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# AN APPROACH TO REDUCING ACCOUNTING COSTS FOR SMALL BUSINESSES

**J. Gregory Bushong, Ph.D., CPA, CMA**
Wright State University

**David W. Cornell, Ph.D., CPA, CMA**
University of Missouri-Kansas City

## ABSTRACT

*Many small privately-held businesses (referred to as small businesses henceforth) prepare financial statements for use by external parties such as banks. Often the small businesses do not have the expertise to prepare these financial statements, instead employing independent certified public accountants (CPAs) for the task. A CPA preparing financial statements in this manner must attach a report stating the degree of responsibility he/she is accepting for the statements. Modification of this report results if the statements are not in conformance with generally accepted accounting principles (GAAP). Owners of small businesses generally elect to have their financial statements produced following GAAP to avoid the modification of the report. This has become a costly decision, however, as the complexity of GAAP has increased*

*The purpose of this article is to help small business owners reduce the cost of preparing their financial statements. The article begins with a discussion of the importance of selecting the right CPA to produce the financial statements. The article then reviews the CPA's level of association with financial statements and the reports that result therefrom. Finally, the article closes with possible reduction of accounting costs through the use of other bases of accounting.*

## HIRING A CERTIFIED PUBLIC ACCOUNTANT

An important decision while producing financial statements is the selection of an independent CPA. The business owner can select from CPA firms ranging in size from large international firms to one-person firms, and will be charged fees almost as varied in size. The selection of the right CPA can be difficult because of this, but there are several questions that the business owner can ask to help with the selection process. Table 1 lists some questions of a prospective CPA. An additional source of information is other business owners who have applied for loans previously. The lender may also provide information regarding preferred accountants.

Table I
<u>Useful Questions for Selecting a CPA</u>

The following list indicates some of the questions which can be asked of a prospective CPA

- Previous experience with SBA clients?
- Previous experience with the bank from which the loan will be obtained?
- Previous experience in the same or a similar industry?
- Experience level and qualifications of the staff working on the financial statements?
- Billing rates for the individuals working on the financial statements?
- Total anticipated bill for the services provided?
- How much would the bill change given different levels of association (i.e., compilation, review and audit)?
- Will the bill for the accounting services be reduced after the first year?
- Will tax services be provided and at what cost?
- Experience in incorporating a company?
- Will services be provided other than financial statement preparation?
- Will the CPA provide any management advice regarding the growth of the company and the control of costs?

## LEVELS OF CPA ASSOCIATION

The bank will also provide the loan applicant with information regarding the level of the CPA's association with the financial statements. The American Institute of Certified Public Accountants (AICPA) recognizes three levels of CPA association with financial statements; audit, review, and compilation. An audit provides the most assurance to the users of financial statements that the statements are not misstated. A review provides negative assurance, meaning that while an audit was not done, nothing came to the attention of the CPA to suggest that the financial statements are misstated. Finally, a compilation provides no assurance about the balances contained in the financial statements. See Wolk and Wooton (1995) for a more detailed discussion of the different levels of assurances provided by the CPA's report.

Businesses often assume that lending institutions require audited financial statements that comply with GAAP. In reality, banks are often willing to accept financial statements that are neither audited nor in compliance with GAAP. Deciding factors include the loan amount, complexity of the business, competence of the owner (including business and financial knowledge), the confidence the loan officer has in the CPA preparing the financial statements, and whether the loan is an asset-based or a cash-flow-based loan. Given certain combinations of these factors, SBA loans of up to one million dollars are granted based on tax returns and compiled financial statements. This would result in significantly lower accounting costs in comparison to audited financial statements. Additionally, the level of CPA association with the financial statements required by the bank may change over the life of the loan as the risk profile of the company changes.

Standard Reports Attached to Financial Statements

A different report will result from the three levels of assurance that the CPA can provide. The reports have standardized format and content. Tables 2, 3, and 4 contain the reports for an audit, review, and compilation of financial statements, respectively. The first paragraph of each report is general, describing the financial statements and the type of assurance the CPA is providing. The second paragraph of the reports describes the work done by the CPA in greater detail. In the compilation report the CPA says that he/she did not audit or review the financial statements and expresses no opinion or other assurance on them. Both the review and the audit report contain an additional paragraph in which the CPA states the results of his/her work. For an audit the result is the expression of the CPA's opinion regarding the financial statements. For a review the result is that the CPA is not aware of any required modification to the statements in order for them to conform to GAAP. The three reports show the different levels of assurance the CPA is providing about the financial statements.

Table 2
**Standard Audit Report**

**Independent Auditor's Report**

We have audited the accompanying balance sheet of Small Business, Inc., as of December 31, 1995, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Small Business, Inc., as of December 31, 1995, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

CPA Firm Name

January 29, 1996

**Source**

American Institute of Certified Public Accountants. *Statement on Auditing Standards No. 58*, "Reports on Audited Financial Statements." New York: AICPA. 1988.

Table 3

**Standard Review Report**

**Accountant's Report**

We have reviewed the accompanying balance sheet of Small Business, Inc., as of December 31, 1995, and the related statements of earnings, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Small Business, Inc.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

CPA Firm Name

January 29, 1996

**Source**

American Institute of Certified Public Accountants. *Statement on Standards for Accounting and Review Services No. 1*, "Compilation and Review of Financial Statements." New York: AICPA. 1978.

Table 4
<u>**Standard Compilation Report**</u>

**Accountant's Report**

We have compiled the accompanying balance sheet of Small Business, Inc., as of December 31, 1995, and the related statements of earnings, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

CPA Firm Name

January 29, 1996

**Source**

American Institute of Certified Public Accountants. *Statement on Standards for Accounting and Review Services No. 5*, "Reporting on Compiled Financial Statements." New York: AICPA. 1982.

## BASES OF ACCOUNTING

The reports shown in Tables 2 through 4 are the standard reports issued for each level of association. Modification of the reports results if financial statements do not follow GAAP. Just as lenders may be willing to accept less than audited financial statements, they may also be willing to accept non-GAAP financial statements. It is important the loan officer understand what the departures are and why they are not important to the financial statements. Therefore, the owner/manager of the small business and the independent CPA should meet with the lender and discuss any non-GAAP changes made to the statements. There are two broad classifications of departures; those classified as other comprehensive bases of accounting, and modified GAAP-basis financial statements.

## Other Comprehensive Basis of Accounting

The Auditing Standards Board (ASB) of the AICPA has identified the three comprehensive bases of accounting other than GAAP listed in Table 5. A discussion of each alternate basis follows.

Table 5
**Comprehensive Bases of Accounting Other than GAAP**

**Regulatory basis** - A basis of accounting used to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject.

**Income tax basis** - the basis of accounting the entity uses or expects to use to file its income tax return for the period covered by the financial statements.

**Cash basis** - the cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

**Source**
American Institute of Certified Public Accountants. *Statement on Auditing Standards No. 62*, "Special Reports." New York: AICPA. 1989.

### Regulatory Basis

An obvious way to reduce the cost of financial statement preparation is to produce the statements on a single basis each year. This removes the complexities of preparing different versions of the financial statements for different users. If the small business is subject to accounting principles established by a regulatory agency, then using that basis for external reporting will reduce the cost of financial reporting. Consulting with external lenders as to the acceptability of these statements is an important first step taken by the owner/manager. The discussion may include an analysis of how the accounting principles differ between regulatory and GAAP. Additionally, the lender may be accustomed to receiving regulatory-basis financial statements for companies in the regulated industry, and may actually prefer that basis of accounting for comparison purposes.

### Tax Basis

Similar to regulatory basis financial statements, tax basis financial statements reduce accounting costs by preparing the financial statements only once. This benefits the business, and may be acceptable to many external users who are familiar with the tax laws. The primary problem with use of the tax basis of accounting is that tax laws are changing continuously. There has been a major revision of the tax code approximately every two years since the mid 1970s. Changes in the tax code can result in changes in income and financial position when tax basis financial statements are prepared. These changes will cause the statements to not be comparable from year to year, and therefore not as useful to the external parties.

Cash Basis

The two primary financial statements used with the cash basis of accounting are the statement of cash receipts and disbursements and the statement of assets and liabilities resulting from cash transactions. Cash basis financial statements do not reflect items such as accounts receivable, inventories, or accounts payable. They are only useful to individuals with intimate knowledge of those items or for small service-type businesses that operate on a cash basis. Today, very few businesses meet these requirements and, therefore, cash basis financial statements are not a realistic option for most small companies.

CPA Report for Financial Statements Based on an Other Comprehensive Basis of Accounting

Table 6 presents a report for financial statements prepared on a comprehensive basis of accounting other than GAAP. Italics highlight the modification of the standard report. Changes to the review and compilation report are similar in nature to the alteration of the audit report.

Table 6
**Report on Statements Prepared on a Non-GAAP Basis of Accounting**

**Independent Auditor's Report**

We have audited the accompanying *statements of assets, liabilities, and capital-income tax basis* of Small Business, Inc., as of December 31, 1995, and the related statements of *revenue and expenses-income tax basis and of changes in partners' capital accounts-income tax basis* for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*As described in Note 1, these financial statements were prepared on the basis of accounting the Company uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.*

In our opinion, the financial statements referred to above present fairly, in all material respects, *the assets, liabilities, and capital* of Small Business, Inc., as of December 31, 1995, and its *revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note 1.*

CPA Firm Name

January 29, 1996

**Source**

American Institute of Certified Public Accountants. *Statement on Auditing Standards No. 62*, "Special Reports." New York: AICPA. 1989.

Italics added to indicate the changes from the standard audit report shown in Table 2.

## Modified GAAP Basis

When a company elects to use one of the other comprehensive bases of accounting it does not attempt to follow GAAP. An alternative to this is for a company to follow GAAP for most of its accounting, yet omit certain disclosures due to their cost and/or complexity. The CPA report will include an additional paragraph that describes the omission and states whether its impact on the financial statements is determinable. Modification of the opinion paragraph regarding the omission also results (AICPA 1988). Table 7 provides an example of how an audit report is modified given the omission of the GAAP requirement to capitalize certain lease obligations.

Table 7
**Report on Statements with GAAP Requirements Omitted**

**Independent Auditor's Report**

We have audited the accompanying balance sheet of Small Business, Inc. as of December 31, 1995, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*As explained in Note 5 to the financial statements, the Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. The affect on financial position and net income has not been determined.*

In our opinion, *except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph,* the financial statements referred to above present fairly, in all material respects, the financial position of Small Business, Inc., as of December 31, 1995, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

CPA Firm Name

January 29, 1996

**Source**

American Institute of Certified Public Accountants. *Statement on Auditing Standards No. 58,* "Reports on Audited Financial Statements." New York: AICPA. 1988.

Italics added to indicate the changes from the standard audit report shown in Table 2.

Many current GAAP requirements are not useful to small businesses and are very costly to implement. Omitting these requirements from the financial statements may save the business substantial accounting fees while providing external users the information they need. GAAP requirements criticized as either not relevant or not cost effective for small businesses include: accounting for long-term leases; capitalization of interest cost; accounting for income taxes; accounting for compensated absences; and, accounting for postretirement benefits other than pensions. A discussion of each of these items follows.

Accounting for long-term leases

Generally accepted accounting principles often treat leased equipment as purchased and financed with long-term debt (FASB 1976). Although the calculations are not too complex, they do require extensive time, particularly in the year of the lease. The independent CPA often does these calculations for small businesses and this directly increases accounting costs. An alternate method of treating leases is to expense the lease payment in the period incurred. The notes to the financial statements will include disclosure of the existence of the lease and the future lease payments. This alternative is appropriate for businesses that enter long-term leases on an occasional basis.

Capitalization of interest costs

Current GAAP (FASB 1979) requires that the total cost of an asset constructed over time for the company's use include an allocation of any interest incurred during the construction period. Allocation of interest to the asset occurs even if the debt resulted from other transactions. The calculations required to determine the amount of interest to capitalize may be very complex and time consuming thereby increasing the cost of the accounting services. An alternate treatment is to treat all interest as an expense in the period incurred with footnote disclosure of the treatment. This treatment reduces the accounting cost during the construction period.

Accounting for income taxes

The income tax expense recorded in the income statement is often not equal to the amount of income tax determined on the tax return because of differences in tax laws and GAAP. *Statement of Financial Accounting Standards No. 109*, "Accounting for Income Taxes" (FASB 1991) requires very detailed and complex calculations to determine the income tax to be used in the income statement. This amount is rarely the same as the amount of tax determined according to IRS regulations. This results in a tremendous amount of time and effort by the CPA to apply two completely different sets of complex rules (IRS and GAAP) to the same information. An alternate treatment is to determine the amount of tax only once using the IRS regulations and use this amount in the financial statements. The company would then disclosure method of determining tax expense in the notes to the financial statements.

Accounting for Compensated Absences

When employees accumulate time off for paid vacations, holidays or sick leave, current GAAP (FASB 1980) requires reporting a liability for future absences. Even for a small business with only a few employees the calculations can be very time consuming and complex. Accounting costs increase when the outside CPA does these computations. An alternate treatment for small businesses is to treat the payment for compensated time off as an expense in the period the employee is absent from work with footnote disclosure of the treatment.

Accounting for Postretirement Benefits Other Than Pensions

Small businesses are only now beginning to accrue a liability for postretirement benefits such as medical insurance premiums (FASB 1990). The FASB delayed implementation for small businesses for two years. Many small businesses provide postretirement benefits to employees (Bushong and Nichols 1996). The FASB acknowledged that the relative cost to small businesses would be high, but concluded that small businesses should not be exempted from accruing the cost of postretirement benefits. As an alternative to accruing the cost, small businesses could continue to account for postretirement benefits on a cash basis with footnote disclosure that the plans exist.

The choices of accounting methods and levels of CPA assurance available to a business owner/manager can be confusing. Table 8 summarizes the 15 different options available to the business owner/manager when producing financial statements for his/her company. Additionally, the options available to the business owner/manager under the omission of certain GAAP requirements are as many as the principles incorporated in GAAP. Table 8 also includes references to the other tables containing representative CPA reports.

Table 8
**Possible Accounting Methods and Levels of CPA Assurance**

<table>
<tr><th rowspan="3">Levels of CPA Assurance</th><th colspan="5">Bases of Accounting</th></tr>
<tr><th rowspan="2">GAAP</th><th colspan="3">Other Comprehensive Basis of Accounting</th><th rowspan="2">Modified GAAP Basis</th></tr>
<tr><th>Regulatory Basis</th><th>Income Tax Basis</th><th>Cash Basis</th></tr>
<tr><td>Audit</td><td>Table 2</td><td>-</td><td>Table 6</td><td>-</td><td>Table 7</td></tr>
<tr><td>Review</td><td>Table 3</td><td>-</td><td>-</td><td>-</td><td>-</td></tr>
<tr><td>Compilation</td><td>Table 4</td><td>-</td><td>-</td><td>-</td><td>-</td></tr>
</table>

The method of accounting and level of CPA assurance provides 15 different approaches a small business owner/manager can take when producing the financial statements for his/her company. This table shows what those 15 possible combinations are, and references the Tables where an example of the CPA report can be found.

## CONCLUSIONS AND RECOMMENDATIONS

The small business owner/manager can begin to assert more control over external financial reporting by opening a dialogue with the company's CPA and primary external users of its financial statements. Although these discussions may not lead to changes in the basis of accounting or the level of CPA involvement, they will assure both the external users and the company's CPA that the owner/manager is concerned with the most effective financial reporting at the least cost.

## REFERENCES


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