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1992

# Accounting Standards Overload Problem - A Suggested Solution

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## Publication Details

This working paper was originally published as Shannon, RP, Accounting Standards Overload Problem - A Suggested Solution, Accounting & Finance Working Paper 92/38, School of Accounting & Finance, University of Wollongong, 1992.

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ACCOUNTING STANDARDS OVERLOAD  
PROBLEM -A SUGGESTED SOLUTION

by

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November 1992

WORKING PAPER NO. 38

**ACCOUNTING STANDARDS OVERLOAD PROBLEM - A SUGGESTED  
SOLUTION**

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**ABSTRACT**

The paper supports the Australian approach to differential reporting as the best solution to the accounting standards overload problem.

The approach requires a technique for differentiating "reporting" and "non-reporting" entities. The paper suggests a technique for such differentiation which is thought to be superior to the current suggested technique.

Finally, the paper suggests that non-reporting entities should still ensure appropriate information is produced which not only assists management in their decision making but also provides government with details which can be used in the formulation of policies to assist them in the future.

## INTRODUCTION

Recent accounting profession sponsored empirical studies in the United States of America (FASB Invitation to Comment 1983 and Abdel-khalik 1983), United Kingdom (Carsberg et al 1985) and Australia (McCahey and Ramsay 1989) have found evidence that accounting standards applicable to small and/or closely-held entities are excessive in number and complexity. The studies have thus confirmed the status of what had previously been an alleged problem - termed in the literature "accounting standards overload problem".

To resolve this problem, the studies have each made suggestions for small and/or closely-held entities to be given exemption from the requirements to comply with all or certain accounting standards. This solution has been termed "differential reporting".

More specifically, each country has appeared to support a different approach to differential reporting. The USA saw differential disclosure for certain entities as appropriate but appeared to remain opposed to differential measurement standards. The UK envisaged differential disclosure and measurement for certain entities as appropriate. These two countries hence support differential reporting based on a standard-by-standard basis, with each new standard bringing with it questions of which entities are to be exempted.

Australia, in contrast, following the direction taken in its proposed conceptual framework, supports an entirely different approach to differential reporting. Their solution involves differentiating "reporting" and "non-reporting" entities on the basis of whether it is reasonable to expect that there exists users dependent on general purpose financial reports or not. Entities which are differentiated as "non-reporting" are given exemption from the requirement to prepare general purpose financial reports prepared in accordance with the accounting standards. The Australian solution hence supports a unique comprehensive form of differential reporting based on an entity-by-entity basis, rather than the USA and UK standard-by-standard basis.

This paper supports the Australian approach to differential reporting as the best solution to the accounting standards overload problem. Further, the paper suggests a technique for identifying if an entity is a "reporting" or a "non-reporting" entity which is thought to be superior to the suggested technique advocated by the Australian profession.

Finally, the paper recommends that "non-reporting" entities should not neglect producing understandable, relevant, reliable, timely and cost-effective information which can assist management decision making and provide government and multiplier agencies with details which can be used in the formulation of policies to assist them in the future.

**DIFFERENTIATION ON AN ENTITY-BY-ENTITY BASIS.**

In April 1988, the Australian Accounting Research Foundation (AARF) issued as part of its conceptual framework, proposed Statement of Accounting Concept ED46A entitled "Definition of the Reporting Entity".

This statement contained two particularly important paragraphs from the point of view of the accounting standards overload problem.

Firstly, paragraph 37 defined "reporting entities" as "entities in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports (GPFR) for information which will be useful to them for making and evaluating decisions on the allocation of scarce resources". (This definition implies that "non-reporting entities" are entities which would not be expected to have users dependent on GPFR.)

Secondly, paragraph 38 stated that "reporting entities shall prepare general purpose financial reports prepared in accordance with Statements of Accounting Concepts and Statements of Accounting Standards". (This statement implies that non-reporting entities are not required to prepare GPFR prepared in accordance with Statements of Accounting Concepts and Statements of Accounting Standards).

In summary, ED46A supports a unique comprehensive form of differential reporting on an entity-by-entity basis, rather than a standard-by-standard basis. If an entity is not expected to have external users dependent on GPFR (financial reports prepared in accordance with accounting standards) it should not be required to prepare such reports.

This solution to the accounting standards overload problem appears to be well supported by the literature.

Financial reports prepared in accordance with accounting standards have long been criticised for their lack of relevance to small and/or closely-held entities and their primary financial statement users - management.

McCahey (1986) found that the management of private companies make only limited use of financial reports because they are able to obtain financial information for decision making purposes without needing to refer to formal financial reports and because they have little knowledge or understanding of the accounting standards on which the reports are based.

Ramsay and Sutcliffe (1986) argue that very low levels of compliance with accounting standards by unaudited exempt proprietary companies is evidence of their irrelevance to such companies.

Shanahan (1987) found that financial statements prepared in accordance with accounting standards did not serve the information or decision needs of small business proprietors. In the areas of "management" and "control", Shanahan perceived that measures should reflect the particular characteristics of the small business concerned, rather than be constrained by a rigid set of standardised pro-forma accounts. In the area of "cash flow", he perceived that existing standards still had a long way to go, and in the area of "commitments", he stated that existing standards only gave limited recognition.

The US study by Abdel-khalik (1983 p58) showed that of ten accounting standards examined, only three (statement of changes in financial position, accounting for inventories, and accounting for contingencies) were considered to be highly relevant to private companies and not overly complex by the accountants and managers surveyed.

Similar results were obtained in the UK. Here, the Carsberg et al (1985 p62) study showed that only standards dealing with fundamental topics (disclosure of accounting policies, extraordinary items, stock, and depreciation) were well accepted as applicable to small businesses by auditors. Unlike in the USA, strong exception was taken to the standard requiring the funds statement.

Recently, arguments have also arisen that accounting standards may not only be irrelevant to small and/or closely-held entities but may also be contributing to a reduction in the quality of their financial reporting.

Henderson (1988) advances two reasons to support this argument:

First, the production of accounting standards has resulted in a massive increase in the information content of financial statements and a growing use of technical jargon. Henderson asserts that this increase in bulk and jargon has reduced financial statements' ability to communicate relevant information to statement users. This assertion is particularly true for small and/or closely-held entities where non-expert users predominate.

Second, under contemporary accounting standards, Henderson asserts that it is doubtful whether the balance sheet now gives much indication of financial position when it is stacked with an increasing number and amount of deferred debits and deferred credits left over from what he describes as a pseudo matching process. These leftover debits and credits have no commercial significance to most users of small and/or closely-held entities' financial statements.



### TECHNIQUE FOR DIFFERENTIATING REPORTING/NON-REPORTING ENTITIES.

The Australian approach to differential reporting requires a technique for differentiating "reporting" and "non-reporting" entities. That is, it requires a technique to identify if an entity can or cannot be expected to have users dependent on general purpose financial reports.

ED46A paragraphs 18-20 offers some guidance by suggesting three primary factors which together or individually could indicate the existence of users dependent on GPFR.

Factor 1 Reporting entities will have greater separation between management and owners/members or others with an economic interest in the entity. (Para. 18).

The implications of this factor are that entities such as public companies, listed trusts and most public sector entities would be identified as reporting entities, whereas entities such as sole traders and, if the owners participate as managers, exempt proprietary companies would not necessarily be reporting entities.

Factor 2 Reporting entities will have greater economic or political importance (i.e. ability to make "significant" impact on the welfare of external parties) (Para. 19).

Entities which are likely to be identified as reporting entities because of this factor are likely to include organisations which enjoy dominant positions in markets and those which are concerned with balancing the interests of significant groups, for example, employer/employee associations and public sector entities which have regulatory powers.

Factor 3 Reporting entities will have larger size (for example, value of sales, purchases or assets, number of employees and customers) or greater indebtedness or resources allocated. (Para. 20).

Entities which may be identified as reporting entities because of their size include exempt proprietary companies which attract a special public interest because they have a large number of employees or very high turnover. Similarly, some public sector entities may not be regarded as reporting entities because the amount of resources that they are responsible for is insignificant.

By implication, it would seem, non reporting entities would have lesser separation of management from economic interest; lesser economic and political importance and smaller size and lesser indebtedness or resources allocated.

The three suggested factors are weak for the following reasons:

Firstly, factors 1 and 3 conflict with the view presented by Stanga & Tiller (1983 p.64) who pointed out that no empirical evidence has been offered to indicate that users needs differ depending on size or ownership characteristics of entities. A later paragraph in ED46A indeed admits "the existence of a range of users dependent on GPFR is not determined by either size or the ownership characteristics of the entity" (Para.33).

Secondly, factors 1, 2 and 3 give little guidance to judgement makers who have to differentiate "reporting" and "non-reporting" entities because they are extremely arbitrary and contain "weasel words" (e.g "significant") which allow a great deal of discretion.

Thirdly, para 17 admits other unspecified factors may also be relevant to whether an entity is a "reporting" or a "non-reporting" entity. Specifying such other factors could have been of some assistance to judgement makers. Not specifying them confuses the issue.

**PREFERRED APPROACH TO DIFFERENTIATING REPORTING/NON-REPORTING ENTITIES.**

This paper suggests a preferred way to determine if an entity has users dependent on GPFR is for the entity to ask any such users to identify themselves.

Any user or potential user would need to apply to the entity's management, stating reasons why GPFR would be required. For example, a loan creditor may need GPFR in order to ensure that any loan conditions have been complied with; an absentee owner may need GPFR in order to determine whether continued support of the entity's activities is warranted; a potential purchaser of the business may need GPFR in order to make appropriate valuations. Approval by management of these requests could mean the gaining of a credit facility; the retention of the absentee owner's support; or the possible sale of the business. Rejection of the requests would probably mean loss of the line of credit; loss of the absentee owner's support; or loss of sale of the business. Management would need to balance the costs of producing GPFR (or cost saving of not producing GPFR) against possible gains, e.g. new loan (or possible losses, e.g. loss of loan) when making their decision.

Request for the provision of GPFR may also come from undesirable sources. For example, competitors who may wish to obtain information about, for example sales revenue. Approval here could put the entity at a marked disadvantage in relation to the competitor and thus impose an unreasonable burden on the entity. Rejection of the request would be in the entity's interest in such circumstances.

In rare situations, it is possible that a conflict may arise between management and a rejected user. Such conflicts would need to be dealt with by the courts.

Hence, under this preferred approach, "reporting" entities would be entities where management receives at least one request for GPFR and accepts that the cost of producing GPFR is less than the benefits gained. "Non-reporting" entities would be entities where management either does not receive any requests for GPFR or where management rejects any requests on the grounds that the cost saving from not producing GPFR is greater than the benefits lost by not producing GPFR.

**TECHNIQUE FOR DETERMINING WHAT INFORMATION SHOULD BE PRODUCED.**

For non-reporting entities, freed from the burden of preparation of GPFR prepared in accordance with the mire of compulsory accounting standards, the critical thing is that any information produced should not attempt to meet the needs of specific users for specific decisions. (Clarke 1988 p.65). Such an approach is an impossible task, as "we cannot say how people will use an object (financial statements), we can only make objective statements about the conditions in which an object (financial statements) is useful (Chambers 1974 p.97--words financial statements added).

Any information selected, measured and disclosed must therefore be understandable, relevant, reliable, timely and cost-effective if it is to assist management in their decision making. For non-reporting entities, understandability of information should assume much greater importance than for reporting entities. Management of such entities often have highly independent personalities which discourages them from seeking any explanation about information they do not understand. A set of recommendations entitled by Kao (1985) "Accounting Standards Applied to Practice" could be developed to improve management's decision making.

Information should also be capable (when aggregated with other non-reporting entities) of highlighting the present plight of these entities (such as their low profitability and high failure rates) and provide government and multiplier agencies with details that can be used in the formulation of policies to assist them in the future.

## SUMMARY

This paper supports the Australian approach to differential reporting as the best solution to the accounting standards overload problem.

This approach requires the identification of "reporting" and "non-reporting" entities. "Non-reporting" entities are given exemption from the requirement to prepare general purpose financial reports prepared in accordance with the accounting standards.

Rather than reliance on the use of arbitrary descriptive factors to distinguish "reporting" from "non-reporting" entities as advocated by the Australian profession, the paper alternatively suggests each entity should ask any users (or potential users) who are dependent on general purpose financial reports to identify themselves. "Non-reporting" entities would be entities where management either does not receive any requests for general purpose financial reports or where management rejects any requests on the grounds that the cost saving from not producing general purpose financial reports is greater than the benefits lost.

Finally, the paper suggests that non-reporting entities should ensure that priority is given to producing understandable, relevant, reliable, timely and cost-effective information which not only assists management in their own decision making but also publicises their plight and provides government with details which can be used in the formulation of policies to assist them in the future.

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