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PREPARING DECISION USEFUL FINANCIAL REPORTS: A CHALLENGE FOR SMALL BUSINESSES*

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ABSTRACT

Small business owners and managers want financial reports which are useful for their own decision-making purposes as well as for fairly presenting their business to others. Accountants and auditors consistently state that financial reports are the product of management. These statements being true, small business administrators should know what constitutes fair and useful financial presentation and how to achieve those characteristics.

Accounting offers many alternatives for the treatment of financial events (e.g., FIFO/LIFO; Straight-Line/Declining Balance). Alternatives are available in order to allow management most fairly and most usefully to present its financial reports. The characteristics which contribute to the decision usefulness of accounting information has been provided by the Financial Accounting Standards Board (FASB), and the FASB expects these characteristics to be considered in all financial statement preparations. However, the FASB has given no guidance for the consideration of the characteristics.

This paper offers small business administrators a rational process for systematically choosing between accounting alternative methods. The procedure is easy to understand and simple to execute. It incorporates and utilizes the characteristics which the FASB states contribute to the decision usefulness of accounting information.

Accountants and auditors consistently state that financial statements are the product of management and that an organization's management is responsible for its financial statements' contents. This being true, small business managers should know what they are doing and how they are presenting the business to others. Management also wants financial reports which are useful for its own decision making purposes.

In the preparation of financial statements, accountants routinely face choices among accounting alternatives. Accounting for inventory costs (FIFO, LIFO, etc.) and accounting for depreciation

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(straight line, declining balance, etc.) are two classic examples of this dilemma. Not only are accountants faced with choices such as these but also on occasion they must decide on the most appropriate treatment for a transaction or economic event for which no specific standard currently exists.

During the 1970's the accounting profession wrestled with the concept of a framework for decision making and quality financial reporting. This process was referred to as the "conceptual framework project." Accounting literature was filled with articles and discussions about these issues (Langenderfer, 1973; Norby, 1977, 1978). Out of this project came the Statement of Financial Accounting Concepts (SFAC) No. 2, "Qualitative Characteristics of Accounting Information" as well as other Concept Statements.

Concept No. 2 states:

> Accounting choices are made at two levels at least. At one level they are made by the Board or other agencies that have the power to require business enterprises to report in some particular way... (FASB, 1980).

SFAC No. 2 further states:

> Accounting choices are also made at the level of the individual enterprise...there are now and will always be many accounting decisions to be made by reporting enterprises involving a choice between alternatives for which no standard has been promulgated... (FASB, 1980).

In the early 1980's the accounting literature appeared to center on the conceptual framework project's accomplishments and speculation about the future of such tasks (Miller, 1985; Puxty & Laughlin, 1983; McCaslin & Stanga, 1983; Pacter, 1983; Lowenberg, 1983; Sterling, 1982). Recently articles have used the SFACs to evaluate accounting standards promulgated by the FASB (Daley & Tronter, 1990; Tyson & Jacobs, 1987; Foran & Foran, 1987). However, the appearance in accounting literature is that little, if any, guidance has been provided to the preparer of financial reports (i.e., management) in selecting accounting treatment for a fair presentation of the data.

This paper offers small business management and its accountants a rational process for systematically choosing between alternative methods. The procedure incorporates and utilizes the characteristics which contribute to the decision usefulness of accounting information. These characteristics are provided by the Financial Accounting Standards Board (FASB, the accounting rule-making body) in its *Statement of Financial Accounting Concepts No. 2* (SFAC No. 2).

How Accounting Choices Are Made

Historically, accounting alternatives have been allowed so individual businesses could present their activities in the fairest manner. If only one method of accounting for an economic event had been permitted, the essence of the event could be lost. Additionally, companies are often faced with transactions for which the standard setting bodies have yet to promulgate standards.

How does management select the most appropriate accounting method and how do CPAs guide their clients in making these choices? One approach is an analysis of the particular organization's operations.

Table 1.

Glossary of Terms (FASB, 1980)

Comparability	the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena.
Consistency	conformity from period to period with unchanging policies and procedures.
Feedback value	the quality of information that enables user to confirm or correct prior expectations.
Neutrality	absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior.
Predictive value	the quality of information that helps users to increase the likelihood of correctly forecasting the outcome of past or present events.
Relevance	the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations.
Reliability	the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent.
Representational faithfulness	correspondence or agreement between a measure or description and the phenomenon that it purports to represent (sometimes called validity).
Timeliness	having information available to a decision maker before it loses its capacity to influence decisions.
Verifiability	the ability through consensus among measures to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.

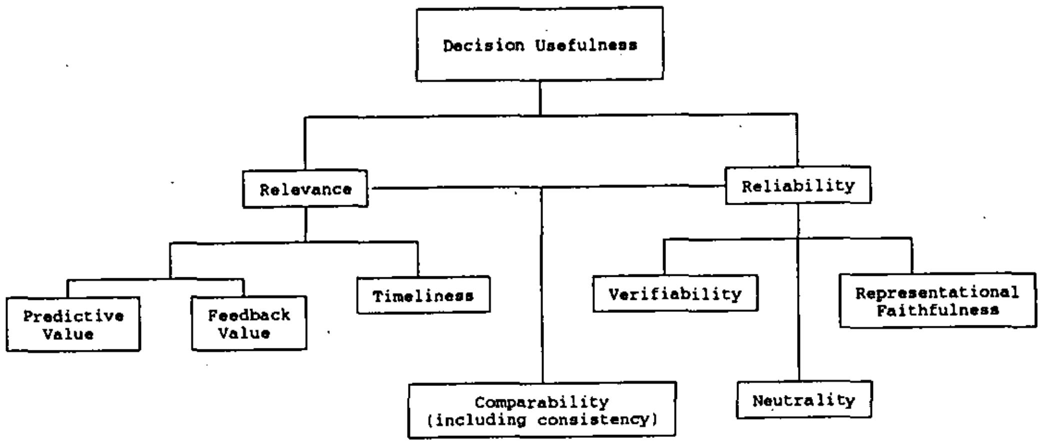
Simplicity of the accounting method's calculations and the procedure used for tax purposes are two other approaches. An analysis of the organization's operations (the former) may appear ideal, but that process could result in little financial statement benefit for the cost of a valid effort.

The management of a small business organization could be more confident about the fairness of the presentation of its choices if a guide was available to help choose an accounting method. This guide should incorporate the characteristics that make accounting information useful.

The Characteristics That Make Accounting Information Useful

The FASB's SFAC No. 2, "Qualitative Characteristics of Accounting Information," sets forth the characteristics which make accounting information useful. These characteristics are comparability, feedback value, neutrality, predictive value, relevance, reliability, representational faithful-

Figure 1. A partial display of statement No. 2's hierachy of accounting qualities (FASB), 1980).



ness, timeliness, and verifiability. These characteristics are expressed in a hierarchy, the goal being usefulness for decision-making. Contributing to decision usefulness are the two primary decision-specific qualities--relevance and reliability. Table 1 is a glossary of terms prepared by the FASB and used in its Hierarchy. A portion of the Statement's "Hierarchy of Accounting Qualities" is shown in Figure 1.

Relevance refers to the information's ability to make a difference in a decision-making context. The qualities which make accounting information relevant are feedback value, predictive value, and timeliness. Reliability is the quality which assures that the information presented is reasonably free from error and bias. Accounting information is reliable to the extent that it can be depended on to represent the economic events and conditions that it intends to represent. The qualities that make accounting information reliable are neutrality, representational faithfulness, and verifiability.

Also included in the hierarchy is the quality of comparability (including consistency). Comparability is not a quality in the same sense as relevance and reliability. Rather, comparability is a quality of the relationship between two or more pieces of information. The decision usefulness of accounting information is greatly enhanced if that information can be compared with similar information about the same enterprise for a different period or point in time. Comparability interacts with relevance and reliability.

The nine qualitative characteristics just discussed are the qualities which, according to SFAC No. 2, contribute to the decision usefulness of accounting information. These qualities can be used to rate alternative accounting method treatments. In order to obtain the choice of accounting method which contributes the most to decision usefulness, the qualitative characteristics can be used in a ranking process. Such a procedure is easy to use, may be performed quickly, and should accomplish the goals of SFAC No. 2.

Figure 2. A form for choosing between alternative accounting methods.

Using the seven-point scale, indicate which accounting method alternative contains more of the stated qualitative characteristic.

Alternative 1 — Alternative 2

1	2	3	4	5	6	7
Much More		More	Does Not Distinguish Between Methods	More		Much More

Comparability ______

Feedback Value ______

Neutrality ______

Predictive Value ______

Relevance ______

Reliability ______

Representational Faithfulness ______

Timeliness ______

Verifiability ______

Sum ______

÷ 9

Average Rating Score ______

A score between 1 and 4 indicates a preference for Alternative 1.

A score between 4 and 7 indicates a preference for Alternative 2.

A score of 4 indicates no preference.

Procedure for Choosing Between Accounting Alternatives

The procedure described here enables two accounting method alternatives to be compared simultaneously. The goal of this procedure is to help the small business manager choose the accounting method which contributes the most to decision usefulness. That method, according to the FASB, is the method which contains the greatest number of the qualitative characteristics. Assume, for example, that a small business's accounting staff is trying to choose between the FIFO and LIFO inventory cost methods. Management would want to choose the method which contained more relevance, reliability and neutrality. The chosen alternative would be the one which, on the whole, contained the most of these qualitative characteristics.

Figure 2 illustrates a form which may be used to implement this procedure. Using a seven point scale, management evaluates the accounting methods by deciding which method contains more of the stated qualitative characteristic. A rating of 1, 2, or 3 would indicate a belief by the rater

Figure 3. An example of the procedure.

Using the seven-point scale, indicate which accounting method alternative contains more of the stated qualitative characteristic.

FIFO Alternative 1						LIFO Alternative 2

1	2	3	4	5	6	7
Much More		More	Does Not Distinguish Between Methods	More		Much More

Comparability	6
Feedback Value	4
Neutrality	4
Predictive Value	7
Relevance	3
Reliability	5
Representational Faithfulness	5
Timeliness	4
Verifiability	4
Sum	39
÷	9
Average Rating Score	4.67

A score between 1 and 4 indicates a preference for Alternative 1.

A score between 4 and 7 indicates a preference for Alternative 2.

A score of 4 indicates no preference.

that Alternative 1 contains more of the stated qualitative characteristic than does Alternative 2. Similarly, a rating of 5, 6, or 7 would indicate a belief that Alternative 2 contains more of the stated qualitative characteristic. A rating of "4" would indicate that the stated qualitative characteristic does not distinguish between the accounting methods being evaluated. This rating procedure would be done nine times, once for each of the qualitative characteristics.

These ratings are then summed, and the sum is divided by nine to obtain an average rating or score, which indicates management's accounting method preference. This score represents the accounting method that, in the rater's judgment, contains the greatest number of the characteristics that make accounting information useful. A score less than 4 indicates a preference for Alternative 1. A score greater than 4 indicates a preference for Alternative 2. A score of exactly 4 indicates that neither accounting method alternative contributes more than the other to decision usefulness.

Figure 3 provides a complete example of this procedure. Assume a small business organization's accounting staff is trying to decide whether inventories should be accounted for with FIFO or LIFO. In this example FIFO is designated as Alternative 1 and LIFO as Alternative 2. The 6 shown next to comparability indicates that the rater believes that LIFO provides information that is more comparable than does FIFO. The 4 next to feedback value indicates that the feedback value does not distinguish between the two methods. The other ratings are interpreted in a similar fashion.

The sum of these ratings is then calculated and divided by nine, the number of qualitative characteristics, to obtain a score of 4.67. Since this score is greater than 4, this means that the rater believes that LIFO provides information that is more useful than that provided by FIFO.

This example assumed that management was interested in choosing between only two accounting methods. However, this procedure may also be used in decision contexts where more than two accounting methods are under consideration. The procedure is simply performed more than once. For example, assume that, in addition to comparing FIFO with LIFO, the weighted average method is to be considered. A comparison is first made for FIFO and LIFO. The recommended alternative from that comparison is then compared against the weighted average method.

The procedure illustrated here makes an accounting method decision by assigning equal weights to each of the qualitative characteristics. Should management not agree with the equal weights given the qualitative characteristics in this example, different weights could be assigned by the rater.

Concluding Statements

The primary reason for accounting alternatives is for individual organizations to provide fair, decision-useful financial information. Therefore, careful, conscientious consideration should be given to the alternative decision making process.

The FASB did not provide a quantitative method for choosing between accounting methods when it issued SFAC No. 2. The FASB does, however, expect the qualitative characteristics to be useful when making such choices. The procedure described here incorporates the characteristics espoused by the FASB and also is relatively easy to use. Decision usefulness is, however, in "the eye of the user," and the small business manager should know how to generate the financial information which is fair in its presentation and useful for decision making.

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