Depreciation of Non Current Assets.
AAS 5 Materiality in Financial Statements.
AAS 6 Accounting Policies: Determination, Application

Most of the standards are concerned with both measurement concepts and disclosure requirements, however AAS 1, AAS 5, AAS 6, and AAS 15 relate only to disclosure. In some standards the disclosure requirements are very specific, in others the requirements are included within the overall recommendations, but always they are subject to the overriding concept of materiality.

On this matter, paragraph 1 of AAS 5 states:
"The concept of materiality is an overriding concept which governs the preparation and presentation of financial statements. It also governs the applicability of Statements of Accounting Standards. Unless explicitly stated otherwise, a Statement of Accounting Standards (or any of its individual provisions) needs only to be applied where it will have a material consequence."

As with the legal requirements as to preparation of accounts, the professional requirements do not distinguish between classes of companies in terms of disclosures required.

The "applicable approved accounting standards" referred to in the Act are those standards which have been approved by the Accounting Standards Review Board (ASRB). The approved accounting standards must be followed by all companies in the preparation of their accounts, except where those standards do not apply, or in the unusual instance where their application would lead to the accounts not showing a true and fair view. The eight standards listed below are those which have currently have ASRB approval.

ASRB 1001 Accounting Policies - Disclosure.
ASRB 1002 Events Occurring after Balance Date.
ASRB 1003 Foreign Currency Translation - Disclosure.
ASRB 1004 Disclosure of Operating Revenue.
ASRB 1005 Financial Reporting by Segments.
ASRB 1006 Accounting for Interests in Joint Ventures.
ASRB 1007 Financial Reporting of Sources and
Applications of Funds.

ASRB 1008 Accounting for Leases.

The functions of the ASRB are to review standards referred to it and to issue approved accounting standards. It is not the function of the ASRB merely to "rubber stamp" those standards prepared by the accounting profession. Rather, the Australian Accounting Research Foundation (AARF), the accounting profession's research arm, is but one group which may develop and submit standards to the ASRB for review. Nevertheless, the standards approved by the ASRB to date are substantially the same as those developed by the accounting profession, and compliance with the profession's standard on a particular matter will ensure compliance with the equivalent approved accounting standard. 10

Schedule 7 of the Regulations to the Act (Schedule 7) sets out the statutory requirements as to contents of accounts. Matters of disclosure rather than valuation are emphasised by Schedule 7. The requirements are detailed and specific, and are presented in Appendix 1. A brief outline of the required disclosures follows:

- details of profit/loss for the period;
- movement within the unappropriated

10 Minor changes have been made to some of the profession's standards to ensure consistency with the approved accounting standards, refer McGregor W., "ASRB Approval of Standards", The Chartered Accountant in Australia, Vol 57, October 1986, pages 23-26.
profits/accumulated losses accounts;
.. analysis of permanent taxation differences where these have resulted in income tax expense being more than 15 per cent different from that which would be calculated if taxable income were equal to the amount of net profit (before tax) shown in the accounts; and
.. specific balance sheet items.

The concept of materiality is not relevant as far as the interpretation of the requirements of Schedule 7 is concerned. The Schedule 7 disclosure requirements reflect the view espoused by the Eggleston Committee\(^ {11}\) in 1969 that there are certain items which companies should be required to disclose in their accounts, irrespective of their magnitude.

In proposing some reforms to the existing Schedule 7, the National Companies and Securities Commission (NCSC) has recognised the need to incorporate the concept of materiality\(^ {12}\). However, the concept has been introduced on a clause by clause basis and, as proposed, would largely affect recommended disclosures for certain types of public companies rather than the disclosure requirements currently

\(^{11}\) Companies Law Advisory Committee (Eggleston Committee), *Report to the Standing Committee of Attorneys-General on Accounts and Audit*, Government Printer, Melbourne, Australia, 1969.

contained in the Schedule. The NCSC has not recognised the fact that some of the disclosures currently required do not have information value for report readers unless they are material in amount.

The attitude of the Australian legislature is interesting when compared with that of the UK and USA legislative bodies. Those bodies have adopted an overriding provision approach to incorporating materiality considerations, similar to that inherent in the Australian accounting standards.

In addition to complying with the requirements outlined above, listed public companies must comply with the disclosure requirements of the Australian Associated Stock Exchanges (AASE). These are additional to those specified in Schedule 7 and provide essentially for the following:

- preparation of a half-yearly report;
- preparation of a preliminary final statement prior to finalising the accounts;
- additional information to be included in the annual report; and
- various additional details for mining exploration companies.

Most small companies would be classified as exempt proprietary companies. The reporting requirements for that class of company are identified below.
1. Companies must prepare a balance sheet, profit and loss statement, and notes thereto in accordance with the profession's accounting standards and the approved accounting standards, where their application has a material effect on the results for the year, and the requirements of Schedule 7.

2. Companies must lodge an annual return form to the CAC each twelve months, disclosing therein specified items of key financial data.

2.3.2 Comparison with Reporting Requirements in the UK

Similar to the Australian requirements, legislation in the UK, specifically the Companies Act, 1981 (UK Act), requires that companies prepare a balance sheet, profit and loss statement and supporting notes thereto depicting their financial position and activities annually. Directors' and auditors' reports must be attached thereto for submission to shareholders at the Annual General Meeting. The detail and format of the accounts, including the notes, must comply with Schedule I of the UK Act. Listed companies are required to circulate additional information to shareholders, based on stock exchange rules.

The accounts must be lodged with the Registrar of Companies annually. Exemptions from this rule exist for "small" and "medium" sized companies which are not public companies, banking, insurance and certain shipping companies, and
companies belonging to an "ineligible" group.

A company is classified as "small" if it satisfies any two of the following conditions:

- turnover does not exceed £1,400,000;
- balance sheet total does not exceed £700,000;
and
- average number of employees does not exceed 50.

A small company may file modified accounts with the Registrar. The modified accounts comprise only a more aggregated presentation of the items specified in the format prescribed by Schedule I. Little information is required to be presented in the notes to the accounts. The company's profit and loss statement and directors' report need not be lodged. An audit report is required, together with a special report by the auditor stating that the requirements for exemption have been met.

A "medium" sized company is one which satisfies any two of the following conditions:

- turnover does not exceed £5,750,000;
- balance sheet total does not exceed £2,800,000;
and
- average number of employees does not exceed 250.

This class of company must lodge a summarised version of its
profit and loss statement, balance sheet, and notes to the accounts. Reports by the directors and auditors must be attached. As for a small company, a special report by the auditor stating that the requirements for exemption are met must be lodged.\footnote{13}

In addition to complying with the legislative requirements, financial reports must be prepared in accordance with the Statements of Standard Accounting Practice (SSAP) issued by the Institute of Chartered Accountants in England and Wales. These SSAP generally apply to all companies regardless of size. However, SSAP 16 (Current Cost Accounting) does not apply to private companies, and SSAP 10 (Statements of Sources and Applications of Funds) contains an exemption for companies with a turnover of less than £25,000.

The differences between the UK and Australian framework can be identified as follows:

\begin{itemize}
\item distinctions are drawn in the UK legislation between companies on the basis of size rather than ownership;
\end{itemize}

\footnote{13 While these exemptions are embodied in the UK Act, there is evidence that some companies choose not to lodge modified accounts. Carsberg et al. have evidence that those companies against filing modified accounts consider that doing so would result in an increase in accounting fees because of the need to produce full accounts for shareholders. Refer Carsberg B.V., Page M.J., Sindall A.J. and Waring I.D., \textit{Small Company Financial Reporting}, Research Studies in Accounting, Prentice-Hall International in association with the Institute of Chartered Accountants in England and Wales, London, United Kingdom, 1985.}
all companies in the UK must be audited, whereas in Australia exempt proprietary companies need not be audited; and some distinctions have been made in the context of UK Accounting Standards on the basis of size - this is not the case in Australia.

Presently the UK requirements as to public disclosure by small and medium sized companies are more detailed than the requirements imposed on equivalent companies in Australia. Prior to July 1986, this was not the case. In Australia, exempt proprietary companies which elected not to be audited were required to make public disclosure of the detailed information prepared in accordance with the Act and Schedule 7. Only those exempt proprietary companies which elected to have their accounts audited were exempted from the disclosure requirements.

There is evidence that the requirements imposed on small companies by the UK Act may soon be reduced. In particular the Government is considering whether it should:

1. eliminate the present statutory audit of accounts for "shareholder-managed" small companies;
2. reduce and simplify the content of accounts and balance sheets currently required from small companies;
3. exempt all small companies from the statutory audit; and
4. increase the thresholds defining small and medium
sized companies.

These matters have been the subject of a consultative document prepared by the Department of Trade and Industry.\textsuperscript{14} Government policy on the matters has not been finalised.

2.3.3 Comparison with Reporting Requirements in the United States of America

Reporting requirements in the USA have been established primarily by the Securities Exchange Commission (SEC), and the Financial Accounting Standards Board (FASB) and its predecessors. In the USA, the FASB promulgates generally accepted accounting principles which form the basis of the financial reporting framework. The principles are presented as Statements of Financial Accounting Standards (SFAS) and cover measurement concepts and disclosure requirements. The elements of the SFAS concerning measurement apply equally to all companies, however there have been some distinctions drawn on the basis of company size and ownership within the disclosure requirements. For example, earnings per share, segment information, and certain disclosures for business combinations are not required to be presented by companies which meet certain ownership criteria. Also, SFAS 33, Financial Reporting and Changing Prices, is applicable only

Companies whose securities are traded on a stock exchange are required, by the Securities Exchange Act, 1934, to file periodic reports with the SEC in addition to any requirements of their home exchange. This requirement also applies to companies which are not publicly-owned, but whose shares are sold in the "over-the-counter" market, and which have at least 500 shareholders and assets greater than $1 million.\textsuperscript{15}

The format and content of the reports are prescribed by the SEC. They are referred to as 10-K schedules and comprise a series of detailed standard forms that must be completed by companies. To the extent that standard forms are used, these reports differ in detail from the accounts published by the companies for distribution to shareholders. The required content of the reports differs between industries, but rarely on the basis of size. However, Accounting Series Release (ASR) 177 requires the disclosure of selected quarterly financial data only for companies whose size is above certain net income or total asset limits. Also, ASR 190 requires disclosure of replacement cost information only by companies whose inventories, property, plant and equipment total more than $100 million.

The SEC requirements are the only Federal requirement for

\textsuperscript{15} The "over-the-counter" market is very popular in the USA. Sales are not transacted on an organised exchange, but are arranged through securities dealers. For a review of the operation of the over-the-counter market, refer to Sharpe W.F., \textit{Investments}, Prentice-Hall, New Jersey, USA, 1978, Chapter 19.
lodgement of accounts. Clearly, the smaller, privately-owned companies are not affected by the requirements. Instead, these companies are affected by rules established at State level. In the majority of States, privately-owned companies, termed "closely held corporations", are exempted from any official reporting requirements.

The differences between the US and Australian frameworks can be summarised as follows:

. distinction is drawn between companies on the basis of ownership in both countries. There is no general requirement in either the USA or Australia for small privately-owned companies to make their financial reports public, however there is a requirement to disclose key financial data items in Australia;
. in the USA, privately-owned companies are not required by legislation to prepare financial statements;
. in Australia, the accounts which are made available to shareholders are the same as those lodged with the CAC. The 10-K schedules lodged with the SEC, in the USA, differ significantly in detail from the accounts made available to shareholders; and
. in the USA some distinctions have been made within the context of accounting standards on the
While the existing legislative requirements for small companies in Australia impose a lesser burden for companies than those in the UK, the requirements are considerably more burdensome than those in the USA. Concern has been expressed at the legislative burden of reporting requirements for small companies in Australia.

2.3.4 Influence of the Concept of Limited Liability on Legislation

The cost of compliance with disclosure requirements and other obligations imposed by company legislation is seen as a major disadvantage of the incorporated form in Australia. The primary barrier to reducing the reporting obligations for small companies is concern with the concept of limited liability. Namely, a company's separate legal personality facilitates the limitation of the liability of shareholders for the trading activities of the company to the amount of capital which they originally subscribed. It is claimed that companies and their shareholders must pay a price, that of formal reporting and disclosure, for the limited liability advantage, irrespective of the size of the company.

Whether the concept of limited liability is relevant for small companies is difficult to determine. Certainly, it seems that small companies do not limit their liability to
banks and major trade creditors. Gower\textsuperscript{16} has argued that

\"...in fact limited liability is mythical in the case of these (small family) companies because in practice whenever they try to get any form of formal credit facility the directors, and sometimes the members as well, would be required to give personal guarantees.\"

However, trade creditors will usually not seek security for amounts owed because the amounts of credit involved are not large or the exposure period is not long. Accordingly, shareholders are able to limit their liability to ordinary trade creditors.

If limited liability is raised as the primary force behind retaining existing disclosure requirements for small companies, it follows that the rationale given for existing disclosure and other reporting requirements is the protection of trade creditors who either are unable to, or simply do not, obtain personal guarantees or other security from their trading partners.

The question arises as to how far one should legislate to protect people from their unwillingness to assess the risks associated with entering into a business transaction. May be the limited liability concept should not be an overriding consideration in determining what might be an appropriate

\textsuperscript{16} Gower L.C.B., \textit{Proposals for Reform} - Proceedings of a Seminar entitled "The Abuse of Limited Liability" held by the Faculty of Law, Monash University, Melbourne, Australia, August 1983, page 2.
reporting framework for small companies in Australia. Legislators in the USA do not appear to have regarded the limited liability concept as being all-important.

2.3.5 Summary of the Argument

Having identified that small companies in Australia are subject to far more regulation in terms of financial reporting requirements than those in the USA, it is appropriate to consider whether the extent of regulation in Australia is necessary or desirable.

It is evident from some recent policy decisions, for example, the revised requirements as to preparation of annual return forms, that the issue of the reasonableness of reporting requirements for small companies is being considered by legislators. However, it is not evident that any substantial research has been completed which would serve to support or refute the existing framework or any proposed amendments. Some research is necessary to determine whether amendments to the existing framework are justified, and to avoid an ad hoc approach being taken with any amendments.
SECTION 2.4 SUMMARY OF THE JUSTIFICATION

In Australia, there certainly appears to be a significant amount of regulation imposed on small companies. It is appropriate to consider whether this is necessary and/or desirable. Some research regarding the general issue of the reasonableness of reporting requirements for small companies has been completed in the UK, and USA. Little has been completed in Australia. The need for some research to be completed in the Australian environment, specifically, is attributable to the large amount of regulation imposed on small companies operating in Australia.
CHAPTER THREE: LITERATURE REVIEW

The growth in the number of regulations affecting financial reporting has led to concern that there are too many reporting requirements. The literature has focused particularly on the burden of existing measurement and disclosure rules for small companies because while

"the accounting standards overload syndrome is apparent in businesses of all sizes ... the brunt of the burden falls on small businesses because they are least able to bear its cost."17

That the overload problem exists particularly for small businesses is reflected in the standard of accounts presented by small companies.18

Responding to widespread sentiment within the profession, the professional accounting bodies in the USA have reviewed, a number of times, the issues involved in resolving the problem. The American Institute of Certified Public Accountants (AICPA) has examined the issues three times by

special committee, specifically the Werner Committee (1976), the Derieux Committee (1980), and the Scott Committee (1983). Unfortunately,

"the AICPA Committee deliberations ... appeared to consist primarily of concerned CPAs talking to other concerned CPAs."¹⁹

and, while some suggestions were made, the lack of supporting empirical evidence proved an obstacle to achieving consensus. For this reason, the FASB was encouraged to consider the problem, and did so in invitations to comment in 1980 and 1981 and a sponsored research study in 1983. In view of the lack of reporting requirements for privately-owned companies imposed by government in the USA, it is interesting that the issue has attracted concern there. The reason for the concern appears to be that, while there are no formal reporting requirements for privately-owned companies, requirements for audited financial statements are sometimes imposed on the companies by lending institutions.

Recently, the accounting profession in the UK has also formally reviewed the issues in a sponsored research study. The accounting profession in Australia is yet to consider the issues formally. Because the involvement of the UK profession is only recent, the majority of this chapter is necessarily concerned with the ideas presented in the

American literature.

SECTION 3.1 VIEWS OF ACADEMICS AND THE AICPA

Possible solutions to the problem of the allegedly excessive burden of reporting requirements for small companies canvassed in the literature and reviewed by the AICPA committees are listed below.

1. Differential disclosure requirements.
2. Simplification of the body of generally accepted accounting principles (GAAP).
3. Two sets of GAAP.
4. Differential GAAP involving measurement and disclosure requirements.
5. One set of GAAP, but an available alternative to prepare accounts on a non-GAAP basis.
6. Allowance for departures from GAAP.

3.1.1 Differential Disclosure Requirements

While this solution would set identical measurement standards for all companies, it would involve one set of disclosure requirements applicable to all companies, and another applicable to only certain companies (i.e., large companies or public companies, depending on the basis for differentiation). Advocates of this solution maintain that it would reduce the cost of complying with GAAP for small
companies and yet ensure adequate information for financial report users.

The solution has widespread support in the literature and was recommended by each of the AICPA Committees. The reason for its popularity is undoubtedly that it is the least radical of the proposed solutions. Indeed, the FASB has made some distinctions in the disclosure requirements contained in certain SFAS based on a company’s ownership, size or a combination of both, for example SFAS No 21, Suspension of the Reporting of Earnings per Share and Segment Information by Non-Public Enterprises.

The following arguments have been raised against its suitability:

1. the difficulty of making a workable distinction between the companies which should apply the core disclosures, and those which should also make the supplementary disclosures;
2. if the distinction is based on size, or ownership, whether report users' needs for information actually vary with that basis; and
3. arguments that the major burden of accounting standards is measurement rather than disclosure.
3.1.2 Simplification of GAAP

Advocates of this solution maintain that all businesses have been overburdened by the proliferation of accounting standards. They recommend that broader standards should be written, and that these should contain few procedural details. The standards would give broad guidance regarding the issues of concern and provide auditors and accountants with the responsibility to apply judgement when interpreting them.

It may not be possible to achieve simplification of GAAP, despite its intuitive appeal. The reasons are:

1. many accountants seek specific guidance on the application of standards, and the needs of these accountants will only be satisfied by the present "cook book" type of standards; and

2. the large number of participants in the standard setting process makes it virtually impossible to simplify the standards any further. In relation to this argument Mosso\textsuperscript{20} makes an appropriate comment, namely

"It is probably true that everyone could simplify the standards - everyone, that is, one at a time with everyone else gagged".

\textsuperscript{20} Ibid, page 128.
3.1.3 Two Sets of GAAP

This proposal, also referred to as "Big GAAP, little GAAP", suggests that similar transactions should be measured and reported differently depending on the size of the reporting company. In effect, a set of GAAP designed specifically for small companies would be developed to co-exist with present GAAP. Some writers\(^{21}\) see this suggestion as a positive approach to providing useful and understandable financial accounting information. It would certainly provide opportunity for reduction in the measurement problem for small companies.

The proposal does not have the support of the AICPA and FASB. The arguments raised against it, in addition to those raised against differential disclosure, are:

1. a two-tier concept of GAAP would inevitably lead to a perception, by the community, that financial statements prepared on a "little GAAP" basis were of lesser quality than those prepared on a "big GAAP" basis; and
2. GAAP measurement principles should be the same regardless of the size of the entity.

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Meager\textsuperscript{22} suggests that the first of these arguments would be overcome if, instead of introducing "little GAAP" to co-exist with present GAAP, a new set of GAAP based on core principles were established. This set (core GAAP) would then be extended to include more comprehensive allocation principles for certain companies. The extended set would be referred to as supplementary GAAP. He maintains that most companies would then apply core GAAP and this would be seen as the norm, while larger companies would apply supplementary, but not necessarily superior, GAAP. An alternative solution which embodies Meager's suggestions, but aims to avoid the "two GAAP" problem, is outlined in Section 3.1.4 below.

The second of the arguments represents the widely held view that GAAP constitutes a single body of rigid, inflexible and detailed measurement rules. It may be this attitude which must be changed if a solution to the overload problem is to be found.

3.1.4 Differential GAAP involving Measurement and Disclosure Requirements

The essential idea inherent in this proposed solution is that there would continue to be a single set of GAAP based on a single set of concepts. Differentiation would result from applying uniform concepts to different situations. This would be a subtle difference from the "two GAAP"

\textsuperscript{22} Ibid.
approach outlined above, which applies separate concepts. The final report of the Scott Committee suggested that the FASB consider introducing measurement alternatives within one set of GAAP even though it did not take a firm stand on the issue.

While this approach might save some accounting costs, it may have the effect of increasing the cost of capital for some companies. Bankers who are not provided with all the information that they have received in the past relating to a company's performance may react by raising interest rates, or reducing the size of loans granted.

3.1.5 One Set of GAAP, but an Alternative to prepare Accounts on a Non-GAAP Basis

To avoid the problems of a "two GAAP" approach, the Scott Committee, in its initial discussion paper issued in 1981, recommended the development of the tax basis as an alternative comprehensive basis of accounting. It would be used where the cost of providing GAAP financial statements was excessive, or where GAAP statements were considered unnecessary. The primary advantage seen in this solution was cost reduction for small companies; tax based data must be prepared for taxation authorities irrespective of any other reporting requirements.

The primary disadvantage of the proposal is that income tax
rules are designed to achieve government policy, not to present fairly firms' financial positions. Indeed, there is no evidence to show that users of financial reports understand tax-based financial information. Another disadvantage that is inherent in the proposal is the difficulty of identifying when the tax basis would be appropriate for companies to adopt, and when it would not. Whether the taxation basis, or another basis, were adopted, application of the alternative basis may prove difficult because of the lack of guidance in the professional literature concerning the application of alternative comprehensive bases of accounting.

3.1.6 Allowance for Departures from GAAP

This alternative recommends that GAAP which are considered not to be cost-beneficial for adoption by small companies be omitted from the financial-statement-preparation process. The auditor would refer to this fact in his audit report.

Allowance for departures from GAAP may overcome concerns regarding the significant costs associated with preparing financial statements for small companies. However, the users of the financial statements may regard the accounts which have been qualified by the auditor as unreliable, and request that the company prepare information consistent with GAAP.
3.1.7 Summary

The literature and the AICPA Committee reviews suggest that the most appropriate solutions to the overload problem are either:

1. provision for differential disclosure within a single body of GAAP; or
2. provision for differential measurement and disclosure either within a single body of GAAP or within a two-tier framework of core plus supplementary GAAP.

A number of issues identified by the reviews have prevented consensus as to the status of the overload problem. The first of these issues is the difficulty in making a workable distinction between those companies which are overloaded and those which are not. Should the distinction be based on size, ownership, or a combination of both? Related to this issue is the question of whether report users' needs actually vary with company size and ownership. Also, it is not evident whether the burden of accounting standards, or GAAP, is primarily disclosure-, or measurement-orientated.

Finally, there is the question of what the result might be if the information provided in the financial statements of small companies was less than, or different from, that provided in the financial statements of large companies.
Identification of these issues has stimulated some empirical research in the USA and the UK. The issue of whether users' needs vary with company size has attracted considerable private research, while the FASB has been involved in research of some of the wider issues.

SECTION 3.2 EMPIRICAL RESEARCH

3.2.1 Private research

The studies which have addressed the users' needs issue rely on the same basic premise, namely, that the primary users of the financial reports of both large public companies and small private companies are banks or other lending institutions.

A study by Falk, Gobdel and Naus23 asked chief commercial lending officers to rate 43 items of information, for example "information about lease commitments", as to the importance of including those items in:

- audited financial statements; and
- unaudited financial statements,

for closely held corporations. The results of the study revealed that the same items of information are considered

important, irrespective of whether the financial statements are audited. The lending officers indicated that they believe that the accountant's report on financial statements should disclose all known departures from GAAP.

Because the study did not aim to investigate the differential measurement/disclosure issue, no implication can be drawn from the study in relation to that matter. Nevertheless, the study indicates that lending officers are concerned to maintain a single body of GAAP.

Using a questionnaire which focused on the financial items (for example, "net income") reviewed when making long-term lending decisions, Stanga and Tiller\(^2^4\) compared needs for information of bank loan officers who make lending decisions that involve large public companies, with those of officers who make lending decisions relating to small private companies.

On the basis of mean and standard deviation rankings, they concluded that the two survey groups had substantially similar needs for information. Mann Whitney U tests of the data revealed that the groups generally agreed about the degree of importance of the items in the questionnaire.

That bank officers' information needs appear not to differ significantly between small private and large public

companies is supported by research completed by Nair and Rittenberg\textsuperscript{25}.

Nair and Rittenberg surveyed a selected sample of CPAs, bankers and businessmen to ascertain their opinions on the overload issue. The opinions of the respondents can be summarised as follows:

1. bankers perceive no difference in their information needs between large and small companies, whereas CPAs and businessmen consider that a difference exists;
2. CPAs and bankers agree that departures from accounting principles occur moderately frequently; and
3. the primary reason that businesses purchase audit, review or compilation services is for bank loan or credit arrangements.

Nair and Rittenberg were keen to interpret the implication of 3. as being that the primary use of financial statements is for bank loan and credit arrangements, a position which cannot be supported from the empirical evidence they obtained.

The result of these studies was to indicate that, in response to questionnaire surveys, bankers admit no differences in their information requirements as between small companies and large.

The results of questionnaire surveys are difficult to interpret because it is often not clear whether the respondent has answered questions honestly, or whether he has given the answers he thinks that the researcher expects. In view of this limitation of research by questionnaire, and the fact that CPAs and businessmen appear to perceive a difference in the use made of financial information by bankers as between small and large companies, it is not possible to draw, from the studies, a conclusion that bankers have identical information requirements as between these classes of companies. The studies rely on the premise, but do not examine it, that the bankers are the primary users of the financial reports of small companies.

3.2.2 Research Sponsored by the FASB

The initial research completed by the FASB in the form of an invitation to comment in 1980 proved inconclusive. The lack of agreement on the issues raised led the FASB to consider the issue of financial reporting for small private companies in some detail. A second invitation to comment on "Financial Reporting by Private and Small Public Companies" was issued in 1981, and a study by independent researchers was sponsored. The FASB studies focused on three groups involved with financial reporting, namely, managers, bankers, and accountants. The results from the 1981 invitation to
comment are summarised below.

The respondents to the invitation to comment identified bankers as the primary external users of financial statements. However, the study reports that about two-thirds of managers indicated that managers are the most important users of the financial statements of small private companies. The users of the financial reports of small public companies were claimed to be more diverse than those who use the financial reports of small private companies.

Most of the bankers who responded to the invitation to comment indicated that their financial information needs and decision-making practices are essentially the same for private as for public companies, whereas accountants perceived differences in the information needs of bankers depending on ownership. The bankers stated, however, that they sometimes accept less financial information from small private companies than they request from large companies.

Ninety per centum of respondent managers said they prepare financial statements in accordance with GAAP, but of those companies with turnover of $1 million or less, the figure was only sixty four per centum. Bankers expressed very little dissatisfaction with specific accounting requirements, whereas accountants expressed dissatisfaction with a range of standards, in particular those relating to accounting for leases and deferred tax. Few managers criticised disclosure
Almost sixty per centum of the accountants surveyed considered that GAAP should permit differential measurement. Managers were equally divided on the issue. Approximately sixty per centum of bankers considered that differential measurement standards would greatly reduce the comparability and usefulness of financial statements.

The responses from managers of private companies, when compared with those from managers of public companies, indicated that private companies are managed and behave differently from public companies.

The independent research study headed by Abdel-khalik surveyed, by questionnaire, the same groups that responded to the 1981 invitation to comment. The questionnaires sent to each group were similar, but the questions were tailored to the particular characteristics of each group. A summary of the research findings is outlined below.

Company manager/owners were identified by respondents as the primary users of financial statements of small private companies, followed by bankers and creditors.

While bankers indicated that financial statements prepared following GAAP provide more reliable information, managers were divided on the issue. Both groups were divided in their opinions as to whether reports prepared on the basis of GAAP result in lower borrowing costs and less restrictive covenants.

Respondents acknowledged that departures from certain standards occur moderately frequently, particularly for small companies. The cost of compliance and perceived lack of relevance to owners were rated as the primary reasons for these departures. Bankers do not always require borrowers to comply with all GAAP. Loan applications from companies, whose financial statements do not comply with all GAAP, are considered on a case-by-case basis. This indicates a tolerance of departures which is not evident in the bankers' attitudes towards the information they require for decision making purposes. Bankers believe that information needed for making decisions relating to public and private companies is similar.

The responding accountants consider that a special set of GAAP for small private companies would be beneficial, however, managers and bankers do not support this view.

Bankers and accountants indicated that a distinction between small and large privately-owned companies could be based on company sales and the number of employees. They suggested
that a company with sales of not more than $4 million, and with not more than 50 employees, would be classified as a small company.

3.2.3 Research Sponsored by the Institute of Chartered Accountants in England and Wales (ICAEW)

Research completed in the UK has taken a different approach in attempting to resolve the overload issue. That research has focused primarily on management's attitudes.

The most recently reported research in the area of financial reporting for small companies is that completed by Carsberg et al.\textsuperscript{27} on behalf of the Accounting Standards Committee (ASC) of the ICAEW. This study involved interviews with managers of small companies, and partners in firms of accountants which deal with small companies. The views of participants were sought on matters ranging from general problems faced by small businesses and general problems of financial reporting, to specific financial reporting problems associated with particular accounting standards.

The results of the interviews with managers are summarised as follows:

1. managers identify themselves as the most important

\textsuperscript{27} Carsberg B.V., Page M.J., Sindall A.J. and Waring I.D., Op Cit.
users of accounts;

2. managers do not identify formal reporting requirements as a particular burden for them, although they object to having to disclose certain information on privacy grounds; and

3. managers have a low awareness of accounting standards.

In relation to the above matters, the results of the survey of auditors were consistent with those from the survey of management. In addition, the following matters were revealed during discussions held with auditors:

1. auditors identify certain standards as being inappropriate for small companies, in particular the standard requiring that funds statements be prepared, and that relating to current cost accounting; and

2. some auditors acknowledge that the accounts audited and approved by them do not always comply with all accounting standards, or with all legislative requirements.

3.2.4 Implications drawn from Empirical Studies

It is necessary to consider, at this stage, the implications that can be drawn from these studies regarding the issues raised as requiring review in Section 3.1.7.

In relation to the issue of the difficulty in making a
distinction between those companies which are overloaded and
those which are not, respondents to the 1981 invitation to
comment and the questionnaires sent by the Abdel-khalik
research team indicated that the appropriate distinction is
between small private companies and others. The UK research
provides some support for this distinction. While the
auditors surveyed by the UK study claimed particular
problems with only certain standards, their admission that
they do not always ensure that the accounts of small private
companies comply with all standards and legislative
requirements, is indicative of agreement that the
requirements are excessive.

The managers of small private companies in the UK object, on
privacy grounds, to having to disclose certain information,
but do not identify formal reporting requirements as a
particular burden for them. While the managers surveyed in
the Abdel-khalik study did not exhibit as overwhelming a
concern as the accountants, they supported the general
thrust of the overburdenment claims. Because private
companies in the UK are required to comply with rather more
reporting requirements than their American counterparts, it
might have been expected that the management group would
display more concern than was evident during the interviews.
However, as is noted by Carsberg et al, the reason for the
lack of concern may be that company managers do not spend a
considerable part of their own time preparing the necessary
information, leaving their public accountants to meet all
reporting requirements. This is supported by the finding
that the managers interviewed have little knowledge of accounting standards.

Respondents to the research completed in the USA suggested that a private company might be considered small if it employed less than fifty people and if its sales did not exceed $4 million. The UK research did not focus on the issue of what might be an appropriate definition of small private company, presumably because a definition is already embodied in UK legislation.

All of the studies indicate that the primary user of financial reports relating to small companies is management, rather than the diverse range of groups that might be expected to make use of the reports of large companies. Despite this finding, bankers in the USA have indicated that their needs for information do not differ between small privately owned companies and other companies.

In considering whether the burden of GAAP is primarily disclosure or measurement, accountants in the USA have been definite in maintaining that the burden is both measurement and disclosure. While managers in the USA do not appear to support a special set of GAAP for small companies, they acknowledge that departures from GAAP in terms of both measurement and disclosure occur moderately frequently. American bankers have indicated on the one hand that they favour one set of GAAP, but on the other, a tolerance for
GAAP departures. In summary, the studies completed in the USA seem to show that a burden exists, but that consensus as to the appropriate method of relieving the burden does not exist.

The results of the UK study appear not to support those of the USA research entirely. Auditors surveyed by Carsberg et al. indicated rather more concern with matters of disclosure than measurement. It is possible, however, that the auditors' responses might be a reflection of the lesser number of accounting standards operative in the UK compared with the USA.

The implications of differential reporting, if this was the solution adopted, are not clear. Bankers in the USA indicated that currently, restrictive covenants or higher interest rates may be imposed in individual cases where information is not provided. However, the implications of all small companies not providing certain information are not evident.

No conclusions can be drawn from the UK study regarding the issue of the implications of differential reporting.

The matters which remain unresolved are discussed below.

1. Whether there is a particular reporting burden imposed on small private companies.

Accountants consider that a burden exists, but their views seem not to be substantially supported by
management. Further consideration as to the reason for this divergence in views is necessary. Review of the issue, as to whether a burden exists, should not be limited to determining whether reporting requirements are seen, by managers, as the major problem encountered in running their businesses, as appears to have been the focus of the UK study. Rather, evidence is needed as to whether the reporting requirements impose a burden on companies that is considered unreasonable.

2. Whether there exists, apart from responses to questionnaire surveys, evidence that groups other than management make substantial use of the financial statements of small private companies.

3. The nature of any burden imposed. The empirical studies indicate that the burden may relate to both measurement and disclosure requirements. In order to determine the nature more precisely, it would be necessary to understand the type and amount of financial information used by the groups which use the financial statements of small companies.

4. An optimal definition of "small private company".
Although the primary user of the financial reports of small companies has been identified as management, its needs have been subordinated in favor of bankers in subsequent analysis of the user needs issues by the FASB. The bankers' view, that existing GAAP are ideal, is probably based on the fact that, at the moment, information contained in financial statements prepared on the basis of GAAP is cost-less to them. They would be concerned that their bargaining power may be inadequate to ensure that sufficient information is provided to them in support of loan applications, if GAAP incorporated different reporting requirements between small and large companies.

Primarily because of its concern with external users, the FASB has regarded the results of research as supporting its view that the burden of reporting imposed on small companies is justified. The FASB considers that the appropriate solution to the overload problem is that of differential disclosure. It has stated that its policy is to consider small business needs in conjunction with each of its ongoing standard setting activities, and limit the application of certain standards to certain companies where this is considered necessary. To date, small companies have not been exempted from complying with any measurement requirements contained in accounting standards.
The recommendation by the authors of the UK study is that a certain class of companies not be exempted from all accounting standards. Rather, their recommendation to the ASC is that certain companies be exempted from complying with the measurement and disclosure aspects of some standards. It is based on the view that all companies should be required to comply with certain standards because:

- accounting standards can be helpful to managers;
- managers may not have the knowledge and understanding of accounting standards to make effective choices in the application of standards by themselves; and
- managers do not consider existing regulation a significant problem in running their businesses.

The ASC has not yet formally declared its position on the issue of differential reporting. Presently, it has incorporated differential disclosure requirements into some standards, however, small companies are not exempted from complying with the measurement aspects of any standard.
Review of the available literature made clear that evidence relating to a number of issues needed to be obtained before an appropriate reporting framework for small companies operating in Australia could be established. The issues identified as requiring detailed review were:

1. whether the primary users of financial reports of small companies are owner/managers and whether there is evidence that these reports are used by other groups;
2. whether small companies consider that they are overburdened by financial reporting as a result of statutory requirements and/or accounting standards; and
3. the financial information used by owner/managers in their decision-making roles.

Because the issues relate to the attitudes and behaviour of the managements of small companies, it is apparent that any review of the issues should include input from that management group. Input from management is obtained by completing a field study involving interviews with the managements of small companies operating in Victoria. As outlined in Chapter One, there being no universally accepted definition of "small company", the definition adopted for the field study is that of "exempt proprietary company" contained in Australian companies legislation. It was anticipated that the field study would provide
opportunity to consider whether this definition could be an appropriate basis for distinguishing a separate group of companies for financial reporting purposes.

SECTION 4.1 RESEARCH HYPOTHESES

The following hypotheses were established on a priori grounds for review in the field study:

1. the primary user of the financial reports of small companies is management;
2. an excessive burden exists for small companies in Australia in terms of both accounting standards and legislative requirements; and
3. a report containing financial information which is less detailed than that which is currently required to be prepared would satisfy management's needs for information.

SECTION 4.2 METHOD OF COLLECTING DATA

The paucity of existing research in relation to small private companies means that little guidance exists regarding the optimal method of collecting information regarding small companies. Essentially, two approaches to data collection were considered - the postal questionnaire and the structured interview. While it could have been relatively fast to
complete, and could have covered a large sample of companies, the postal questionnaire approach was not used. The problems envisaged with using a postal questionnaire were considered to outweigh the advantages of speed and coverage for this study. The problems envisaged were:

1. a low percentage of returns and the difficulties of analysing non-response bias;
2. a lack of uniformity in response - the same question might have different meanings for different people; and
3. that questionnaires usually facilitate only "fixed-alternative" answers and if "open-ended" questions are used the sample of appropriate responses may be reduced because of people's reluctance to express themselves in writing.  

The data collection method chosen for this study was the structured interview - an interview based on a prepared questionnaire. This method was expected to be slower to complete than a postal questionnaire, and, in view of time constraints, would restrict the size of the sample of companies to be reviewed. Despite this limitation, it was considered that a structured interview was a better instrument for sounding people's behaviour, feelings, attitudes, and reasons for behaviour than a postal

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questionnaire. The questionnaire used as a basis for a structured interview can satisfactorily contain both fixed-alternative and open-ended items, whereas the postal questionnaire cannot. The structured interview also allows each question to be taken to a much greater depth and understanding than would otherwise be possible.

The flexibility offered by open-ended questions, although considered an advantage of structured interview research, was anticipated to have, in particular, two associated problems. One of these is the potential to encourage biased responses. The other is the difficulty of obtaining quantifiable responses from interviewees. Potential to encourage biased responses exists if discussions reveal the interviewer's personal attitudes. In order to reduce the opportunity for bias to arise, it was planned that discussions with the interviewee would begin with a focus on general matters such as the activities of the company and environmental factors, and lead on to the matters of more specific interest to the interviewer.

Following this approach, it was expected that the answers to the questions contained in the prepared questionnaire could be drawn out gradually during the course of the interview, and that fewer detailed explanations of particular questions would be required.

Quantifiable responses to open-ended questions are often difficult to obtain. To minimise this difficulty, it was planned that, wherever possible, questions be asked in
unprompted form and in a way that enabled responses to be subsequently classified by the interviewer. Despite the concern to obtain quantifiable responses, it was planned to allow interviewees to present as much descriptive detail as they wished in responding to a question. Qualitative information obtained in this way could provide a useful insight into the attitudes and behaviour of managements.

SECTION 4.3 SAMPLE SELECTION

4.3.1 Selection of Appropriate Population

A number of alternative populations from which to make a selection of companies to be reviewed was considered. These possibilities were:

1. the client lists of several chartered accounting firms;
2. the Kompass directory of business; 29
3. the register of companies maintained by the Victorian Corporate Affairs Commission; and
4. the membership register of the Small Business Association of Victoria.

The client lists of several chartered accounting firms were not considered to be appropriate bases for selection. A

major obstacle to using these lists for any research is the difficulty of obtaining access to them. It was expected that firms would be particularly reluctant to allow access to their lists in a case such as this, where an individual sought to review the lists of several firms.

Even if the lists had been readily available, the population would not have been used. The reason is that it was expected that the responses of companies selected from those lists would reflect the attitudes of the particular accounting firm with which they were associated.

Opportunity existed, within the planned research, for the managements of small companies to seek the views of their accountants in relation to certain of the matters raised in the preliminary questionnaire, prior to the interview. If this occurred, the responses of the interviewees would reflect the views of only those accountants whose membership lists were used as a basis for selection rather than the wider population of all public accountants, and considerable bias would be incorporated in the research findings.

The Kompass directory of business provides a detailed list of both incorporated and unincorporated businesses which operate in Australia, classified by State. A broad range of industries is covered. This directory was not used as a basis for selection because the guidelines for excluding or including particular companies by the publishers of the directory were not clear, meaning that some unknown bias might exist in any sample selected.
All companies which were incorporated in Victoria are required to register with the Victorian Corporate Affairs Commission. Companies which operate in Victoria, having been incorporated in another state, are also required to register. A register of these companies is maintained by the Commission and is publicly available. The register contains many companies which either do not operate, or are largely inactive. It does not distinguish between these companies and active companies.

Whilst it would have been the most complete list of exempt proprietary companies available, this register was not used as the basis for selection. It was expected that the owners of non-operating or inactive companies selected for review would be reluctant participants in the research, and their responses would display a lack of interest in many of the issues raised. To avoid any bias in the research findings resulting from the inclusion of inactive companies in the sample, it was considered appropriate to exclude these companies from the sample population.

Because the register does not distinguish active from inactive companies, and it would be a labour-intensive exercise to identify inactive companies from an alternative source, it was considered that the register would be an inappropriate population from which to select a sample of
The population used as a basis for selecting the sample of companies to be reviewed in the field study was the membership register of the Small Business Association of Victoria (SBA). According to the SBA, a business is defined as small if its ownership group is also its management group. The SBA permits the owners of both incorporated and unincorporated businesses to join the Association provided that they are actively involved in the management of the business. The incorporated businesses which meet the definition of "small business" would be classified as exempt proprietary companies by the Companies Act.

Use of this register has the disadvantage that it does not contain all exempt proprietary companies which currently operate, however, a complete and exclusive listing of these is not publicly available. In the absence of such a list, the membership register was considered to be a useful surrogate because all businesses recorded on the register are active, and the incorporated businesses meet the definition of "small company" adopted for this study.

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30 It is possible to distinguish active from inactive companies only by reviewing the annual return forms lodged by the companies with the Commission. To obtain these forms it is necessary to complete a formal company search in respect of each company selected for review in the study. The task would be very time consuming, and a charge of $5 would be levied for each search.
4.3.2 Problems Associated with Sample Selection

Potential problems associated with using the SBA membership register as a selection source were identified in the planning stage. The first potential problem was that relatively few of the total number of small businesses in Victoria are members of the SBA. Secondly, of the businesses that are members, most are based in the city of Melbourne and surrounding suburbs. Only 10 of the 750 companies on the register are located in country areas.

The other potential problem that was identified is that the members of the SBA may be far more concerned with improvement of management performance, and familiar with the usefulness of accounting information than the wider population of all owners of businesses.

Discussions were held with the manager of the SBA to consider the effect these issues might have on the interpretation of the results of the field study. The outcome of those discussions appears below.

The small membership of the SBA is attributable to the independent nature of small business owners. Owners of small businesses generally regard their businesses as being unique and take the view that, because they know their businesses very well, they are the best advisors for their businesses. Hence, they are not keen to participate in the many activities offered by the SBA. The independent nature
of the owners of small businesses was expected to be reflected in the interviews held with them, and indeed this was the case (refer Chapter Five). Another reason for the low number of members is that many businesses join an association related to their particular trade, for example, the Metal Trades Industry Association, rather than join the SBA.

The SBA has been active in seeking city-based members, but not country members. The reason for this is that the SBA has not yet developed facilities in locations attractive to country members. The low number of country members is consistent with the emphasis placed by the SBA on attracting city members. It is not evident that small businesses based in the country would have different attitudes and/or approaches to management from city-based businesses.

It was expected that the small number of businesses which were members of the SBA might exhibit management characteristics in terms of concern with improvement of management performance and familiarity with accounting information, not reflected in the wider population of small businesses. However, discussions indicated that this was not the case. Very few companies participate in SBA activities, and most believe that the advantage offered to them by SBA membership is lobbying power, rather than the opportunity to improve management practices.

It was expected that the attitudes of the companies to the
benefits from SBA membership could be obtained informally from discussions with interviewees during the field study. The discussions could provide evidence either to refute or support the above suggestion, that there are no particular management skills exhibited by the population.

4.3.3 Mechanics of Selection

The membership register contains both incorporated and unincorporated businesses. Because this study is concerned with companies rather than trusts, partnerships, and sole traders, only those businesses whose names ended with Pty Ltd were considered for selection. This selection necessarily excluded public companies whose names appear on the membership list only to facilitate distribution, to those companies, of promotional material relating to small businesses.

There were 750 Pty Ltd businesses on the membership register dated 21st January 1986. Ten per centum of those companies was considered an appropriate number for selection of the sample. This number was considered adequate to allow for some wastage as a result of the following problem. Some companies on the register were subsidiaries of overseas-based public companies. These companies were not strictly legitimate members of the SBA, and it was not appropriate that they be reviewed for the purposes of this research. Because these companies could not be identified easily from the register, no attempt was made to exclude
them from selection until after the final sample had been selected.

A random selection was made of 75 companies.31

Interviews were held with the general manager, or equivalent, of the companies selected for review. Part of the questionnaire was sent to the interviewees well before the day of the interview in order that the interviewee would be aware of the matters of interest to the interviewer.

The mechanics of data collection were planned with a view to minimising non-response problems. The planned approach was as follows.

Letters inviting the sample companies to participate in the interview process were sent, with a covering letter from the University of Melbourne, on 25th February 1986.32 Telephone calls were made to the companies in the following week in order that appropriate interview times could be arranged.

Interviews were held over the period 6th March 1986 to 30th April 1986. The average duration of the interviews was one hour.

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31 Random number tables were used as a basis for the selection process.

32 A sample of these letters, together with the section of the questionnaire sent to the interviewees in advance of the interview, appear in Appendix 2.
SECTIO N 4.4 PILOT REVIEW OF QUESTIONNAIRE

The proposed method of data collection was expected to avoid problems of lack of understanding of the questions contained in the questionnaire. However, a pilot review was completed prior to the field study to discover potential problems. The participants in the review were:

1. managers of small companies which were similar to companies in the sample - the accounting knowledge levels of these managers were expected to cover the broad range of knowledge levels of the wider population of small business managers;
2. academic accountants employed within Universities;
and
3. an officer of the Australian Accounting Research Foundation.

Additionally, the questionnaire was reviewed by an officer of the Statistical Consulting Service at the University of Melbourne to ensure that the type and format of the questions were amenable to statistical procedures.
SECTION 4.5 STATISTICS

As well as qualitative information, both ordinal and nominal data were collected during the field study. The data were analysed using the SPSSx package on a Vax computer. Essentially, descriptive statistics such as frequencies and cross-tabulations were produced. However, to check that the results obtained were not affected by factors such as background of the interviewee and company size, contingency tabulations were analysed to determine whether there exists independence between certain external factors and the individual responses to questions. It was planned that the chi-square statistic would be used to test the significance of any lack of independence that was apparent from the contingency tabulations. The chi-square statistic was chosen because, being a non-parametric test, it was appropriate for use with nominal and ordinal data. Non-parametric tests such as Spearman Rank Coefficient tests could not be used because the data being analysed were not solely ordinal.

Analysis was also completed to provide some assurance of the consistency of an individual's responses to questions which are related. This analysis was completed using contingency tabulations.

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33 Complete explanation of the appropriateness of non-parametric statistical tests for the type of data collected in this study is available in Siegel S., *Non-parametric Statistics for the Behavioural Sciences*, McGraw-Hill Inc, Tokyo, Japan, 1956.
The questionnaire used as a basis for the structured interview is presented in Appendix 3. The rationale for each question is explained in detail in Chapter Five, where an analysis of the responses to each question is also presented. Brief explanation appears below of the link between the particular questions in the questionnaire and the research hypotheses identified at the beginning of this chapter.

1. Interviewees were asked directly whom they regarded as being the users of their companies' financial statements in question 1. The focus of questions 2, 7, 8, and 9 is the nature and amount of use that the interviewee expected that the different external user groups made of the company's financial statements. Within these questions, interviewees were asked about the use made of financial statements relative to that made of alternative sources of information. Evidence was sought as to the use the interviewees made of the financial information relating to other companies in questions 3, 4, 5, and 17. These questions were designed to complement the questions relating to external users.

2. Interviewees were invited to comment on the burden, for them, imposed by reporting requirements in terms of the content of financial statements in questions 18, 19, and 20. Prior to these questions being asked,
information relating to the sophistication of the company's accounting system and the accounting knowledge of the person interviewed was obtained from answers to questions 6, 10, 11, 12, 13, and 14.

Their attitudes to the burden of reporting requirements in terms of privacy considerations were sought in questions 15, 16, and 22.

3. Question 21 was designed to seek an indication of the financial information used by management in its decision-making roles. However, information regarding this issue was also obtained from discussion of many of the other questions, particularly numbers 5, 10, and 13.

Interviewees were asked to identify the basis they would use to distinguish small entities from others in question 23. It was expected that answers to this question would provide an indication of the appropriateness of the definition of "small company" used for this study.

The questions were approximately evenly divided between fixed-alternative and open-ended. After the interview process was completed, the responses from the open-ended questions were classified to enable analysis of the responses.
In addition to the field study, supplementary investigations were undertaken. These were designed to discover if support could be drawn for conclusions made as a result of analysing the responses of individuals to the matters raised during the field study. A summary of these investigations is outlined below.

A review was completed of the financial statements of a sample of the selected companies and other small companies to assess the extent of non-compliance with accounting standards and company law requirements, so far as is evident from the accounts themselves. This review was expected to give insight into the overburdenment issue as far as it relates to the content of financial statements.

Discussions were held with a small number of accountants who service small companies to obtain their views with respect to the content of the financial statements of small companies, and the financial information used by the managements of small companies in their decision-making roles.

Discussions were also held with senior officers of a mercantile agency and the Corporate Affairs Commission. The aim of the discussions was to obtain an indication of the amount and type of use made of small companies' financial statements by groups external to the companies themselves.

The reason for obtaining information from these sources was
to ensure that there was not substantial use being made of financial statements although the companies themselves were not aware of that use.

The findings of these supplementary investigations are presented in Chapter Six along with the interpretation of the results of the field study.
Presented in this chapter is detail concerning the interviews held with the management representatives of the selected sample of small companies. The rationale for asking particular questions is explained, and the responses to the questions are summarised. The discussion of responses includes consideration of the possibility that responses to certain questions might be influenced by environmental factors.

SECTION 5.1 THE PARTICIPANT COMPANIES

Interviews were completed with representatives from 40 of the 75 companies initially selected to participate in the field study. The number of interviews actually held differs from the number of companies initially selected for the following reasons:

1. some companies which were selected in the original sample were subsidiaries of overseas-owned public companies and thus did not satisfy the requirement that the sample companies be privately owned;
2. a few companies from the original sample were in liquidation;
3. some companies were based in States other than Victoria and were unable to make available, for an interview, representatives from their administration;
4. The representatives from some companies declined to participate in an interview because they were either too busy, or unwilling.

Companies which were unable to participate in the field study for the reasons 1, 2, and 3 above were regarded as invalid selections.

A reconciliation of the number of companies originally selected with the number of final participants is presented in Table 5.1.

Table 5.1: Reconciliation of final sample population

<table>
<thead>
<tr>
<th>Original sample population</th>
<th>75</th>
</tr>
</thead>
</table>

Deduct

<table>
<thead>
<tr>
<th>Subsidiaries of public companies and companies in liquidation</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies based interstate</td>
<td>6</td>
</tr>
<tr>
<td>Companies unwilling to participate</td>
<td>21</td>
</tr>
</tbody>
</table>

| Final sample population                                      | 40 |

The final sample population represents sixty six per centum of the valid selections, and is considered to represent a
sufficient number of participants for the field study without the selection of additional companies.

The environmental characteristics of the final sample of companies are presented in Tables 5.2, 5.3, 5.4, and 5.5.

Table 5.2: Number of persons employed

<table>
<thead>
<tr>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than 10</td>
<td>22 55</td>
</tr>
<tr>
<td>More than 10, not more than 50</td>
<td>15 38</td>
</tr>
<tr>
<td>More than 50</td>
<td>3 7</td>
</tr>
<tr>
<td>Total</td>
<td>40 100</td>
</tr>
</tbody>
</table>

Table 5.3: Number of shareholders

<table>
<thead>
<tr>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>21 53</td>
</tr>
<tr>
<td>More than 2, not more than 5</td>
<td>17 42</td>
</tr>
<tr>
<td>More than 5, not more than 10</td>
<td>1 2.5</td>
</tr>
<tr>
<td>More than 10</td>
<td>1 2.5</td>
</tr>
<tr>
<td>Total</td>
<td>40 100</td>
</tr>
</tbody>
</table>

Table 5.4: Book value of company assets

<table>
<thead>
<tr>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than $100,000</td>
<td>8 20</td>
</tr>
<tr>
<td>Between $101,000 and $500,000</td>
<td>17 43</td>
</tr>
<tr>
<td>Between $501,000 and $1,000,000</td>
<td>2 5</td>
</tr>
<tr>
<td>More than $1,000,000</td>
<td>13 32</td>
</tr>
<tr>
<td>Total</td>
<td>40 100</td>
</tr>
</tbody>
</table>
Table 5.5: Annual company turnover

<table>
<thead>
<tr>
<th>Number</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than $500,000</td>
<td>4</td>
</tr>
<tr>
<td>Between $501,000 and $1,000,000</td>
<td>2</td>
</tr>
<tr>
<td>More than $1,000,000</td>
<td>21</td>
</tr>
<tr>
<td>Declined to answer</td>
<td>13</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>40</strong></td>
</tr>
</tbody>
</table>

Few companies have more than fifty employees, or more than five shareholders.

The book value of the assets owned by the sample companies varies widely. In part, this is because the sample of companies includes representatives from both the manufacturing and service industry sectors. Some interviewees declined, on confidentiality grounds, to indicate the annual turnover of their company. However, in relation to those companies for which the information was disclosed, most have an annual turnover in excess of $1million.

The companies in the final sample do not exhibit any particular environmental characteristics which depart from what are considered to be the "normal" characteristics of the wider population of all small companies. Nevertheless, the responses of the interviewees to some of the questions outlined in subsequent sections of this chapter are interpreted in the light of the environmental
characteristics to determine whether the responses to the questions are determined by the characteristics.

SECTION 5.2 THE USERS AND USES OF FINANCIAL STATEMENTS

Interviewees were first asked to identify the primary users of their company's financial statements. They were asked to rank, in order of importance, certain groups whom it was expected might use the financial statements. Interviewees were advised that, for the purpose of this question, the group whom they consider makes most use of the information contained in the financial statements should be identified as the "most important user". The detailed results from this question are presented in Table 5.6. Two interviewees gave equal first ranks for managers and bank lending officers. For these responses, both first ranks have been recorded in Table 5.6
Table 5.6: Please indicate which of the groups listed below are the users of the financial statements of your company. Rank them in terms of their importance. (Give a rank of one to the most important users).

<table>
<thead>
<tr>
<th>No.</th>
<th>Score</th>
<th>Order</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>first basis on ranks 1st -5 score</td>
</tr>
<tr>
<td>Managers</td>
<td>31</td>
<td>183</td>
</tr>
<tr>
<td>Bank lending officers</td>
<td>10</td>
<td>141</td>
</tr>
<tr>
<td>Owners of the company, not managers</td>
<td>1</td>
<td>20</td>
</tr>
<tr>
<td>Competitors</td>
<td>-</td>
<td>8</td>
</tr>
<tr>
<td>Creditors</td>
<td>-</td>
<td>7</td>
</tr>
</tbody>
</table>

Results of this question, and others, requiring rank ordering, are presented in two ways:

1. In order of the number of times each response was ranked highest (1st ranks); and
2. On a cumulative points score basis (e.g., giving 5 points for a 1st rank, 4 for a 2nd rank and so on).

Managers were ranked as the most important users of the financial statements of small companies on a first ranks basis and a score basis. Bank lending officers were ranked second on a first ranks basis with relatively few first
ranks, but on a scores basis their total score was much closer to the managers group. While it might appear that the bank lending officers group was usually ranked closely behind the managers, in fact, most interviewees consider that the amount of use made of the financial statements by bank lending officers is relatively low when compared with that made by the managers.

Few companies in the selected sample are owned by individuals who do not participate in management. In instances where this does occur, the "non-managing owners" were ascribed a high rank, but usually behind that for the management group.

Overall, creditors and competitors were regarded as making very little use of the company's financial statements. Interviewees do not provide these groups with extracts from their financial statements. Only one person was aware that these groups had obtained information regarding his company from the Corporate Affairs Commission (CAC).

Having identified the users of their company's accounts, interviewees were asked an open-ended question to identify the financial information which they provide to the groups not involved with the management of the company. The results are summarised in Table 5.7.
Table 5.7: What sort of accounts do you make available to the external users?

<table>
<thead>
<tr>
<th></th>
<th>Statistical Copy of Detailed Other Accounts</th>
<th>Return P&amp;L only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank lending officers</td>
<td>9</td>
<td>82</td>
</tr>
<tr>
<td>Owners, not managers</td>
<td>-</td>
<td>40</td>
</tr>
<tr>
<td>Others</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Most interviewees indicated that they provide a copy of their taxation return, including all schedules accompanying the return, to the banks, with which they deal, at the end of each year. This information is also often given to "non-managing owners" annually. However, many companies provide information in more detailed form than is evident in the taxation return, and on a more regular basis throughout the year, to the "non-managing owners".

Interviewees claimed that they do not provide any information directly to creditors or competitors, and that information used by this group would be obtained from mercantile agencies or the CAC.

Discussions indicated that, as a result of the nature of their businesses, some companies are required to disclose their financial information to external groups other than
those identified. For example, financial information regarding insurance companies must be lodged with the Insurance Board annually. Also, a company which operates at a central shopping centre is required to furnish the administration of the centre with an audit report relating to the accounts of the company.

In these instances, the content of the information provided is prescribed by a body which has the ability to demand information which may be more, or less, specific and detailed than is provided in the accounts that the companies prepare for shareholders.

Questions 3, 4 and 5 were designed to complement the previous questions relating to the use made of financial statement information by creditors and competitors. Evidence was sought regarding the use that the interviewees make of other companies' financial information. Interviewees were first asked whether they had investigated the publicly filed accounts of another company within the last year (Table 5.8).
Table 5.8: How many times in the last year have you had cause to "search" the publicly filed information about a debtor or competitor?

<table>
<thead>
<tr>
<th>Number of times</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nil</td>
<td>95</td>
</tr>
<tr>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>3 - 5</td>
<td>-</td>
</tr>
<tr>
<td>more than 5</td>
<td>-100</td>
</tr>
</tbody>
</table>

The interviewees who have completed company searches indicated that the reason for the searches was to obtain information regarding debtors, from whom payment had not been received. While the accounts of the debtors were perused during the search, the particular details sought were the names and addresses of the owners and/or directors of the company.

Surprisingly, some interviewees were not aware that corporate financial information is made publicly available by the CAC. Others, while aware that it is available, do not consult financial information lodged by companies with the CAC because it tends to be out of date. Another reason that some companies do not complete company searches relates
to the taxation incentives that exist, within Australian taxation law, for some companies to adopt complex company structures. Some interviewees claimed that the structure of many companies, i.e., interposed with trust arrangements, means that the information contained in those companies' accounts might not reflect the economic reality of their circumstances.

To identify any informal use of the accounts of other companies, interviewees were asked how they assessed the credit-worthiness of a new debtor. Interviewees were asked to indicate the sources of information used for that credit decision from a list of alternatives. They were also invited to indicate other sources of information. Four of the selected companies did not offer credit transactions and therefore did not answer this question. The results from the question are presented in Table 5.9.

**Table 5.9: How do you assess the credit-worthiness of a new debtor?**

<table>
<thead>
<tr>
<th>Source of Information</th>
<th>Number of times mentioned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal contacts</td>
<td>28</td>
</tr>
<tr>
<td>Trade reference</td>
<td>20</td>
</tr>
<tr>
<td>Bank reference</td>
<td>6</td>
</tr>
<tr>
<td>Ask to see accounts</td>
<td></td>
</tr>
<tr>
<td>Mercantile agency advice</td>
<td>7</td>
</tr>
</tbody>
</table>
The most popular sources of information were identified as personal contacts and trade references. A few interviewees indicated that they participate in formal arrangements whereby representatives from a number of companies, from the industry in which they are involved, meet on a regular basis to discuss customers in financial difficulty and related matters. Others obtain credit-worthiness information from participants in the industry, or a related industry, on an informal basis. Both of these responses were classified as making use of "trade references".

When explaining their use of personal contacts, many interviewees indicated that they consider it very important to utilise sales personnel in making an initial decision to offer credit. Sales personnel might be asked to assess the position of a customer from the viewpoints of its general level of activity, the saleability of stocks on hand, and market awareness.

Most interviewees claimed that banks do not give advice as to the credit-worthiness of their customers. In relation to those companies which claim to obtain bank references, it is not clear whether they are able to obtain different information from that available to the other companies, or whether their reliance on the information is misplaced. Mercantile agencies are consulted, by a small number of companies, before the decision to offer credit to a potentially large debtor is made. Reasons that other companies gave for not using agencies were:
previously made unsuccessful decisions following agency advice; the cost is not worth the service provided; and the information used by the agencies as a basis for their advice is out of date or likely to be incorrect.

Many interviewees advised that they utilise the services of mercantile agencies or legal firms to collect payment from debtors when it is evident that a customer is unlikely to pay the amounts owed. Interviewees claimed that they do not request customers to provide a set of accounts when asking for credit for two reasons. Firstly, on privacy grounds, they would not be prepared to provide a set of accounts relating to their company to a prospective creditor. Secondly, they are aware that companies' affairs are often structured to minimise liability to taxation. They are therefore concerned that a company's balance sheet and profit and loss statement might present an incomplete picture of the affairs of the business.

Interviewees did not identify any other useful sources of information, however, they indicated that they sometimes offer credit only after the customer has completed a satisfactory record of trading on cash terms.

Interviewees were next asked to indicate the way in which their debtors administration function was organised (see
Tables 5.10 and 5.11).

Table 5.10: Within your organisation, who makes the decision to give credit?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managing Director</td>
<td>83</td>
</tr>
<tr>
<td>Accountant</td>
<td>14</td>
</tr>
<tr>
<td>Clerk</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
</tbody>
</table>

Table 5.11: Who manages debtors on an on-going basis?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managing Director</td>
<td>58</td>
</tr>
<tr>
<td>Accountant</td>
<td>14</td>
</tr>
<tr>
<td>Clerk</td>
<td>28</td>
</tr>
</tbody>
</table>

That the interviewees identified the Managing Director as making an important contribution to the administration indicates that the companies place emphasis on controlling their debtors function. Many identified debtors control as a key to maintaining a smoothly running business. Very few companies have experienced recurring bad debt problems.
Because it was apparent that the interviewees consider that bank lending officers make little use of information contained in financial statements, the next part of the interview sought to identify the type of information that is used by lending officers. While the management group cannot be expected to identify, in general terms, the information used by bank lending officers, they can identify the information which the lending officers, with whom they deal, emphasise as being important to their decisions.

Interviewees were first asked to indicate the relative importance of certain factors in obtaining bank loans. The results of this question are presented in Table 5.12.

Table 5.12: In general, how important do you believe that each of the following factors is in obtaining bank loans for your company?

<table>
<thead>
<tr>
<th>Factor</th>
<th>Very Important</th>
<th>Moderate Importance</th>
<th>Not Important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit history</td>
<td>97</td>
<td>3</td>
<td>-</td>
</tr>
<tr>
<td>Having accounts audited</td>
<td>-</td>
<td>17</td>
<td>83</td>
</tr>
<tr>
<td>Preparing monthly accounts</td>
<td>-</td>
<td>-</td>
<td>100</td>
</tr>
</tbody>
</table>

Credit history was identified as one of the primary factors considered by bank lending officers in making a lending
decision. Some information of this nature is obtained from banking records. The factual information obtained from these records is complemented by relevant qualitative information, such as management's intentions to expand and enter new markets. Branch bank managers seek to establish rapport with their customers in order that this information may be obtained directly from the customers on an on-going basis. Only half of the interviewees who identified having audited accounts as being moderately important, intend to have their accounts audited in 1986. The term "moderate importance" has thus been interpreted by these interviewees as meaning "little importance".

Some indications were evident during the interviews that companies are required to present rather more formal financial information to the banks in the early years of operation than in later years. However, most interviewees found it difficult to remember, in fairly precise terms, the requirements imposed during the early years of the company's operations.

Almost all interviewees who had previously sought bank loans indicated that they provided their banks with a set of the company's financial statements in support of those loan applications. A small number indicated that they also provided certain other information. Interviewees were asked an open-ended question to identify the accounts they would provide in making a loan application. Four interviewees had not previously sought bank loans for
their companies. Some of these declined to indicate what information they would provide if they sought a loan in the future. For that reason, Table 5.13 excludes responses from the group which has not previously sought bank loans.

Table 5.13: What accounts would you provide in support of a loan application?

<table>
<thead>
<tr>
<th>Account</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Previous year's financial statements</td>
<td>94</td>
</tr>
<tr>
<td>Updated management reports</td>
<td>17</td>
</tr>
<tr>
<td>Cash flow projections</td>
<td>17</td>
</tr>
</tbody>
</table>

Although the interviewees indicated that they would provide the bank with a set of accounts, their experience has been that the lending officers do not regard the information contained in the accounts as being as important to the lending decision as the company's credit history.

While credit history is identified as being very important, the interviewees indicated that the security offered for the loan is the primary concern for bank lending officers. In response to question 9, "What is the ease of obtaining a fully secured loan?", interviewees who had sought bank finance previously claimed that, providing adequate security is offered, bank finance is easy to obtain. They indicated that credit history is a very important factor in the
decision as to whether a portion of a company's total finance package (that package might comprise, say, overdraft, bill financing, and loans) might be granted as unsecured. They consider that credit history is also important in the determination of the interest rates charged.

Very few interviewees indicated that they had been able to raise unsecured finance from banks where this was not part of an overall finance package (refer table 5.14).

Table 5.14: Are banks willing to lend on an unsecured basis?

<table>
<thead>
<tr>
<th>Yes</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>72</td>
</tr>
<tr>
<td>Don’t know</td>
<td>20</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>

SECTION 5.3 CHARACTERISTICS OF COMPANIES' ACCOUNTING SYSTEMS

The next section of the questionnaire sought information regarding the sophistication of the accounting systems maintained by the companies and the accounting knowledge of company personnel. The objective of seeking this information is to enable interviewees' responses to
subsequent questions concerning financial reporting and disclosure practices (refer Section 5.4) to be judged as reflecting an informed or uninformed view.

Most companies maintain simple accounting systems. Often these comprise manual records, although many interviewees indicated that they were presently moving their manual records onto a microcomputer. For reasons relating to the size of their operations, relatively few respondent companies operate minicomputers. The results from question 10 are presented in Table 5.15.

Table 5.15: What sort of accounting system do you maintain?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manual</td>
<td>58</td>
</tr>
<tr>
<td>Computerised financial, manual cost</td>
<td>20</td>
</tr>
<tr>
<td>Computerised financial and cost</td>
<td>22</td>
</tr>
</tbody>
</table>

100

The background and qualifications of the interviewees vary considerably, however, few have had financial/accounting training (refer Table 5.16).

Not all of the selected companies employ a qualified accountant (refer Tables 5.17, 5.18 and 5.19). In many instances a bookkeeping role is performed by a clerk, and periodic accounting reports are prepared for management by a
public accountant. With the exception of two, all companies employ a public accountant to assist with the preparation of year-end accounting reports (refer Table 5.20).

Table 5.16: What is your background?

<table>
<thead>
<tr>
<th>Background</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial</td>
<td>15</td>
</tr>
<tr>
<td>Technical</td>
<td>30</td>
</tr>
<tr>
<td>Sales</td>
<td>20</td>
</tr>
<tr>
<td>General management without financial training</td>
<td>35</td>
</tr>
</tbody>
</table>

100

Table 5.17: Is your accountant formally qualified?

<table>
<thead>
<tr>
<th>Answer</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>25</td>
</tr>
<tr>
<td>No</td>
<td>75</td>
</tr>
</tbody>
</table>

100

Table 5.18: Is he a member of the Australian Society of Accountants or the Institute of Chartered Accountants?

<table>
<thead>
<tr>
<th>Answer</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>23</td>
</tr>
<tr>
<td>No</td>
<td>77</td>
</tr>
</tbody>
</table>

100
Table 5.19: Is your accountant sufficiently qualified in terms of legal requirements and accounting standards to prepare your financial accounts?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>25</td>
</tr>
<tr>
<td>No</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

Table 5.20: Do you employ a public accounting firm to assist with year-end accounting procedures?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>95</td>
</tr>
<tr>
<td>No</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

SECTION 5.4 REPORTING AND DISCLOSURE PRACTICES

During the final section of the interview, the interviewees' attitudes as to reporting and disclosure practices were sought. Interviewees were asked whether, and for what particular reason, their company's accounts were audited in 1985. The accounts of fifteen (38%) of the selected companies were audited in 1985. The interviewees' reasons for having the accounts audited are presented in Table 5.21.
Table 5.21: For what reasons were your accounts audited in 1985? Rank them in order of importance.

<table>
<thead>
<tr>
<th>No</th>
<th>Score</th>
<th>Order</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>first basis on ranks 1st - 5 score</td>
<td></td>
</tr>
<tr>
<td>To promote effectiveness of operations</td>
<td>6</td>
<td>52</td>
</tr>
<tr>
<td>To avoid lodging accounts publicly</td>
<td>5</td>
<td>36</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>23</td>
</tr>
<tr>
<td>To avoid Taxation Office audits</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>To comply with lending requirements</td>
<td>-</td>
<td>11</td>
</tr>
</tbody>
</table>

Because the number of companies which had their accounts audited in 1985 is small, it is difficult to interpret the responses contained in Table 5.21 any further than to say that the reasons vary widely. Two of those companies whose accounts were audited in 1985 for "other" reasons are required to have their accounts audited by industry regulatory bodies. The third company in the "other" classification employed auditors in 1985 primarily to identify the extent of a management fraud. Interviewees cited one, or both, of two reasons for not having their company's accounts audited. The reasons are:

- concern with the high cost of employing auditors; and
Only one interviewee was aware of the revision to the NCSC's requirements regarding the annual returns of exempt proprietary companies for 1986, i.e., that unaudited exempt proprietary companies are no longer required to lodge copies of their accounts with the return forms. The changed requirements were briefly explained to the other interviewees. In response to the question, "Will you have your accounts audited in 1986?", three interviewees indicated that as a result of the changed requirements, the accounts of their company would not be audited in 1986. The other two interviewees who indicated that the primary reason that the accounts of their company were audited was to avoid public lodgement requirements, believe that the secondary reasons are sufficient justification for an audit to be completed in 1986. The company whose accounting records were audited in 1985 to detect a management fraud also does not intend to have its accounts audited in 1986.

While explaining the revisions to the requirements regarding lodgement of annual return forms, it was pointed out that exempt proprietary companies would be required to include on their 1986 return forms certain items of "key financial data". The interviewees' attitudes towards disclosing this information were sought. Specifically, the interviewees
were asked whether they considered that the items required to be disclosed on the forms would provide useful information to anyone who was interested in assessing the company's performance. The interviewees' responses to this question are presented in Table 5.22.

Table 5.22: What is your view regarding the usefulness of the "key financial data" requirement as proposed for simplified annual returns for 1986.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Useful</td>
<td>10%</td>
</tr>
<tr>
<td>Not useful</td>
<td>90%</td>
</tr>
<tr>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

Most interviewees indicated that they would not consult the information if they were seeking to review the performance of another company. The interviewees suggested that because the information would be in very aggregated form, and it would not be available on a timely basis, it would have little value.

The interviewees who indicated that the information would be useful, advocated the view that all information can be useful. Interestingly, none of these interviewees had previously completed a company search at the CAC.

The focus of the interview then turned to the particular
problems faced by companies in ensuring that they comply with the accounting standards and legal requirements as to preparation of financial statements.

It became clear during this stage of most of the interviews that few interviewees have even a reasonably sound knowledge of the accounting standards and legal requirements. Most are not familiar with the concept of accounting standards in terms other than "the rules accountants follow". Generally, they are not familiar with company law requirements. Many made comments similar to "... the public accountant does all of that. He just brings in everything at the end of the year for me to sign".

Accordingly, they found it very difficult to understand and answer the following question:

"The following have been suggested as reasons for establishing a special set of accounting standards for privately held companies.

Please indicate the extent to which you see each of these as an appropriate reason for establishing this set.

- It would increase the usefulness of published financial statements to management.
- It would increase the usefulness of published financial statements to outside users.
- It would reduce the degree of accounting sophistication demanded of business managers."
It would reduce the cost of applying generally accepted accounting principles."

As a result, it was decided not to request interviewees to answer that question. Instead, discussion turned to the more general issues associated with a comparison of the costs and burdens of complying with the requirements as to preparation of accounts, and the benefits obtained from preparation of the accounts. The attitudes of the interviewees were recorded and subsequently classified into the format presented in Table 5.23.

The general conclusion that can be drawn from the responses is that, while management is aware that there are considerable costs associated with the preparation of financial statements, and it acknowledges that not all of the information contained in the statements is found useful by management, the burden of reporting for management is no more excessive than many other requirements that have been imposed on companies. Many interviewees cited the preparation of sales tax returns and Bureau of Statistics forms as being far more burdensome for them than preparing financial statements.

The primary reason that the interviewees do not feel a particular burden from the reporting requirements is that the companies' public accountants prepare all the necessary information to satisfy the requirements, and thus there is very little of their own time devoted thereto. This being the case, it might be expected that the accounting costs
incurred by the companies are sufficiently high to lead management to suggest that a burden exists. When asked specifically about the reasonableness of the fees charged them by their accountants, most interviewees indicated that they consider accounting costs to be a substantial proportion of their total costs. However, it is clear that many do not know the relative proportion that the fees charged for accounting bear to the total fees charged by their public accountant. Many regard the cost as being the price paid for minimising taxation liability, and thus do not concern themselves with the costs of complying with the reporting requirements.
Table 5.23: Attitudes towards current reporting requirements

<table>
<thead>
<tr>
<th>Statement</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>The requirements as to preparation of financial statements do not impose a burden on the company</td>
<td>28</td>
</tr>
<tr>
<td>The requirements impose a cost for the company, but the company receives expertise in the area of finance and taxation in return, so is not concerned with the cost</td>
<td>23</td>
</tr>
<tr>
<td>The company is concerned with costs of complying with the requirements and simpler accounts may reduce these</td>
<td>5</td>
</tr>
<tr>
<td>The company is concerned that there is no benefit for management from the amount of detail currently included in the accounts. Accounts would be more useful for management in a simpler form</td>
<td>17</td>
</tr>
<tr>
<td>Both of the two previous statements are valid</td>
<td>17</td>
</tr>
<tr>
<td>The company considers that the costs of complying with the requirements are high, but questions whether a special set of standards would reduce these, yet still provide useful information to the users of accounts</td>
<td>10</td>
</tr>
</tbody>
</table>
To determine whether there exists any association between the interviewees' backgrounds and their attitudes towards the reporting requirements, contingency tabulations of the responses were extracted from the interview data file. The tabulations indicate that the responses recorded in each classification in Table 5.23 are drawn approximately evenly from each of the classifications recorded in Table 5.16. However, of the four interviewees whose responses were recorded in the last classification in Table 5.23, three have a financial background. Because this number represents fifty per centum of all interviewees who have a financial background, a claim might be made that the attitude of the more informed interviewees is that a burden exists, but changed accounting standards will not remedy the burden. However, the low absolute number of interviewees with a financial background severely limits the appropriateness of that claim.

Contingency tabulations were also extracted to examine whether the size of the company (as reflected in the number of its employees, the book value of its assets, number of shareholders, and its annual turnover), with which the interviewee is associated, influences his attitude. The tabulations do not indicate any association between company size and the attitudes of interviewees to reporting requirements.

The general discussions concerning reporting requirements made evident the fact that most interviewees have little knowledge or understanding of accounting standards and legal
Question 19 was asked to provide opportunity for the interviewees to indicate any particular problems that they encountered in understanding or interpreting the financial statements prepared for their company. However when asked the question, "When examining financial statements, what deficiencies or omissions have caused you difficulty", all interviewees responded that they have no difficulty in understanding financial statements. If they have a particular question about any item in the statements, they are able to obtain adequate explanation from their accountant.

Because some interviewees had expressed concern at the amount of detail currently contained in financial statements it was considered appropriate to ask question 20, despite the indication obtained earlier in the interviews that the interviewees have little knowledge of legal requirements. Table 5.24 presents the responses from the question.
Table 5.24: In general, do you consider that small companies should present to shareholders:

<table>
<thead>
<tr>
<th>Option</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less information than at present</td>
<td>28</td>
</tr>
<tr>
<td>About the same information as at present</td>
<td>70</td>
</tr>
<tr>
<td>More information</td>
<td>-</td>
</tr>
<tr>
<td>Don't know the disclosure requirements</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Only one respondent indicated that he was not aware of the particular information that was required to be included in his company's financial statements. Most others, having earlier expressed concern at the amount of detail required to be presented in accounts, indicated that about the same information should continue to be included in companies financial statements for the information of shareholders. It is probable that many interviewees chose not to advocate that less information should be provided because they were concerned that, if they did so, they might be asked which particular items of information were unnecessary.

Responses to the previous two questions highlight the interviewees' lack of knowledge concerning the form and content of financial statements. Many interviewees appear to think that the schedules prepared for taxation return purposes form part of the accounts. Indeed, the only formal
records that some companies have of their financial position are copies of previous years' taxation returns. During discussions, the interviewees from these companies advised that this was the only information provided to them by their public accountants.

The responses suggest, also, that the interviewees make limited use of their company's financial statements.

Interviewees were next invited to indicate the particular variables that they use as a guide to monitor the performance of their company. Most interviewees identified one variable as being the "key" to the performance of the company, however opportunity was given for them to indicate more than one variable. Because this question was asked in an open-ended manner, interviewees responses were classified for the purposes of presentation of Table 5.25.
Table 5.25: What particular variables do you consider to be the most important indicators of the performance of your organisation, and how do you monitor these?

<table>
<thead>
<tr>
<th>Variable</th>
<th>Number of mentions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balance - daily position including amounts owing by and owed to the company is reviewed at least twice per week.</td>
<td>20</td>
</tr>
<tr>
<td>Cash balance - balance, together with debtors, creditors and stock is reviewed each month.</td>
<td>18</td>
</tr>
<tr>
<td>Turnover - reviewed monthly.</td>
<td>18</td>
</tr>
<tr>
<td>Net profit - reviewed monthly.</td>
<td>7</td>
</tr>
<tr>
<td>Costs of production etc. - reviewed monthly.</td>
<td>8</td>
</tr>
<tr>
<td>Profit margin on projects - reviewed on completion of projects.</td>
<td>3</td>
</tr>
</tbody>
</table>

The most popular variables are cash position and turnover. Many interviewees indicated that their primary concern is the company's level of cash. They consider that their
company is doing well if it can pay its creditors each month and yet there remain funds in the bank account.

Interviewees from all companies, except those with the highest turnover, indicated that they are so familiar with the operations of the company on a day to day basis, i.e., as regards sales and production, that there is no need for any formal analysis of the company's activities apart from reviewing the cash position. They often referred to the management process as being based on "gut feel".

Contingency tabulations were extracted from the data to determine whether interviewees' responses to this question are related to their backgrounds. Similar proportions of all interviewees mentioned each of the particular variables recorded in Table 5.25, indicating no apparent association between the interviewees' backgrounds and the recorded variables.

The views of the interviewees as to concerns of privacy of information relating to the financial information of their company were sought in question 22. Table 5.26 presents the responses from this question.
Table 5.26: Do you consider that privately owned companies have a responsibility to report to parties other than shareholders?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>15</td>
</tr>
<tr>
<td>No</td>
<td>83</td>
</tr>
<tr>
<td>Don't know</td>
<td>2</td>
</tr>
</tbody>
</table>

Most interviewees, from all backgrounds and sizes of company (size is expressed by turnover and number of employees in this instance), have the view that the financial information relating to their company should not be required to be disclosed to any parties other than shareholders. They did not agree with the suggestion that public disclosure of information is the price that should be paid for the limited liability advantage. Instead, they maintained that in view of the personal security they, as individuals, were required to lodge with their trading banks, their personal liability was not limited in any real sense.

The interviews were concluded by inviting the interviewees to suggest an appropriate base for making a distinction between small private companies and others (refer Table 5.27). Discussion centred on the question as to whether it is possible to make a distinction between small privately-owned companies and other privately-owned companies.
Table 5.27: What would you suggest as an appropriate base for distinguishing small private companies from others?

<table>
<thead>
<tr>
<th></th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of employees</td>
<td>15</td>
</tr>
<tr>
<td>Book value of assets</td>
<td>-</td>
</tr>
<tr>
<td>Turnover</td>
<td>10</td>
</tr>
<tr>
<td>Combination of the above 3</td>
<td>58</td>
</tr>
<tr>
<td>Other</td>
<td>17</td>
</tr>
</tbody>
</table>

A base which includes a combination of number of employees, book value of assets, and turnover, was the most popular choice. Some interviewees who indicated this to be an appropriate base suggested that an equally appropriate base might incorporate only number of employees and turnover. The interviewees who suggested an "other" basis consider that it is not appropriate to make a distinction between small private companies and other private companies. They consider that if a distinction is to be drawn between companies for any particular reason, the appropriate distinction is merely public versus private ownership.
CHAPTER SIX: INTERPRETATION OF RESULTS

The results of the field study are interpreted in this chapter with reference to the research hypotheses established on a priori grounds. The results are considered in conjunction with evidence obtained from supplementary investigations and research reported in the literature, to ensure that adequate support exists for the interpretations made.

SECTION 6.1 THE USERS OF THE FINANCIAL STATEMENTS

The interviewees' responses to question 1, as presented in Table 5.6, support the research hypothesis stated in Section 4.1, namely,

"the primary user of the financial reports of small companies is management".

Management was ranked by the interviewees as the primary user of the financial reports of small companies. The use made by management is considered to be substantially more than that made by any other user group. This finding is supported by research completed in the USA and UK (refer Chapter Three).

While most managers lodge a copy of the company's taxation return with their trading banks annually (refer Table 5.7),
management considers that little use of the information contained therein is made by bank lending officers. Rather, management's experience is that bank lending officers place more emphasis on factors such as security and credit history when making a lending decision (refer Tables 5.12, 5.13 and 5.14). This attitude is supported by surveys of management and accountants completed in the USA and UK (refer Chapter Three).

In response to questionnaire surveys, lending officers in the USA have indicated that they make similar use of the information contained in the financial statements of both large and small companies. While it may be true that lending officers review the same items of information in the financial statements of all companies, it is probable that the review forms only a small part of the basis for lending officers' decisions. Thus, the attitude of the bank lending officers does not invalidate the claim that management is the primary user of the financial statements of small companies.

There is evidence that banks have the ability to demand information and assurances from companies that seek finance, and that this ability is exercised. Some interviewees indicated during discussions that, when they have sought finance for their company, lending officers have requested that they provide the bank with projected cash flows and other information regarding the company's operations on standard pre-printed bank forms. In view of this ability,
and the banks' evident concern with security and credit history, it is suggested that the banks are a less important user of the financial statements of small companies than the management of those companies.

It is evident from the field study that creditors and competitors make little use of small companies' financial statements. Management does not provide these groups with financial information, and discussions with management did not reveal any substantial use, by them, of the financial information relating to other companies. Management appears to make little use of the financial statements of other companies, even in credit decisions. Credit decisions are usually made on the basis of trade references and personal contacts. Financial statements are not requested, and companies accounts are not searched at the CAC (refer Tables 5.8 and 5.9). It is apparent that the information used for making credit decisions is adequate as the sample companies have experienced very few significant bad debt problems.

The evidence obtained from the field study in relation to this matter is supported by that obtained during discussions held with a senior officer of the CAC. That officer revealed that a study of the usage of publicly lodged information about companies, completed internally by the Victorian CAC, indicated that the information sought most often by the public is the names and addresses of the company owners and directors. Essentially, only
representatives from mercantile agencies make use of the companies' financial information. It is probable that the result of this internal study is the basis for the following comment, made in the consultative paper prepared by the NCSC\(^{34}\) to support the amendments to the annual return requirements of the Companies Act:

"It has been suggested from time to time that few people searching company files made any significant use of either the accounts or the auditor's certificates of such (exempt proprietary) companies".

Discussions held with senior officers of a leading mercantile agency confirmed that representatives from mercantile agencies use the financial information lodged with the CAC. Financial information is extracted from CAC records and is incorporated with information obtained from other sources on agencies' data files. Other sources of company-related information for the agencies are:

- direct communication with subject companies; and
- information contained in other companies' debtors ledgers.

The agency officers judge information obtained directly from subject companies, say by telephone, as a reliable source of

information. However, many of the company managers interviewed doubt that the information obtained in this way is accurate. Some indicated that they have provided incorrect information to agencies. The information obtained from other companies' debtors ledgers indicates credit history, and is used as a basis for assessing a company's ability to meet commitments.

The mercantile agency officers do not consider that the changed annual return reporting requirements will significantly affect the service they provide. They indicated that in future they would make more use of sources other than the publicly filed information, although they would continue to review companies annual returns to extract the items of key financial data that are recorded. They consider that the information obtained from other companies' debtors ledgers is the most valuable source of information for their assessment of a company's ability to meet its commitments.

Consistent with the evidence obtained during discussions with management, the officers indicated that their credit collection services are more popular than their credit rating advice.
SECTION 6.2 THE BURDEN OF REPORTING

Although managers are identified as the primary users of the financial reports of small companies, it is unlikely that they have the ability to analyse and interpret financial statements in order to make optimal use of the financial reports.

Discussions with managers revealed that they have little knowledge or understanding of accounting standards. Few managers interviewed have any financial training.

The claim that management has limited ability to analyse and interpret financial statements is supported by discussions held with a small number of practising accountants who service small business. The view of those accountants is that management understands financial statement items which are in the nature of cash, but has difficulty with non-cash items. Specific examples of non-cash items, with which they believe management has difficulty, are depreciation, amortisation, tax effect accounting balances, and the distinction between operating and finance leases. Overall, the accountants with whom discussions were held consider that management has reasonable understanding of accounting reports providing that results for the year are in line with the current cash position. They consider that management finds reports difficult to understand if a profit is recorded, yet no cash is on hand.

The managers who were interviewed see the main benefit of
financial statements as being that they present a formal picture of the results of operations of the company for the year. Managers review the financial statements to ensure that their expectations of the company's performance, based on knowledge of the business, are confirmed by the formally presented results. The financial statements are also used as a basis for dividend decisions and for taxation return purposes.

Most of the managers claim not to use formally prepared financial information for other decision-making purposes. The primary reason for this is that the information is not timely. The financial statements are often not prepared until some months after year-end.

Few companies prepare formal accounting information, i.e., balance sheets and profit and loss statements, on other than an annual basis. Rather, managers monitor the performance of the company on a "gut feel" basis, and place emphasis on the company's cash position (refer Table 5.25). The reason that there is limited use made of formal accounting information is somewhat circular. Managers do not use the information because it is not timely, however they decide not to prepare the information on a more timely basis, say monthly, because of the limited use that is made of that formal information which is currently prepared.

The discussions held with practising accountants revealed that, within the context of a set of financial statements, management makes use only of the balance sheet and detailed
profit and loss statement. Management is not interested in reviewing the notes to the accounts because it is already aware of the matters contained therein, such as the basis for depreciation and the method of stock valuation.

The accountants, with whom discussions were held, displayed concern that they are required to prepare accounts for their "small business" clients which contain substantially more detail than is used by management. While some accountants claimed that the financial statements which they prepare on behalf of clients comply with professional accounting standards and disclosure requirements, others indicated that those which they prepare do not always comply with all accounting standards. They cited AAS 12 and AAS 17 as standards which they consider to be inappropriate for the purposes of preparing information for their clients. They claim to make a decision as to whether or not to comply with a standard on the basis of the client's ability to understand the information.

The views of these accountants were supported by the others interviewed in that they expressed particular concerns with the appropriateness of AAS 12 and AAS 17.

Although the accountants with whom discussions were held did not admit that they consistently departed from accounting standards and disclosure requirements when preparing financial statements for their clients, a review of the financial statements relating to the companies selected for
the field study, and other privately-owned companies, revealed many instances where requirements seem not to have been followed. Many of the financial statements reviewed comprise a balance sheet and detailed profit and loss statement, but no explanatory notes thereto. Others, which include explanatory notes, do not appear to disclose therein all required information. This finding, that the accounts of many privately-owned companies appear not to be prepared in accordance with professional accounting standards and legislative requirements is supported by the findings of a study by Ramsay and Sutcliffe\(^{35}\). That study examined the accounts of 423 unaudited exempt proprietary companies lodged with the Victorian CAC, for evidence of compliance with aspects of selected accounting standards. A very low level of compliance with the requirements was detected.

The widespread incidence of departures from accounting standards and statutory requirements, and the concerns expressed by the accountants with whom discussions were held, indicate that many accountants consider that the existing requirements in Australia as to preparation of the accounts of small companies are excessive. This indication is consistent with the results of surveys of accountants in the UK and USA that are reported in Chapter Three.

In view of the apparent limited use that is made of financial statements, and the not insignificant costs associated with hiring a public accountant, it might be expected that management would display considerable concern as to the burden of reporting.

Consistent with the views of managers interviewed by Carsberg et al.\textsuperscript{36} in the UK (refer Section 3.2.3), managers interviewed during the field study indicated concern for the privacy of the financial information relating to their company (refer Table 5.26). However, few consider that the amount of detail currently contained in financial statements for the information of management should be reduced (refer Table 5.24).

Furthermore, interviewees did not exhibit an overwhelming concern with the price paid for accounting information (refer Table 5.23). Rather, their attitude seems to be that, aside from privacy considerations, the reporting requirements do not impose a particular burden for them. In this respect, their attitude is similar to that noted by Carsberg et al.

For the purposes of interpreting the results from the field study, management's attitude must be judged in light of its lack of knowledge of accounting standards and legal requirements.

Management's lack of concern with the cost of accounting services and the burden of reporting requirements appears to

reflect the fact that management does not participate in, or understand the detail of, the reporting process. Management's attitude as to the appropriate amount of detail to be included in the financial statements of small companies probably reflects concern with its ignorance of the requirements as to the contents of financial statements, rather than the view that the amount of detail currently contained therein is ideal. Certainly management agrees that little use is made of much of the detail, and there is evidence that the financial statements of many companies do not comply with the prescribed requirements.

Thus, while the managers who were interviewed did not specifically say that they believe an excessive burden exists, evidence collected during the field study and supplementary investigations supports the second research hypothesis stated in Section 4.2 that, "an excessive burden exists for small companies in Australia in terms of both accounting standards and legislative requirements".
SECTION 6.3 THE CASE FOR SIMPLIFIED REPORTS

The final research hypothesis stated in Section 4.1 is:

"a report containing financial information which is less detailed than that which is currently required to be prepared would satisfy management's needs for information".

As is outlined in Section 6.2, the field study and supplementary investigations revealed that the financial statements currently prepared in respect of many small companies do not comply with all accounting standards and legislative requirements. It was also revealed that the managers of most small companies make limited use of the financial statements that are currently prepared. Most of the companies in the sample maintain a very unsophisticated accounting system which is based on either manual records or a micro-computer (refer Section 5.3). The backgrounds of the company managers vary widely (refer Table 5.16). Because few have financial backgrounds, they find the analysis of financial information difficult. Even in respect of decisions for which financial information might be expected to be useful, such as the decision to grant credit to a customer, little use is made of financial information (refer Table 5.9). The credit decision is made on the basis of personal contacts and trade references rather than on reviews of the prospective debtor's financial
statements.

Generally, managers complete little analysis or interpretation of financial statements relating to their own company. The main use of the financial statements is as a confirmation of expectations based on "gut feel". Managers rely on cash-based information as the main indicator of the company's performance; some review the company's cash position on a daily basis (refer Table 5.25).

A few of the larger companies in the sample maintain a relatively more sophisticated accounting system and prepare financial information on a monthly basis. Managers of these companies review this information on a regular basis, but still consider information regarding their cash position as a most important indicator of performance.

In view of the amount and type of use of financial reports made by management, it is evident that a report which contains a balance sheet, detailed profit and loss statement, and a schedule which reconciles the profit (or loss) for the year with the movement in the cash position over the year would provide most of the managers who were interviewed with sufficient formal financial information for their decision-making purposes.

Some of the managers who were interviewed revealed that their accountant currently provides them with a reconciliation of the profit for the year with the movement in the company's cash balance. They claimed to find this very useful in understanding the affairs of the company, as
presented in the balance sheet and profit and loss statement.

However, it is clear that some managers make substantially more use of formal financial information than others, and that a report such as outlined above may not satisfy their needs for information.

SECTION 6.4 GENERALISATION OF FIELD STUDY RESULTS

The sample of companies selected for review in the field study represents a very small proportion of the total number of small companies operating in Australia. Therefore, it is necessary to consider whether the results from the field study can be generalised as representing the views of the wider population of the managements of all small companies. The supplementary investigations, as outlined in Section 4.7, were directed towards discovering whether support exists for the results of the study and the interpretation of those results.

It was expected that the indications obtained from these investigations would determine whether generalisation is appropriate.

Evidence reported in Section 6.1 suggests that it is appropriate to conclude that the primary user of the financial reports of small companies is management.

Similarly, the evidence outlined in Section 6.2 indicates that the burden of compliance with reporting requirements is
excessive for the managements of small companies. As far as the indications reported in Section 6.3 are concerned, it is clear that some managers make substantially more use of formal financial information than others. Therefore, while simplified reports would satisfy the needs for information for the managers of many small companies, a standardised report format would not satisfy the information needs of the managers of all small companies.

Therefore, while it is appropriate to generalise that reporting requirements impose an excessive burden for small companies, it is not possible to generalise a solution for the burden. Any recommendations made concerning an appropriate reporting framework for small companies should be based on the understanding that all managers of small companies do not make identical use of financial information.

SECTION 6.5 THE DISTINGUISHING FEATURE OF SMALL COMPANIES

Because there exists no universally accepted definition of "small company", the definition adopted for the purposes of this study was that a company is small if it meets the definition of exempt proprietary company contained in the Companies Act 1981 (refer Section 2.3.1). It was anticipated that the field study would provide opportunity to consider whether a definition based on the ownership characteristics inherent in the classification of
exempt proprietary company could be an appropriate basis
distinguishing a separate group of companies for financial
reporting purposes.

Discussions held during the field study revealed that small
companies see their private ownership as being the
singularly significant characteristic which distinguishes
them from other companies (for example, see Table 5.26).
Some interviewees indicated that within the class of
privately-owned companies it may be possible to disting,
companies on a size basis. However, although the number
employees and annual company turnover were recommended by
many as valid bases for the distinction (refer Table 5.27),
no indications as to what might be appropriate "bench marks"
were given. Interestingly, all of the interviewees
described their company as "small" even though some
companies employ more than 50 persons and others' annual
turnover exceeds $10 million.

Because the significant characteristic of small companies is
private ownership, the definition of exempt proprietary
company embodied in the Companies Act is considered to be
the appropriate basis for distinguishing a group of
companies for financial reporting purposes in Australia. A
clear distinction within the classification of exempt
proprietary company is not evident from the data collected.
Therefore, any attempt to distinguish companies on a size
basis within the classification would involve the use of
"bench marks" that are arbitrarily based, and \text{inappropriate}.\]
CHAPTER SEVEN: RECOMMENDATIONS

Having identified in Chapter Six that it is appropriate to consider exempt proprietary companies as a separate class of companies for financial reporting purposes, the focus of this chapter is to recommend for Australia an appropriate financial reporting framework for those companies.

It is evident that a burden is imposed on the management of small companies by the existing financial reporting requirements. As outlined in Chapter Six, the burden is reflected in the views of management regarding the privacy of the financial information relating to their company, the standard of financial statements prepared by small companies, and the views of practising accountants. The practitioners find it difficult to justify the fees they charge for preparing clients' financial statements when much of the detail prepared is neither understood nor used by the clients.

SECTION 7.1 SUMMARY OF EXISTING REPORTING FRAMEWORK

The existing reporting requirements for exempt proprietary companies are as follows.

Unaudited companies are required to lodge an annual return form, which is made available for public inspection, to the Corporate Affairs Commission annually. Companies must
Companies must prepare a balance sheet, profit and loss statement, and notes thereto which, together, present a true and fair view of the results and state of affairs of the company and which comply with the disclosure provisions of Schedule 7 of the Regulations to the Act and the accounting standards which have Accounting Standards Review Board approval. It is expected that a true and fair view is shown only if the financial information has been prepared in accordance with the accounting standards promulgated by the accounting profession. The accounting standards approved by the Accounting Standards Review Board to date are consistent with the standards on equivalent matters that are promulgated by the profession. Thus, compliance with the professional requirements will ensure compliance with the approved accounting standards.

In attempting to recommend an appropriate financial reporting framework for small companies in Australia it is necessary to consider the framework as comprising two separate components. These components are:

1. the requirement for small companies to make public disclosures in their annual returns to the Corporate Affairs Commission; and
2. the reporting rules that companies are required to
The discussion in this chapter considers each of the components independently.

SECTION 7.2 PUBLIC DISCLOSURE REQUIREMENTS

Two arguments might be advanced to support the case for companies being required to make public disclosure. One relates to the concept of limited liability, the other to the amount of use that is made of the public disclosures.

It has been claimed, traditionally, that public disclosure is required on the grounds that all companies should pay a price for the limited liability advantage afforded them by the corporate form. Although it may be claimed that public disclosure is the price paid for the limited liability advantage, in fact, it seems that the liability of company owners and managements is not typically limited. Banks often require company directors to commit personal assets as security for finance. Also, recent legal developments regarding the responsibilities of company directors have limited the opportunities for company directors to stand behind the corporate veil. Indeed, if limited liability is a prevailing concern, then it does not seem consistent that companies can avoid the requirement to disclose by having their accounts audited.

Consistency would require that either, all companies be
required to make the disclosures, or no companies be required to make the disclosures.

Because the requirement for companies to disclose specified items of financial information has been operative only since July 1986, it is not possible to determine precisely the use that is likely to be made of that information. However, predictions regarding that use can be made. It is evident from discussions held during the field and supplementary investigations that there have been relatively few users of publicly disclosed information despite the fact that the information disclosed prior to July 1986 was more extensive than that which is currently required to be provided. Essentially, only mercantile agencies have used the information, and it is likely that they will be the main users of any information provided in the future. Managers who were interviewed during the field study indicated that they would not seek the information disclosed by other companies in the future. Their view is that the items of information which are required to be disclosed are not particularly useful to third parties in terms of interpreting the company's performance. Few managers intend to have their accounts audited in order to avoid the requirement to disclose.

Mercantile agencies use Corporate Affairs Commission records as only one of a number of sources of information for their data files. In view of this fact, and the expectation that,
essentially, only mercantile agencies will use the information, the requirement for exempt proprietary companies to make public disclosure cannot be justified grounds of usage.

An ideal reporting framework would remove the requirement for exempt proprietary companies to make public disclosure of their financial information. Removal of this requirement is consistent with the views as to the privacy of information expressed by managers who were interviewed during the field study.

SECTION 7.3 RULES PRESCRIBING THE FORM AND CONTENT OF FINANCIAL STATEMENTS

Companies are presently required to prepare accounts which comply with the disclosure provisions of Schedule 7, the approved accounting standards, and the accounting standards promulgated by the profession.

Schedule 7 essentially requires companies to disclose particulars of items of revenue and expense included in the determination of operating profit, and particulars of asset and liability balances (a copy of Schedule 7 appears as Appendix 1). The National Companies and Securities
Commission\textsuperscript{37} has claimed that:

"Schedule 7 sets forth the forms of financial disclosure which are regarded as the minimum level of accountability by incorporated enterprises".

The requirements for reporting financial information were originally predicated on the separation of ownership from control. The concept of accountability does not apply for exempt proprietary companies because ownership and control are usually held by an identical group in these companies. The managers would be aware of the particulars of matters required to be presented by the Schedule, therefore compliance with the requirements of the Schedule would not provide them, as users of the financial statements, with any new information.

Accordingly, it is inappropriate that exempt proprietary companies are required to include, in their financial statements, the details required by Schedule 7.

One view of financial reporting is that all companies must prepare their financial statements using the same accounting standards in order that the financial statements present a true and fair view of the companies' affairs. However, in Australia, it is apparent that many companies and their accountants consider that the costs of complying with the standards are not outweighed by the benefits derived from

providing the information and they have, therefore, departed from accounting standards in preparing financial information.

This circumstance requires that the system of application of accounting standards be rationalised, and is justification for pragmatic considerations dictating the direction of the rationalisation, even though they may not accord with sound theoretical argument. The financial reporting framework may lose credibility if rationalisation is not undertaken.

One possible solution to the problem is to impose standards on companies differentially. Compliance with some standards would be compulsory for exempt proprietary companies, but others would not require compliance. This is the solution which has been advocated in the USA literature (refer Section 3.1.7), and adopted in the USA and UK. The problem with a solution such as this is how to determine which standards require compliance.

For standards which prescribe matters of disclosure rather than asset or liability measurement, for example AAS 12, Statement of Sources and Applications of Funds, and the approved accounting standard relating to preparation of funds statements, ASRB 1007, the argument presented in recommending that exempt proprietary companies not comply with the disclosures required by Schedule 7 would be followed.

Exempt proprietary companies should not be required to comply with disclosure standards.
However, the burden for companies is imposed disclosure and measurement standards, and the problem of determining whether companies should be required with measurement standards is not clear. It is to determine precisely which aspects of measurement important for companies to comply with than others. of the difficulty in resolving value judgements. Example, it is the view of some accountants that Accounting for Leases, and the approved accountin which prescribes lease accounting, ASRB 1008, are complicated for small companies to comply with, with others consider that the rights to use assets which from lease contracts should be identically recorde irrespective of the size of the company. It is also possible for an approach to be based on the aspects the management of exempt proprietary companies use and understand, because, as was outlined in Chapter Six, the managers of small companies have differing levels of understanding of accounting information, and make different uses of the information.

A more appropriate solution would be to limit the application of approved standards to companies other than exempt proprietary companies and to incorporate, within the profession's accounting standards, a provision which clearly indicates that it is not necessary for all companies to comply with all standards in order for a true and fair view
of their financial position to be presented
This solution would place the onus on the prepare accounts, the accountants and managers of exempt companies, to determine, in each set of circumsta particular accounting standards that it is appropr. apply. Financial statements would then be prepared into account:

1. management's knowledge and understanding of accounting information;
2. the costs of preparation of the accounting information; and
3. particular requirements that may be imposed entitled parties, for example, shareholders who participate in the management of the company and industry regulatory authorities.

If this solution were adopted, the financial statements would comprise the information that management wants and is prepared to pay for. The responsibility for advising

38 It seems that a professional accountant may already have the opportunity to make an assessment as to whether or not a standard is appropriate for application on the basis of the intended users of the financial statements. Paragraph 5 of APS 1, Conformity with Statements of Accounting Standards, states:
"Departures from a Statement of Accounting Standards occur whenever the provisions of the Statement are not applied and there could be a material consequence for the users of the financial statements.". However, this point, if implicit in the above paragraph, is certainly not clear.
management as to the information appropriate for making purposes remains with the accounting profession at the level of the individual professional accountant. Other parties who want, and are entitled to, information additional to that prepared by management, or in a form which differs from that used by management, have to bargain with management to obtain the information.

SECTION 7.4 SUMMARY OF RECOMMENDATIONS

Exempt proprietary companies should be required by the Companies Act to present, to shareholders, financial statements which reflect a true and fair view of the financial position of the company for the financial year and of the state of the affairs of the company at the end of the financial year. This requirement would preserve the equality of access to information for non-managing shareholders.

The particular accounting methods used by the preparers of financial statements should be determined by the exercise of the professional judgement of the company's accountant. Standards should not be prescribed as mandatory for this class of company by the National Companies and Securities Commission, in the form of approved accounting standards, or prescribed by the accounting profession as requiring to be complied with in order for a true and fair view to be presented.

Matters of disclosure, such as those contained in
Schedule 7, should also be left to the discretion of the preparers of the accounts.
Finally, exempt proprietary companies should not be required to make public disclosure of their financial information. The requirement to include specified items of key data in the annual return forms submitted by unaudited exempt proprietary companies should be removed.

It could be argued that this solution would inevitably lead to problems currently faced in the USA in that banks require exempt proprietary companies to prepare financial statements which comply with all accounting standards. However, banks which operate in Australia appear to emphasise matters of security and credit history in their decisions, and in many cases accept companies' taxation return data as presenting adequate financial information for their purposes. It is unlikely that banks would alter their behaviour in this regard to require all companies to present financial information prepared in accordance with all accounting standards. Banks may impose this requirement on some companies; it would then be for those companies to comply with the bank's request or obtain finance elsewhere. This would not be seen as inequitable behaviour on the part of the banks, rather it would be just an extension of their present practice of imposing different security requirements and rates of interest on some companies.
SECTION 7.5 ANTICIPATED DIRECTION OF AUSTRALIAN REPORTING FRAMEWORK

There is some evidence that the National Companies and Securities Commission is attempting to simplify the reporting requirements imposed on exempt proprietary companies. This is reflected in the Companies Amendment Bill 1985 which reduced disclosure requirements for exempt proprietary companies to the extent that those companies need no longer include a copy of their financial statements with the annual return form lodged with the Corporate Affairs Commission each year. It is, therefore, worthwhile to consider how closely the developments that are anticipated to occur in financial reporting in Australia approximate the recommended framework.

The intentions of the accounting profession with respect to the need to reduce the burdens of financial reporting for exempt proprietary companies are not evident. When certain of the profession's accounting standards were first released in exposure draft form, for example AAS 16, Financial Reporting by Segments, they were recommended as having differential application. However, differential application was not incorporated into the final versions of the standards on the grounds that it was not supported by the profession. Recently, there has been some lobbying undertaken by some members of the profession, particularly those who service
small business clients, with respect to the application of the standard on lease accounting approved by the Accounting Standards Review Board.\textsuperscript{39} This lobbying activity indicates a renewed interest in the concept of differential application of accounting standards. In addition, the Australian Accounting Research Foundation has indicated that it is presently reconsidering its policy with respect to differential application of accounting standards.\textsuperscript{40} Despite this renewed interest in the reporting burden issue, it is not clear what will be the profession's response to the issue.

The National Companies and Securities Commission has the power to exempt proprietary companies from complying with Schedule 7 and the approved accounting standards. The Miscellaneous Amendments Act 1985 enlarged the capacity of the National Companies and Securities Commission to exempt companies and classes of companies from any of the accounting requirements in current legislation. This power can be exercised if compliance with a statutory requirement would render the accounts misleading or would impose unreasonable burdens on those companies. To date this ability has not been used to limit the application of all of

\textsuperscript{39} An advertisement encouraging members of the profession to lobby for differential application of ASRB 1008 was placed in The Institute of Chartered Accountants Newsletter in September 1986.

\textsuperscript{40} McGregor W., "ASRB Approval of Standards", The Chartered Accountant in Australia, Vol 57, October 1986, page 26.
the standards to companies other than exempt companies.

Instead, it appears that the National Companies Securities Commission has attempted to simplify requirements by imposing standards differentially: standard-by-standard basis, in line with the solution outlined, but not recommended, in Section 7.3. ASRB 1005 which deals with financial reporting by has application only for listed companies and such overseas listed companies. For other purposes, alternative bases for differentiation have been proposed. It is unlikely that the overall framework will be if more than one basis for differentiation is used.

The National Companies and Securities Commission has released a draft revised Schedule 7 which proposes differential disclosure requirements for different classes of companies. The intention is to impose more extensive requirements on those companies in which there is substantial public interest and to reduce substantially the disclosures required to be made by exempt proprietary companies which meet a certain size test. The draft requires that exempt proprietary companies should continue to disclose certain items of information, for example, audit fees and transactions with related parties. Following the argument presented in Section 7.3, there is no justification for retaining these requirements.
The attempts that have been made by the N and Securities Commission may reduce, but are not remove, the burden of reporting for exempt propr companies.
SCHEDULE 7

Regulation 57
Sub-section 269(8)

1. (1) In this Schedule—

“accounts” means profit and loss accounts and balance-sheets and includes statements, reports and notes, other than auditors’ reports or directors’ reports, attached to or intended to be read with any of those profit and loss accounts or balance-sheets;

“current liability”, in relation to accounts or group accounts, means a liability that would in the ordinary course of events be payable within 12 months after the end of the financial year to which the accounts or group accounts relate;

“group accounts”, in relation to a holding company, means—
(a) a set of consolidated accounts for the group of companies of that holding company;
(b) 2 or more sets of consolidated accounts together covering that group;
(c) separate accounts for each corporation in that group; or
(d) a combination of one or more sets of consolidated accounts and one or more separate accounts together covering that group;

“group of companies”, in relation to a holding company, means the holding company and the corporations that are subsidiaries of the holding company;

“holding company” means a company that is the holding company of a corporation;

“non-current liability” means a liability that is not a current liability;

“reserve” does not include any amount written off or retained by way of providing for depreciation, renewal or diminution in value of assets or retained by way of providing for any known liability, or any amount set aside for the purpose of its being used to counter the effect of undue fluctuations in charges for taxation;

“the profit or loss” means—
(a) in relation to a corporation that is not a holding company—the profit or loss resulting from operations of that corporation;
(b) in relation to a corporation that is a holding company of a group of companies for which group accounts are required—the profit or loss resulting from operations of that corporation;
(c) in relation to a corporation referred to in paragraph (b) and its subsidiaries—the profit or loss resulting from operations of the group of companies of which the corporation is the holding company; and
(d) in relation to a corporation that is a holding company of a group of companies for which group accounts are not required—the profit or loss resulting from operations of that corporation.

(2) A reference to a financial year in relation to group accounts of a holding company is, where the financial year of any one or more of the companies in the group of companies does not end on the date on which the financial year of the holding company ends, a reference to the financial year of the holding company and the financial year of each other company in the group of companies that does not end on that date.

(3) The term “reserve” shall not be included in any accounts or group accounts to describe any amount that is excluded by the provisions of sub-clause (1) from the meaning of that term for the purposes of this Schedule.
2. (1) There shall be shown separately in the accounts or group accounts (whether by way of note or otherwise) in addition to any other matters necessary to present a true and fair view of the profit or loss of the company or of the company and its subsidiaries—

(a) the amounts of income received, or due and receivable, as dividends declared on shares in—
(i) related corporations; and
(ii) other corporations,
separate amounts being shown in respect of each related corporation;

(b) the amounts of income received, or due and receivable, as interest on debentures, deposits, loans or advances from—
(i) the holding company;
(ii) subsidiaries;
(iii) other related corporations; and
(iv) other persons;

(c) the following—
(i) the amount of any profit arising from the sale of assets (other than current assets); and
(ii) the amount of any profit arising from the re-valuation of assets (other than current assets)
and, in respect of that profit (if any), a statement whether it has been brought into account in determining the net amount of the profit or loss of the company or of the company and its subsidiaries;

(d) the amount of any other profit arising otherwise than in the ordinary course of business;

(e) the amounts of interest paid, or due and payable, on debentures, deposits, loans or advances, or otherwise, to—
(i) the holding company;
(ii) subsidiaries;
(iii) other related corporations; and
(iv) other persons;

(f) the following—
(i) the amount of any loss arising from the sale of assets (other than current assets); and
(ii) the amount of any loss arising from the re-valuation of assets (other than current assets)
and, in respect of that loss (if any), statement whether it has been brought into account in determining the net amount of the profit or loss of the company or of the company and its subsidiaries;

(g) the amount of any other loss arising otherwise than in the ordinary course of business;

(h) the amount charged for, or set aside to a provision for depreciation, diminution in value or amortization of—
(i) fixed assets;
(ii) investments; and
(iii) intangible assets;

(j) the amount charged for, or set aside for, the renewal or replacement of fixed assets;

(k) in respect of each class of debts shown separately in the accounts or group accounts—
(i) the amount of bad debts written off in the profit and loss account:
(ii) the amount of bad debts written off against any provision, reserve or other account, stating the name of the provision, reserve or account and the amount written off against it; and
(iii) the amount of debts on which interest or credit charges that is or are due has or have not been brought fully to account in the profit and loss account, whether or not a provision for doubtful debts has been made in respect of those debts:
(1) in respect of each class of debts shown separately in the accounts or group accounts, the amount set aside to any provision for doubtful debts;

(m) separately, the total of the emoluments received, or due and receivable (whether from the company of from a related corporation), by—

(i) directors of the company engaged in the full-time employment of the company and its related corporations (including all bonuses and commissions received or receivable by them as employees but not including the amount received or receivable by them by way of fixed salary as employees); and

(ii) other directors of the company, including in each case, commissions for subscribing for, or agreeing to procure subscriptions for, any shares in or debentures of the company or any related corporation, and the portion (if any) of the total amount contributed or to be contributed otherwise than by the company but not including, in either case, emoluments received, or due and receivable, by a director of the company who is not resident in Australia from a holding company of which he is a director or employee and which is a corporation formed outside Australia and the external Territories, being emoluments received, or due and receivable, by him as such a director or employee; and

(n) the amounts (including benefits in kind) received, or due and receivable, by the auditors for their services to the company, separate amounts being shown in respect of—

(i) the auditing of the accounts or group accounts; and

(ii) other services,

and the portion of each such amount contributed or to be contributed otherwise than by the company, with a statement whether the auditors receive any other benefits, and, if so, the general nature of those benefits.

(2) There shall also be shown in the accounts or group accounts in respect of the financial year (whether by way of note or otherwise) the amount set aside for the payment of income tax attributable to the financial year.

3. There shall be shown in the accounts or group accounts in respect of the financial year (whether by way of note or otherwise), separately—

(a) the amount of unappropriated profits or accumulated losses (however described) at the beginning of the financial year;

(b) the net amount of profit or loss after providing for payment of income tax attributable to the financial year;

(c) any amount set aside to any provision for the payment of income tax attributable to a period other than the financial year;

(d) any amount set aside or proposed to be set aside to any reserve, stating the origin of that amount;

(e) any amount withdrawn, or proposed to be withdrawn, from any reserve;

(f) any amount set aside to a provision (other than a provision specifically provided for in this Schedule);

(g) any amount withdrawn from any provision where the amount withdrawn was not applied for the purposes of the provision;

(h) any amount set aside for redemption of share capital or of loans;

(i) the amount of dividends paid during the financial year and the amount of dividends proposed to be paid, excluding any amount shown in a profit and loss account or balance-sheet relating to a previous financial year as an amount proposed to be paid by way of dividends;

(j) the amount of any appropriation or adjustment that affects the amount of unappropriated profits or accumulated losses at the end of the financial year; and

(k) the amount of unappropriated profits or accumulated losses (however described) at the end of the financial year.
4. Where in accounts of a company or in group accounts the amount set aside for the payment of income tax attributable to the financial year differs, or but for compensatory items would differ, by more than 15 per cent from the amount of income tax that would be payable by the company or by the company and its subsidiaries of its taxable income for that year were equal to the amount shown in or ascertainable from the accounts or group accounts as being the amount of the net profit or loss before provision is made for the payment of income tax attributable to that year, there shall be set out an explanation of the difference, including a statement of the major items responsible for the difference and the amount, or estimated amount, of those items.

5. (1) There shall be shown separately in the accounts or group accounts as at the end of the financial year (whether by way of note or otherwise)—

(a) the amount and particulars of authorized capital, calls in arrear and paid-up capital, a distinction being drawn in those amounts and particulars between any different classes of shares;

(b) the nominal value of shares in the capital of the company in respect of which options are outstanding, the amount of premium (if any) payable in respect of those shares and particulars of the options;

(c) where any part of the capital consists of preference shares—

(i) the rate of dividend on each class of preference shares;

(ii) the amount of arrears of dividend on each class of preference shares;

(iii) whether the preference shares are cumulative, non-cumulative, participating or non-participating;

(iv) whether the preference shares are to be redeemed or at the option of the company are liable to be redeemed; and

(v) if the preference shares are to be redeemed or at the option of the company are liable to be redeemed—the date on or before which they are to be redeemed, or are liable to be redeemed, the earliest date on which the company has power to redeem them, and—

(A) if the preference shares are to be redeemed, or are liable to be redeemed, at a premium—the amount of the premium; or

(B) if the preference shares are to be redeemed, or are liable to be redeemed, at a discount—the amount of the discount;

(d) the amount of capital that is not capable of being called up except in the event of, and for the purposes of, the winding up of the company;

(e) the amount of capital upon which interest has been paid out of capital during the financial year (and the rate of interest so paid);

(f) where the company is a no liability company—

(i) the number of shares forfeited and remaining unsold; and

(ii) the number of shares forfeited during the financial year showing the number of shares forfeited in respect of each call and the amount of each such call;

(g) the amount of reserves of all descriptions, a separate amount being shown for each class;

(h) the amount of the share premium account;

(i) the amount of unappropriated profits or accumulated losses (if any) as shown under paragraph 3(i), any accumulated losses (in so far as they have not been written off) being shown as a deduction from the amount of paid-up capital and reserves; and
(k) the amount and particulars of provisions there being
   (i) the amount of any provision for depreciation, amortization of assets shown as deductions from the respective assets;
   (ii) the amount of any provision for doubtful debts shown as from the amounts of the respective debtor's accounts to which the provision relates;
   (iii) the amount of provision for income tax, a distinction being drawn between the amount provided for current liability and that provided for future liability, and any amount provided for the purposes of its being used to counter the effect of undue fluctuations in liability for income tax being shown separately; and
   (iv) the amount and purpose of any other provision shown, if appropriate, as a deduction from the amount of the asset to which the provision relates.

(2) There shall be shown in the accounts or group accounts at the end of the financial year (whether by way of note or otherwise) the amounts and descriptions of all current liabilities and non-current liabilities, under headings appropriate to the business of the company or of the company and its subsidiaries, and arranged in classes under those headings according to their nature or function in the business, each of the following being shown separately:
   (a) bank loans;
   (b) bank overdrafts;
   (c) debentures held by—
      (i) subsidiaries;
      (ii) the holding company;
      (iii) other related corporations; and
      (iv) other persons;
   (d) the amount due to trade creditors and on bills payable;
   (e) other amounts payable to—
      (i) subsidiaries;
      (ii) the holding company; and
      (iii) other related corporations;
   (f) the aggregate amount, or estimated aggregate amount, and particulars of capital expenditure contracted for, so far as the amount has not been provided for; and
   (g) the aggregate amount, or estimated aggregate amount, and particulars of lease and hire expenditure contracted for so far as the amount has not been provided for, and the amount of that expenditure which is payable within 12 months after the end of the financial year; and
   (h) the amounts and descriptions of other liabilities and particulars of their nature.

(3) There shall be shown in the accounts or group accounts, if not otherwise shown, as at the end of the financial year (whether by way of note or otherwise), contingent liabilities with a statement as to the general nature of those liabilities and so far as practicable, the maximum amount, or an estimate of the maximum amount, for which the company or the company and its subsidiaries could become liable in respect of those liabilities.

(4) There shall be shown separately in the accounts or group accounts at the end of the financial year (whether by way of note or otherwise) the amounts and descriptions of all fixed assets, intangible assets, current assets, investments and
assets of any other kind, under the headings appropriate to the business of the company or of the company and its subsidiaries, and arranged in classes under those headings according to their nature or function in the business, the following being shown separately:

(a) cash at bank and in hand;
(b) stock on hand, divided, where appropriate, into raw materials, finished goods, work in progress and other stock;
(c) government, municipal and other public debentures, stock and bonds;
(d) shares in—
   (i) the holding company;
   (ii) subsidiaries;
   (iii) other related corporations; and
   (iv) other corporations;
(e) options in respect of shares in—
   (i) the holding company;
   (ii) subsidiaries;
   (iii) other related corporations; and
   (iv) other corporations;
(f) debentures of each of the following—
   (i) the holding company;
   (ii) subsidiaries;
   (iii) other related corporations; and
   (iv) other corporations;
(g) the amount due from trade debtors and on bills receivable;
(h) amounts of interest due from each of the following;
   (i) the holding company;
   (ii) subsidiaries;
   (iii) other related corporations; and
   (iv) other persons,
that are not brought to account in the profit and loss account:
(i) other amounts receivable from—
   (i) the holding company;
   (ii) subsidiaries;
   (iii) other related corporations; and
   (iv) other persons;
(j) subject to sub-clause (6), the total amount outstanding of any loans made, guaranteed or secured by the company, or by the company and its subsidiaries, being loans made to—
   (i) a director of the company, a spouse of such a director, or a relative of such a director or spouse:
   (ii) a director of a corporation that is related to the company, a spouse of such a director or a relative of such a director or spouse;
   (iii) a trustee of a trust under which a person referred to in sub-paragraph (i) or (ii) has a beneficial interest; or
   (iv) a corporation, where a person referred to in sub-paragraph (i) or (ii) has, or 2 or more such persons together have, a direct or indirect beneficial interest in shares in the corporation the nominal value of which is not less than 10 per cent of the nominal value of the issued share capital of the corporation;
(k) the aggregate of the amounts of any items of goodwill and of any patents and trademarks, to the extent that they have not been written off;
the amounts of each of the following, to the extent that they have not been written off—

(i) preliminary expenses;
(ii) expenses incurred in connection with any issue of shares or debentures;
(iii) sums paid by way of commission in respect of any shares or debentures;
(iv) sums allowed by way of discount in respect of debentures; and
(v) sums allowed by way of discount on any issue of shares; and

(m) the amounts and descriptions of other assets, with particulars of their nature.

(5) There shall be shown in the group accounts the net amount of consolidated profit or loss of the group for the financial year after provision for income tax, showing separately the extent to which each corporation in the group contributed to that consolidated profit or loss, and after deducting from that consolidated profit or loss any amounts that should properly be attributed to any person other than a corporation in the group.

(6) Where a company makes a loan to a corporation, or gives a guarantee or provides security in connection with a loan made to a corporation, a person or persons shall not be taken for the purposes of paragraph (4)(j) to have a beneficial interest in shares in the corporation by reason only that the company has a relevant interest or relevant interests in shares in the corporation and the person or persons has or have a relevant interest or relevant interests in shares in the company.

6. (l) In respect of each liability or contingent liability shown in the accounts or group accounts, being a liability the payment of which is secured by a charge on assets of the company or of the company and its subsidiaries, whether registered or unregistered, there shall be shown a statement that is secured and the extent to which is secured and each such liability or contingent liability shall be distinguished from any other liabilities or contingent liabilities the payment of which is not so secured.

(2) Current liabilities and current assets shall be clearly distinguished from other liabilities and assets.

(3) Where by reason of the manner in which the records of a company were kept before the date of commencement of section 81 of the Companies Ordinance 1973 [or the equivalent provision in State Companies legislation] it is not possible to show separately the amounts of any classes of assets or liabilities required by this Schedule to be separately shown, there shall be shown the total amount of assets or liabilities of those classes acquired or incurred before that date, and the separate amounts of assets or liabilities of those classes acquired or incurred after that date.

7. (1) In respect of all fixed assets, investments, stock on hand and work in progress shown in the balance-sheet there shall be stated the method of arriving at the respective amounts of the assets, investments, stock or work in progress, and when more than one method is used, a separate total shall be shown in respect of each of the methods used.

(2) There shall be shown in respect of each class of fixed assets or investments referred to in the accounts or group accounts—

(a) the cost of the assets or investments of that class or (at the option of the directors) where they have been valued, the amount of the assets or investments of that class as so valued, and, where the valuation applies only to part of such a class, separate totals for such of the assets as have been valued and for the remainder of the assets of that class;
(b) the aggregate amount written off in respect of each class or part of a class since the date of acquisition or valuation, as the case may be; and

c) the difference between the amounts shown under paragraph (a) and paragraph (b).

(3) For the purposes of sub-clause (2), the net amount at which any asset stood in the company's records at the date of the commencement of section 81 of the Companies Ordinance 1973 [or the equivalent provision in State Companies legislation] (after the deduction of the amounts previously provided or written off for depreciation, diminution in value or amortization) shall, if the figures relating to the period before that date cannot be obtained without unreasonable expense or delay, be treated, until a valuation is made, as if it were the amount of a valuation of those assets made on that date, and, where any of those assets are sold, that net amount (less the net amount at which the assets sold stood in the records as at that date, or, if no separate amount is available, their estimated value as at that date) shall be treated as if it were the amount of a valuation of the remaining assets made on that date.

(4) Paragraphs (2)(b) and (c) do not apply to fixed assets the replacement of which is dealt with wholly or partly—

(a) by making any provision for renewal or replacement and charging the cost of renewal or replacement against that provision; or

(b) by charging the cost of renewal or replacement directly against revenue, but in respect of those assets there shall be stated—

(c) the method by which their renewal or replacement is dealt with; and

(d) the aggregate amount of the provisions (if any) made for renewal or replacement and not used.

(5) If any investments of a class for which paragraph 5(4)(d), (e), (f) or (g) requires a separate amount to be shown are listed for quotation on the stock market of a stock exchange in Australia or elsewhere that is specified in regulation 16, a separate total shall be shown for the quoted investments of that stock exchange in Australia or elsewhere that is specified in regulation 16, or for the quoted investments of each class, and there shall also be shown the aggregate quoted market value, calculated on the official quotation of that stock market, of the quoted investments of each class.

(6) Where the amount of any fixed asset or investment (other than an investment the quoted market value of which has been included in an aggregate market value in accordance with sub-clause (5)) is shown at a valuation or at a valuation less amounts written off, there shall be shown whether by way of note or otherwise the date of the valuation, and whether the valuation was made by an officer of the company or of a related corporation or by a person not being such an officer.

(7) If the valuation referred to in sub-clause (6) was made on or after the date of commencement of section 81 of the Companies Ordinance 1973 [or the equivalent provision in State Companies legislation] by a person not being such an officer, the name of the person who valued it and particulars of his qualifications shall be shown in the first accounts in which reference is made to the valuation.

(8) For the purposes of sub-clause (6), the expression "officer's valuation" may be used to indicate a valuation made by an officer of the company or of a related corporation and the expression "independent valuation" may be used to indicate a valuation made by a person not being such an officer.

(9) In addition to any other information required to be shown, there shall be shown separately (whether by way of note or otherwise), in respect of land or interests in land acquired or held for sale or resale, to the extent to which they have not been written off—
(a) the total cost of acquisition (exclusive of any cost of surveys, roads and drainage and other development expenses);
(b) the total of any development expenses capitalized; and
(c) the total of any amounts of rates, taxes or interest and any other amounts capitalized.

8. There shall be shown (whether by way of note or otherwise) in the balance-sheet of every company that is a borrowing corporation or a guarantor corporation a schedule setting out, separately, estimates of the amounts payable by, and the debts payable to the company—
(a) not later than one year;
(b) later than one year but not later than 2 years;
(c) later than 2 years but not later than 5 years; and
(d) later than 5 years.

after the end of the financial year.

9. The accounts of a company that is a subsidiary of another corporation shall state (whether by way of note or otherwise) the name of the corporation that the company believes to be its ultimate holding company and, if known to the company, the country in which that ultimate holding company is incorporated.

10. (1) Group accounts of a holding company shall state (whether by way of note or otherwise)—
(a) the name and place of incorporation of each subsidiary, and if any business of the subsidiary is carried on in a country other than Australia, the name of the country;
(b) the amount of the holding company's investment in each class of the share capital of each subsidiary;
(c) the percentage of each class of the shares in each subsidiary held by the holding company; and
(d) where the financial year of a subsidiary does not coincide with the financial year of the holding company, the date on which the financial year of the subsidiary ends.

(2) Where any consolidated accounts are to be laid before a holding company at its annual general meeting, transactions and balances between the corporations covered by the consolidated accounts shall be eliminated in determining any amounts to be stated in the consolidated accounts.

(3) Subject to sub-clause (4), where separate accounts of a subsidiary are to be laid before the holding company at its annual general meeting as part of the group accounts, the accounts of the subsidiary shall as far as practicable be in the same form as the accounts of the holding company.

(4) In the case of a subsidiary incorporated outside the Territory (whether or not it has established a place of business in the Territory), it is sufficient compliance with the provisions of sub-clause (3) if the accounts of the subsidiary—
(a) are in such form;
(b) are reported on by an auditor in such manner;
(c) contain such particulars; and
(d) include or are accompanied by such documents (if any), as is or are required by the law of its place of incorporation concerning accounts to be laid before the subsidiary in general meeting.

(5) Where group accounts are prepared otherwise than as one set of consolidated accounts covering the group, the directors of the holding company shall certify on, or in a certificate attached to, the accounts—
(a) that the preparation of one such set of consolidated accounts is impracticable or that it is preferable, in the interest of the shareholders, that the accounts be prepared in the form in which they are prepared (as the case may be), for reasons to be stated in the certificate; and

(b) that, in the opinion of the directors, the accounts so prepared are not significantly affected by transactions and balances between the corporations covered by the accounts, except to the extent stated in any notes forming part of the accounts.

(6) Where any accounts included in group accounts laid before a holding company at its annual general meeting are presented in a form or grouping different from that in which the immediately preceding group accounts (if any) were so laid, the directors shall certify on, or in a certificate attached to, the accounts the names of the corporations the accounts of which have been so presented and the reasons for presenting them in that form or grouping.

(7) A certificate under sub-clause (5) or (6) shall be signed by not less than 2 directors.

11. All amounts shown in the accounts or group accounts shall be expressed in Australian currency and, where any conversion has been made other than on the basis of the rate of exchange current at the end of the financial year of the company or holding company, an explanation of the methods used in calculating the conversion shall be given.

12. (1) Except in the case of the first accounts after the incorporation of the company and in the case of the first group accounts after the company becomes a holding company, there shall be shown—

(a) in every balance-sheet and in all notes attached to that balance-sheet the corresponding amounts as at the end of the immediately preceding financial year; and

(b) in every profit and loss account and in all notes attached to that profit and loss account the corresponding amounts for the corresponding period of the immediately preceding financial year.

and, where the respective financial years are not equal in length, the periods covered shall be clearly indicated by way of note or otherwise.

(2) If—

(a) the balance-sheet or notes attached to that balance-sheet do not include an item corresponding to an item in the balance-sheet or notes attached to that balance-sheet as at the end of the immediately preceding financial year; or

(b) the profit and loss account or notes attached to that profit and loss account do not include an item corresponding to an item in the profit and loss account or notes attached to that profit and loss account covering the corresponding period of the immediately preceding financial year,

that previous item and the amount of that previous item shall be shown.

13. (1) Where the accounts or group accounts could be misleading by reason of a failure to explain the method used in dealing with, or calculating the amount of, any item or information included in or excluded from the accounts or group accounts, there shall be stated (whether by way of note or otherwise) the method used to deal with, or calculate, the amount of the item or information.

(2) Any sums that consist of or are in the nature of interest, accommodation charges, service charges, maintenance charges or insurance premiums, being income that has not been earned at the end of the financial year, shall not be included in any estimate of the gross amount of any of the following classes of debts owed to the company or to the company and its subsidiaries:

(a) debts payable not later than one year after the end of the financial year;

(b) debts payable later than one year but not later than 2 years after the end of the financial year;

(c) debts payable later than 2 years but not later than 5 years after the end of the financial year;

(d) debts payable later than 5 years after the end of the financial year,

unless the amount of unearned income so included is shown as a deduction from the estimate of the gross amount of the class of debts concerned.

(3) A short statement of the method by which the amount of unearned income has been calculated shall be included in the accounts or group accounts (whether by way of note or otherwise).
APPENDIX TWO : SAMPLE COPIES OF LETTERS INVITING

COMPANIES TO PARTICIPATE IN THE FIELD STUDY
Dear

I write to seek your assistance with a research project I am completing at The University of Melbourne.

The objective of my research project is to make recommendations towards an appropriate reporting framework for small companies. In Australia most research in the area of financial reporting is completed by the National Companies and Securities Commission and the Accounting Research Foundation. The focus of these bodies to date has been publicly-owned companies. Little regard has been paid to the issue of whether the reporting needs of small privately-owned companies differ from those of publicly-owned companies.

Results from the study are intended to assist the future development of financial reporting in Australia and ensure that reporting requirements for small companies provide meaningful and relevant information to the users of those companies' financial reports.

As part of this research, I intend to discuss with the managements of small companies the use made of the companies' financial statements, and the influence of statutory and professional recommendations on their preparation. The discussions held will be based on the matters raised in the enclosed questionnaire.

I hope that you are able to assist me in this research by setting aside half an hour or so to discuss the matters with me. I shall contact you by telephone within the next week to arrange a meeting at a time convenient to you.

The confidentiality of the data collected during my discussions with you will be assured at all times, and care will be taken to ensure that it is not possible to identify an individual's response in any published works.

Yours faithfully,

Jan McCahey.

Parkville, Victoria 3052, Australia. Telephone 03 344 5350 Telex AA35185 UNIMEL Cables UNIMELB
Dear Mrs Jan McCahey, a lecturer in this Department, is aimed at developing a reporting framework for small com

With the encouragement and assistance of the Sm she has selected a sample of small privately-owned o was one of those selected, I am writing to ask for you project.

We should be very grateful if you would take the yourself with the material in the questionnaire and to raised with Mrs McCahey.

I also take this opportunity to reinforce Mrs McCahey's a regarding the confidentiality of the information you provide.

Sincerely,

C.J. Warrell,
Chairman.
Name of company:

Number of employees at present:

Number of shareholders:

Book value of assets:

Title of respondent:
1. Please indicate which of the groups listed below are financial statements of your company. Rank them in order of importance. (Give a rank of 1 to the most important):

- Bank lending officers
- Management
- Creditors
- Competitors
- Owners of the company who are not managers

2. How many times in the last year have you had cause to "see" publicly filed information about a debtor or competitor?

- Nil
- 1
- 2
- 3-5
- more than 5
3. How do you assess the credit-worthiness of a new debtor?

- Personal contacts
- Trade reference
- Bank reference
- Ask to see accounts
- Mercantile agency advice
- Other

4. In general, how important do you believe that each of the following factors is in obtaining bank loans for your company?

- Credit history
- Having your accounts audited
- Preparing monthly management reports

5. Were your accounts audited in 1985? If so, for what reason?
(Rank 1-4 in order of importance)

- To avoid having to lodge accounts publicly
- To comply with bank lending requirements
- To promote effectiveness of operations
- To avoid being audited by the Taxation Office
6. (a) Is your accountant sufficiently qualified in terms of legal requirements and accounting standards to prepare your financial accounts?

(b) Do you employ a public accounting firm to assist with year-end accounting procedures?

7. The following have been suggested as reasons for establishing a special set of accounting standards for privately held companies. Please indicate the extent to which you see each of these as an appropriate reason for establishing this set.

- It would increase the usefulness of published financial statements to management
- It would increase the usefulness of published financial statements to outside users
- It would reduce the degree of accounting sophistication demanded of business managers
- It would reduce the cost of applying generally accepted accounting principles
8. In general, do you consider that small companies shareholders:

- Less information than at present
- About the same information as present
- More information

9. What would you suggest as an appropriate base for differentiating private companies from others:

- Number of employees
- Book value of assets
- Turnover
- Combination of the above
- Other
APPENDIX THREE : QUESTIONNAIRE USED AS

THE STRUCTURED INTERVIEWS
Questionnaire

Name of company:

Number of employees at present:

Number of shareholders:

Book value of assets:

Title of respondent:
1. Please indicate which of the groups listed below are the users of the financial statements of your company. Rank them in terms of their importance. (Give a rank of 1 to the most important users).

- Bank lending officers
- Management
- Creditors
- Competitors
- Owners of the company who are not managers

2. What sort of accounts do you make available to the

3. How many times in the last year have you had cause publicly filed information about a debtor or corr

- Nil
- 1
- 2
- 3-5
- more than 5

4. What was the reason for your search(es)?
5. How do you assess the credit-worthiness of?

- Personal contacts
- Trade reference
- Bank reference
- Ask to see accounts
- Mercantile agency advice
- Other

6. Within your organisation, who makes the decision:

Who manages debtors on an on-going basis?

7. In general, how important do you believe that each factor is in obtaining bank loans for your company?

- Credit history
- Having your accounts audited
- Preparing monthly management reports

8. What accounts would you provide in support of a loan application?

9.(a) What is the ease of obtaining a fully secured loan – Is the emphasis of the lender primarily on the amount of security?

(b) Are banks willing to lend on an unsecured basis?
10. What sort of accounting system do you use?

11. What is your background?

12. Is your accountant formally qualified?

13. Is he a member of the Australian Society of A
    Institute of Chartered Accountants?

14.(a) Is your accountant sufficiently qualified in terms of requirements and accounting standards to prepare accounts?

(b) Do you employ a public accounting firm to assist with accounting procedures?

15. Were your accounts audited in 1985? If so, for what reason?
    (Rank 1-4 in order of importance)
    - To avoid having to lodge accounts publicly
    - To comply with bank lending requirements
    - To promote effectiveness of operations
    - To avoid being audited by the Taxation Office
16. Will you have your accounts audited in

17. What is your view regarding the usefulness of the requirement as proposed for simplified accounting standards for privately held enterprises?

18. The following have been suggested as reasons for establishing this set of accounting principles:
Please indicate the extent to which you see each as an appropriate reason for establishing this set.

- It would increase the usefulness of published financial statements to management.
- It would increase the usefulness of published financial statements to outside users.
- It would reduce the degree of accounting and auditing practices among private business managers.
- It would reduce the cost of applying generally accepted accounting principles.

19. When examining financial statements, what deficiencies or omissions have caused you difficulty?
20. In general, do you consider that small companies should present to shareholders:

- Less information than at present
- About the same information as present
- More information

21. What particular accounting variables do you consider important indicators of the performance of private companies? Do you monitor these?

22. Do you consider that privately owned companies should report to parties other than shareholders?

23. What would you suggest as an appropriate base for comparing private companies from others:

- Number of employees
- Book value of assets
- Turnover
- Combination of the above 3
- Other


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