CHAPTER 3: SME FINANCIAL REPORTING CONTEXT AND THEORY

3.1 Introduction

This third chapter of the thesis is concerned with the institutional context and theoretical framework for financial reporting by smaller enterprises, with a particular focus on internal use of financial reports by owner-managers for overall financial management purposes. The intention is provide a conceptually sound but realistic backdrop against which to view existing and new empirical evidence on financial reporting practices in small and medium-sized enterprises presented in later chapters of the thesis.

The chapter first explains what is meant by financial reporting practices in the context of financial management of a business. The Australian accounting context for financial reporting is subsequently outlined. There follows consideration of the legal context of financial reporting by SMEs in Australia, with specific attention given to financial reporting for taxation purposes and mandated financial reporting by proprietary companies. Broad organisational and managerial background for the inquiry is provided by next considering the role of financial reporting in strategic management of businesses. The chapter thereafter presents various theoretical perspectives on financial reporting in smaller business concerns drawn primarily from the literature of economics and finance. The chapter closes with an attempted synthesis of elements of these theoretical perspectives, intended to sketch as succinctly as possible the likely financial reporting scenario for small and medium-sized enterprises in a less than perfect world.

3.2 Financial Management Context of Financial Reporting

What constitutes financial reporting practices for the purposes of this research is addressed briefly in Chapter 1 of the thesis. It is now necessary to consider the meaning and significance of financial reporting on a business's affairs in greater depth. In this section of the chapter, the broader financial management context of financial reporting is outlined and financial reporting practices are identified in this setting. This is appropriate since the primary concern in the study is with preparation and use of standard financial reports for overall financial management purposes involving owner-managers and, to a lesser extent, managerial employees of smaller enterprises. In subsequent sections of the chapter, financial reporting is placed in its accounting and legal contexts, and more detailed specifications for financial reporting practices are developed. Note that, since the focus in this research is upon financial reporting by proprietary companies, financial reporting practices required of public companies by the Australian Stock Exchange are not considered.

In their textbook, McMahon *et al* (1993a, p. 3) describe financial management as a function in a business enterprise as being concerned with:

> . . . raising the funds needed to finance the enterprise's assets and activities, the allocation of these scarce funds between competing uses, and with ensuring that the funds are used effectively and efficiently in achieving the enterprise's goals.

They go on to indicate that the financial management function involves planning, controlling and decision-making responsibilities embracing:

- Various types and sources of finance an enterprise might employ, how these can be accessed and how to choose between them.
- Alternative ways in which finance raised may be used in an enterprise and how to select those which are likely to prove most profitable.
- Different means of ensuring that finance entrusted to specific activities realises the returns that were anticipated on its allocation to them.

In general terms then, financial management practices are whatever is undertaken in a business enterprise to enable financial management, so conceived, to be conducted successfully in the sense which has been described. In this research, financial management practices are taken to refer broadly to facilities or amenities, activities, methods or procedures, policies, capabilities, or customary beliefs or behaviours associated with the following aspects of business management:

- Accounting systems – including the nature and purpose of financial records, bookkeeping, cost accounting, and use of computers in financial record keeping and financial management.
- Financial reporting and analysis – including the nature, frequency and purpose of financial reporting, audit, analysis and interpretation of financial statements, and use of physical and financial performance benchmarks.
- Working capital management – including financial management practices for cash, stock, debtors and creditors.
- Fixed asset management – including non-financial and financial considerations in fixed asset acquisition, quantitative techniques for capital project evaluation, investment hurdle rate determination, and handling risk and uncertainty in this context.
- Financial structure management – including financial leverage or gearing, accountability to lenders knowledge of sources and uses of finance, non-financial and financial considerations in financial structure decisions, and non-financial and financial considerations in profit distribution decisions.
- Financial planning and control – including financial objectives and targets, cost-volume-profit analysis, pricing, financial budgeting and control, and managerial responsibility centres.
- Financial advice – including internal and external sources and types of financial advice, and use of public accounting services.
- Financial management expertise – including informal and formal education, training and experience in financial management, relevant qualifications, and overall financial management expertise.

These headings were devised and used by McMahon & Holmes (1989, 1990, 1991, 1992) as a means of classifying financial management practices in small enterprises in comprehensive reviews of the literature providing empirical evidence on this subject to around 1988.

For the purposes of this study, financial reporting practices are considered to comprise financial reporting and analysis and aspects of financial planning and control, as detailed above. Having made this specification, it must be acknowledged that many other aspects of financial management identified above have some bearing on or relationship to financial reporting. For example, the nature of a business's accounting system, the financial advice available to owner-managers and the financial management expertise of owner-managers are all likely to influence the nature and extent of financial reporting undertaken. Furthermore, the expectations and outcomes of decisions made in relation to working capital, fixed assets and financial structure are inevitably reflected in the contents of financial reports.

3.3 Accounting Context of Financial Reporting

3.3.1 Defining Financial Reporting

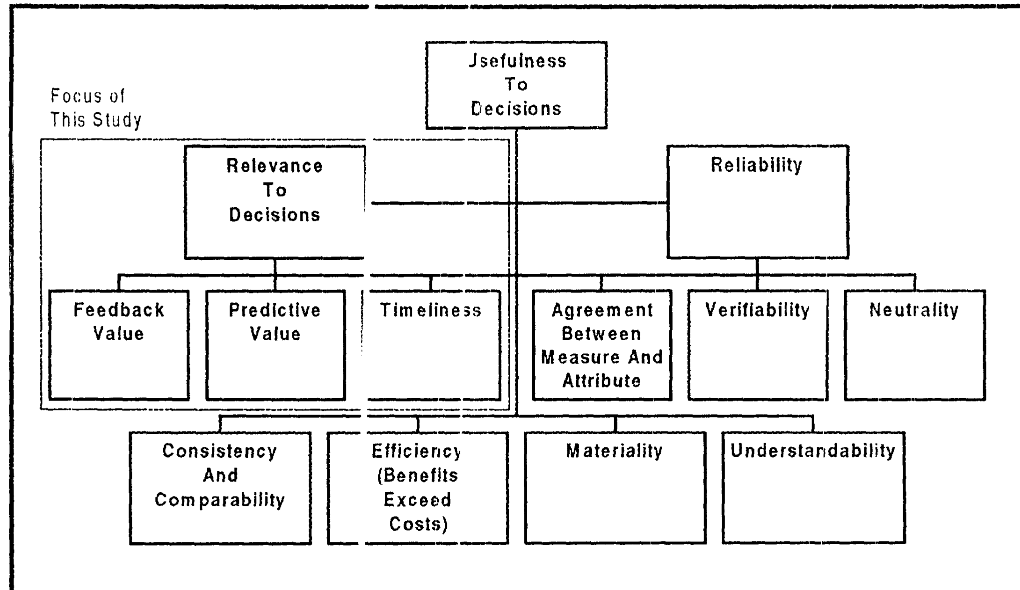
For the purposes of this study, financial reporting is conceived as being the outcome of more or less formal accounting activities in a business enterprise. Arguably the best-known and most enduring definition of accounting is that developed by the American Accounting Association (1966) for its seminal publication *A Statement of Basic Accounting Theory*. In that work, accounting is defined as 'The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information' (American Accounting Association, 1966, p. 1). Note that the definition does not prescribe specific forms of financial reporting. Nor does it specifically identify the likely users of financial reports or statements. The definition does, however, emphasise the intended decision-usefulness of such financial reporting.

The Financial Accounting Standards Board (1978, p. 5) in the United States proposes a similar decision emphasis for financial reporting in its *Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises*:

> Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions – for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.

Drawing on the Financial Accounting Standards Board's (1980) *Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information* and a corresponding Australian statement (Australian Accounting Research Foundation, 1990a), the qualitative characteristics accounting information should exhibit in order to fulfill its envisaged decision role have been represented as in Figure 3.1 on the next page (adapted from Whittred *et al.*, 1996, p. 22, Exhibit 1-4).

Figure 3.1: Qualit ıtive Characteristics of Accounting Information



While it is clearly difficult to cr ɔose unequivocally some of these characteristics over others in terms of importance, the attributes of timeliness and relevance tend to receive most mention in the literature ‹lealing with financial decision-making (McMahon *et al.*, 1993a). This is taken to sugge st that the feedback value of historical financial statements and the predictive value of future-oriented financial statements, and the timeliness of both types of fin ıncial statement, should receive particular attention in this research. Note that historical financial statements may provide guidance for future action if what is known to hav ɜ happened in the immediate past is believed to be a reasonable basis for predictin j what is likely to happen in the immediate future. In this sense then, there is conceptu ıl overlaɔ between historical and future-oriented financial reporting, and historical finan ial statements may have both feedback and predictive value. Analysis and interpreta tion of financial statements, whether historical or future-oriented, can be similarly con strued tc have both feedback and predictive value.

The Australian professi ɔnal accounting bodies – the Australian Society of Certified Practising Accountants and tl e Institute of Chartered Accountants in Australia – through their jointly sponsored Austra ian Accounting Research Foundation (AARF) are engaged in on-going development of a conceptual framework for general purpose financial reporting. The definition of ge neral purpose financial report employed within this framework is as follows (Aus ralian Accounting Research Foundation, 1990b, p. 21):

> . . . a financial report intended to meet the information needs common to users who are unable to com mand the preparation of reports tailored so as to satisfy, specifically, all of their informa ion needs.

Any financial reports which c ɔ not meet this definition are referred to as a special purpose financial reports. In relation to such reports, Anon. (1996a, p. 57) points out that:

> All special purpose financial reports and any attached accountant's statement or auditor's report must clearly state that they are a special purpose financial report, the specific reason for their preparation and the extent to which accounting standards . . . have or have not been adopted in their preparation and presentation. The only time this is not required is if it is reasonable to expect a special purpose financial report will be used solely for internal purposes. This is required by mandatory professional statement APS1 [Australian Accounting Research Foundation, 1995b].

There is a view that it might be necessary for special purpose financial reports to adhere to measurement requirements of relevant accounting standards, even though disclosure requirements need not be fully met (Edwards & Zimmer, 1996; Grounds *et al.*, 1996; Ma & Edwards, 1996).

Since those within a business are always free to command financial reports with any content and format which best meets their decision needs, the focus of the definition of general purpose financial report in the previous paragraph is clearly upon decision-makers external to the business. It must be recognised, however, that many external parties do have sufficient influence to require financial reports which meet their specific needs. Examples include taxation authorities, corporate regulatory bodies, creditors and financiers who through the force of law or the possible denial of support can create imperatives for the content and format of financial reporting made to them. This being so, in the present context it is considered more appropriate to conceive general purpose financial reports as being more or less standardised financial statements as to content and format which can serve a variety of decision purposes both within and without a business enterprise. These commonly used financial statements are identified below.

3.3.2 Reporting Entity Concept

Another important concept within the Australian conceptual framework for general purpose financial reporting is that of the 'reporting entity' which is defined as follows (Australian Accounting Research Foundation, 1990c, p. 15):

> . . . all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

Reporting entities, so defined, must prepare general purpose financial reports in accordance with promulgated Australian accounting concepts and standards. At this stage, the reference to accounting concepts and standards should be interpreted as embracing only those intended for non-corporate reporting entities. Strictly speaking, Australian Accounting Standard (AAS series) pronouncements are solely directed to such concerns. However, non-corporate reporting concepts and standards do form the backdrop to corporate reporting concepts and standards, and in many instances the latter parallel the former quite closely. Given the focus on proprietary companies in this research, accounting concepts and standards relevant to corporate reporting entities are specifically addressed in the subsequent section of this chapter.

The AARF (Australian Accounting Research Foundation, 1990c) indicates that the primary factors taken into account in the identification of reporting entities should include:

- Separation of management and ownership – the more owners of an entity there are, and the greater the separation of management and ownership, the more likely there will be parties dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.
- Economic or political importance and influence – the greater the ability of an entity to have a significant impact on the welfare of external stakeholders, the more likely there will be parties dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.
- Financial characteristics – the larger the size, the greater the indebtedness and the more substantial the resources allocated to an entity, the more likely there will be parties dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.

For the purposes of this thesis, it is important to recognise that small and medium-sized enterprises:

- Typically have relatively few owners.
- Are often distinguished on the basis of having significant overlap between management and ownership.
- Are seen as individually having comparatively little economic or political importance and influence.
- Are by definition small in terms sales revenues, assets, and numbers of employees and customers.
- Usually have limited access to debt finance.
- Are sometimes alluded to as suffering from resource poverty.

Hence, small and medium-sized enterprises frequently are not reporting entities, as specified. They are therefore not required by the Australian accounting profession to prepare general purpose financial reports, as defined by the profession, in accordance with promulgated accounting concepts and standards. As will be seen, many smaller enterprises avail themselves of the differential reporting opportunity thus provided. On the other hand, the point has been made that the accounting profession is not the only source of financial reporting imperatives on smaller business concerns. Furthermore, the issue of whether differential reporting opportunities are in the best long-run economic interests of such businesses and the society as a whole is subject to debate in Australia (McCahey, 1986; Ramsay & Sutcliffe, 1986; McCahey, 1987; Holmes *et al.*, 1991b; McMahon *et al.*, 1992c, 1993b 1994b; Ma, 1996) and elsewhere (Ingram *et al.*, 1977; Hildebrand, 1982; Horowitz & Kolodny, 1982; Abdel-Khalik, 1983; Coles, 1983; Hutchinson, 1983; Lippitt & Oliver, 1983; Nair & Rittenberg, 1983; Stanga & Tiller, 1983;

Friedlob & Plewa, 1984; Knutson & Wichmann, 1984; Carsberg *et al.*, 1985; Knutson & Wichmann, 1985a, 1985b; Hiltebeitel, 1986; Bryant, 1991; Friedlob & Plewa, 1992). One aspiration of this thesis is to shed empirical light on some pros and cons of the differential reporting debate. More is said on the likely future status of the reporting entity concept in the following section of this chapter when considering the Australian legal context of financial reporting by smaller enterprises.

3.3.3 Specifying Financial Reporting Practices

The approach and emphasis in relation to financial reporting practices in this research study differ from the tenets of financial reporting as currently propounded by the Australian professional accounting bodies in a number of respects:

- As indicated earlier, a somewhat different perspective is taken on what constitutes general purpose financial reporting. This seems justified in the circumstances which have been identified.
- The study is primarily concerned with financial reporting for the benefit of those parties making financial management decisions about a business from within. These most obviously include owner-managers, non-managing owners and managers who are not owners. Having made this point, it needs to be recognised that decision-makers within small and medium-sized enterprises are probably strongly influenced in their choices regarding financial reporting by imperatives from external parties such as professional accountants, taxation authorities, corporate regulatory bodies, creditors, financiers, etc. (McMahon *et al.*, 1992c, 1993b, 1994b).
- Following on from the latter part of the previous point, the study is primarily concerned with use of general purpose financial reports of the type most likely to be sought by parties external to a business. While decision-makers within smaller enterprises can and do demand special purpose financial reports, it is probable that they also employ general purpose financial reports in the overall financial management of their businesses especially when these have already been advocated or required by external parties. Formal accounting systems installed and used by smaller business concerns, particularly those which are computer-based, are inevitably keyed to producing general purpose financial reports (Department of Industry Science and Technology, 1995b). Furthermore, any relevant education or training undertaken, publications read, professional accounting advice or services received, etc. by smaller enterprise owner-managers are more than likely to emphasise general purpose financial reports.
- The study takes a broad view of what should be included amongst financial reporting practices. Specifically, both historical and future-oriented financial reporting are contemplated. Moreover, financial reporting practices are seen as extending to the analysis and interpretation of historical financial statements in

particular. The Australian professional accounting bodies currently focus upon the preparation and presentation of historical financial reports; and their conceptual framework for general purpose financial reporting does not specifically embrace the analysis and interpretation of such reports. Note, however, that the importance of prospective financial reporting is sometimes recognised in publications of professional accounting bodies, and the possible extension of general purpose financial reporting to include future-oriented reports is not precluded (Jones & Ward, 1986; Pallais & Guy, 1986; Stilwell, 1986; Australian Accounting Research Foundation, 1990b; Cheatham & Cheatham, 1993).

At the present time in Australia, as in most other developed Western economies, the three most widely recognised, approved and accepted general purpose financial reports or statements relating to a business enterprise's affairs in an overall or whole-of-business sense are:

- Balance sheet (or statement of financial position)
- Profit and loss statement (or profit and loss account or income statement)
- Cash-flow statement (or statement of cash-flows or statement of sources and uses of cash)

Because of their unmatched significance in business practice, the research described in this thesis focuses upon preparation and use of these financial statements which are mandatory for reporting entities according to Australian accounting standards (Australian Accounting Research Foundation, 1990c). As indicated earlier, both historical and future-oriented forms of the three standard financial statements identified above are of interest to the study.

No consideration is given in this research to outmoded, less common, less standardised or more purpose-specific financial reports which may be and are sometimes used. Note, in particular, that the funds statement (or statement of changes in financial position or statement of sources and uses of funds) is not considered because it has generally been replaced by the cash-flow statement (Australian Accounting Research Foundation, 1991; Australian Accounting Standards Board, 1991a). Note also that specific purpose financial reports or statements of the type usually advocated for cost and management accounting purposes in business segments, whether historical or future-oriented, are not considered.

It remains to specify what constitutes analysis and interpretation of financial reports for the purposes of the present research. Following McMahon & Davies (1991a, 1991b, 1992a, 1992b), McMahon *et al.* (1992a, 1992b) McMahon & Davies (1994), McMahon *et al.* (1994a) and McMahon (1995), analysis is seen as breaking down the comprehensive and complex set of facts and figures presented in financial reports into more focused and simplified pieces of insightful information about the business concerned. For example, financial reports may be disaggregated into smaller sets of

information regarding specific financial dimensions of a business such as profitability, liquidity, solvency, asset structure and financial structure. Interpretation is seen as explaining the meaning and implications of the information revealed by analysis. The aim here is to be able to say whether the business's financial fortunes have improved, remained stable or deteriorated relative to suitable financial benchmarks such as past trends, industry averages and targets. Together analysis and interpretation are intended to lead to a clearer and more revealing account of a business's financial position and performance. While acknowledging the distinction made here between analysis and interpretation, many writers use the shorter descriptor 'financial analysis' when referring to both activities.

Specific techniques for the analysis and interpretation of historical financial reports which are considered in this research are as follows:

- Comparisons of key figures presented in a business's most recent financial statements with those in financial statements of previous periods. The latest period may be compared with earlier periods in the same financial year, or with the same period in earlier financial years. Alternatively, year-to-date figures may be compared with the same period in earlier financial years.
- Comparisons of financial ratios calculated from a business's most recent financial statements with available benchmarks for such measures. The benchmarks could include generally accepted rules-of-thumb, financial ratios of previous periods (trend analysis), financial ratios of similar businesses in the same industry (industry averages or inter-firm comparisons), or target values set for the business in the light of circumstances it is expected to encounter.
- Comparisons of key figures actually achieved in historical financial statements with anticipated figures (budgeted or target values) included in forecasted financial statements (variance analysis).

Techniques of financial analysis such as these may be applied to the whole business, to business segments based on products/markets/customers/etc., or to geographically distinct activities (for example, domestic versus export business).

Of the techniques of financial analysis identified, financial ratio analysis appears to be most widely advocated in the smaller enterprise literature. For example, Brigham (1982, p. 823) believes that:

> Financial ratio analysis will be of major and overriding importance to the small firm. Such analysis, on a regular basis, is essential to ascertain whether the firm is operating efficiently. Whereas a larger, stronger firm may have the financial strength to fall below its industry standards and still recover, the small firm has less margin for error. Thus, anyone running a small firm is well advised to look at trends in its financial ratios and to compare them with industry standards.

Most recent books especially written for smaller enterprises stress the importance of obtaining regular financial reports, and exercise of financial ratio analysis skills in their interpretation, as part of a broader competence in financial management which is considered to be fundamental to survival and success (Grablowsky & Rowell, 1980;

Rausch, 1982; Carey & Olson, 1983; Wise, 1984; Flamholtz, 1986; Meredith, 1986; Price, 1986; Walker & Petty, 1986; Barrow, 1988; Ronstadt, 1988; Dewhurst & Burns, 1989; English, 1990; Dunn & Cheatham, 1993; McMahon *et al.*, 1993a; Ratnatunga *et al.*, 1993; McMahon, 1995; Osteryoung *et al.*, 1997).

There are also a significant number of publications specifically dealing, in whole or part, with use of financial ratio analysis in connection with smaller enterprises (Bureau of Economic and Business Research, 1961; Edminster, 1970; Sanzo, 1970; Edminster, 1971, 1972; Gru, 1973; Konstans, 1973; Konstans & Martin, 1973a, 1973b; McCaughley, 1974; Mayo & Rosenbloom, 1975; Skomp & Edwards, 1978; Patrone & DuBois, 1981; Van Voorhis, 1981; Welsh & White, 1981; Howell *et al.*, 1982; Konstans, 1982; Konstans & Martin, 1982; Lawrence, 1982; Tibbits, 1982; McMahon, 1985a, 1985b; Rader, 1986; Shailer, 1986; Simyar & Doutriaux, 1987; Thomas & Evanson, 1987; Dwyer & Lynn, 1989; Idrus & Staunton, 1990; Van Der Wijst, 1990; Idrus & Staunton, 1991; Koon & Lee, 1993). Some of these writings strongly advocate acquisition and/or application of financial ratio analysis skills, while others do so with significant reservations or cautions.

3.4 Legal Context of Financial Reporting

3.4.1 Financial Reporting for Taxation Purposes

In Australia, legal imperatives on financial reporting by smaller business enterprises principally stem from two federal government sources. The first is the Australian Taxation Office (ATO) as empowered by legislation relating to income, capital gains and other forms of taxation. The second is the Australian Securities Commission (ASC) as empowered by legislation regulating companies and the financial securities they issue. In the interests of a fuller appreciation of the financial reporting demands on smaller enterprises in Australia, the dictates of the ATO and ASC regarding record keeping and financial disclosure are now considered in turn.

As indicated by Holmes *et al.* (1991b) and McMahon *et al.* (1992c, 1993b, 1994b), income taxation legislation requiring the annual filing of a return from which income tax payable may be calculated is arguably the most stringent imperative for financial reporting by Australian smaller enterprises. All taxpayers are compelled to maintain adequate accounting records for this purpose, and must retain all documentation for a period of five years to facilitate audits or other investigations by the ATO. A full self-assessment system operates for companies in accordance with which they provide only abbreviated information leading to calculation of taxable income and tax payable. However, a statistical summary relating to business operations and financial position must be appended to their returns. Sole proprietors and taxpayers in partnerships or trusts are required to submit comprehensive individual returns; with partnerships and trusts being further required to submit returns for the business as a whole.

The relationship between the income tax returns of businesses and their accounting or financial statements is described by McMahon *et al.* (1994b, p. 24) as follows:

> Instructions issued by the ATO on completing tax returns require that amounts included be taken from available financial statements prepared in accordance with 'generally accepted accounting principles' where applicable. However, for some classes of taxpayer, these instructions appear to implicitly recognise and allow for the situation where a taxpayer's financial statements are not prepared in accordance with such principles. The Income Tax Regulations provide for a reconciliation of the profit and loss statement and taxable income in the case of company returns . . . but make no such reference for other taxpayers.

Commenting on the practice common in smaller enterprises by which compulsory annual income tax returns are also used for financial management purposes, McMahon *et al.* (1994b, p. 24) go on:

> The dangers of preparing financial reports on an income tax basis, rather than according to generally accepted accounting standards, are usually self-evident to professionals who support and work with smaller enterprises. The type of information included in taxation returns is very often inappropriate for uses other than assessing liability to pay tax and, in any case, is almost never sufficiently timely for the purposes of sound financial management. Nevertheless, because of the non-trivial costs of additional financial reporting and a less acute appreciation on the part of owner-managers of the differences between taxation returns and general purpose financial reports, the inherent dangers of using the wrong information for the wrong purpose may be down-played or ignored.

The reference to timeliness in the quotation immediately above highlights the fact that sound financial management of a smaller enterprise is likely to require financial reporting on a more frequent basis than annually – an option not generally available with sole dependence on income tax returns. Furthermore, McMahon *et al.* (1994b, p. 25) point out:

> In a recent study in the USA, Coker and Hayes (1992) found that potential lenders to smaller enterprises perceived loan applications prepared on an income tax basis as being less useful and presenting greater risk than those prepared according to generally accepted accounting principles. Usually, they required additional financial information to be produced. From this, it would appear that smaller enterprises submitting income tax based financial statements may face higher interest rate charges or higher loan application rejection rates because of the additional risk perceived by lenders, or may be required to incur further reporting costs to provide additional information requested by lenders. These additional borrowing costs may offset the initial cost savings arising from using the income tax financial reporting basis.

The outcome is then that income taxation legislation could be considered advantageous to the extent that it legally compels Australian smaller enterprises to keep accounting records adequate for underpinning taxation returns. And it does lead to some form of financial reporting – frequently the only financial reporting undertaken in smaller business concerns. A problem is that, unless prepared strictly in accordance with generally accepted accounting principles, the information presented is unlikely to be sufficiently relevant for sound financial management. Furthermore, regardless of how it is prepared, it is also unlikely to be sufficiently timely.

3.4.2 Financial Reporting by Proprietary Companies

3.4.2.1 Prior to Corporations Law Simplification

The financial reporting imperative on Australian smaller enterprises stemming from the regulatory role of the ASC is limited in its scope to businesses legally organised as proprietary (or private) companies. Included are those operating as trading trusts controlled by a proprietary company as trustee (Eddy, 1995; Australian Accounting Standards Board, 1991b). The data used in this study were collected immediately prior to a period of considerable flux in the financial reporting demands upon many small and medium-sized enterprises (as defined in this thesis) that are organised as proprietary companies. This thesis has been completed as the first indications of the impact of the flux become apparent. While the changes described below have their origins in attempts to reform and simplify the Australian Corporations Law, there have necessarily been consequential changes in financial reporting dictates emanating from the accounting profession in this country. After considering all these changes, the reader might be inclined to concur with Hardman (1996, p. 151) that, however well intentioned, the Corporations Law simplification programme of the federal government is 'illnamed' – especially in view of its impact upon financial reporting by smaller proprietary companies.

For most smaller concerns, the financial reporting imperative created by the Corporations Law has been relatively non-onerous for some time. Moreover, like the imperative from the Australian accounting profession, it may recently have become even less of a burden for a significant number of these businesses. The *First Corporate Law Simplification Act 1995* came into force on 9 December, 1995 and many of its financial reporting provisions apply to the first financial year finishing after that date (for example, a financial year ending on 31 December, 1995). Previously, a so-called exempt proprietary company – the legal status of the majority of smaller enterprises organised as companies – was excused many of the financial reporting demands of the Australian Corporations Law which applied to non-exempt proprietary companies and public companies. A proprietary company could be limited by shares or shares and guarantee, or could be unlimited with shares. It had to have at least two members (or shareholders) and no more than 50; and there had to exist a restricted right to transfer shares. A proprietary company was prohibited from inviting the public to subscribe for shares or debentures; and was also prohibited from soliciting deposits of money from the public. An exempt proprietary company was a truly private company in which no public company held even one share, or indeed a part interest in one share (Ford & Ramsay, 1996). Grounds *et al.* (1996, p 27) indicate that:

> As at 30 June 1994, there were some 885,000 companies registered with the Australian Securities Commission. Of that total, approximately 867,000 were proprietary companies, and approximately 99 per cent of these companies were exempt proprietary companies . . .

The accounting and financial reporting demands on exempt proprietary companies before the *First Corporate Law Simplification Act 1995* came into force were as follows (Parker & Reilly, 1995; Govey, 1995; KPMG, 1995; Ford & Ramsay, 1996; Govey, 1996):

- Like all other companies, exempt proprietary companies had to keep accounting records that revealed their commercial transactions and financial position in a manner which would enable true and fair financial statements to be prepared as needed. These statements had to be capable of being audited. The accounting records had to comprise more than just collections of source documents such as cheque stubs, receipts, invoices, bank statements, etc.; and they had to be held for up to seven years after the transactions to which they related. They had to reveal a company's financial position at all times and at any time (Ford & Ramsay, 1996).
- Exempt proprietary companies had to prepare annual financial statements which met only the requirements of Schedule 5 of the Corporations Regulations. These did not have to be lodged with the ASC.
- Exempt proprietary companies did not have to be audited if members agreed no audit was required.
- Unless they were audited, exempt proprietary companies had to include key financial data in their Annual Returns to the ASC which then became available on the public record. Govey (1995) and King (1995), amongst others, believe that this information had doubtful value since many exempt proprietary companies did not comply with prevailing accounting standards.

It is interesting to note that there is some evidence of a significant level of non-compliance with these requirements. For example, Yum (1984) indicates that 21 per cent of exempt proprietary companies in his study submitted neither accounts or an audit statement, and were therefore in breach of the legislation.

Before the *First Corporate Law Simplification Act 1995* came into force, non-exempt proprietary companies had to prepare annual financial statements, but these could be special purpose statements not adhering to prevailing accounting standards if the business was not a reporting entity – although the financial reporting provisions of Schedule 5 of the Corporations Regulations still applied (KPMG, 1995). For the purposes of the Corporations Law, a reporting entity is defined as in the previous section of this chapter. The definition is held to embrace – but is not limited to – a listed corporation, a borrowing corporation or an Australian subsidiary of a foreign listed corporation (Australian Accounting Standards Board, 1991c). The financial statements had to be audited and lodged with the ASC together with an Annual Return, and thus become available on the public record. Note that the prevailing accounting standards referred to in this paragraph (and in the remainder of this sub-section of the chapter) are those approved by the Australian Accounting Standards Board (AASB series). The

AASB, which cooperates closely with the AARF, has legislated responsibility for reviewing, and approving for the purposes of the Corporations Law, accounting standards promulgated by the Australian professional accounting bodies which apply to reporting entities.

3.4.2.2 Subsequent to Corporations Law Simplification

Following the *First Corporate Law Simplification Act 1995* coming into force, proprietary companies need have only one member, but they must have no more than 50 members who are not employees (Factor 1995a; KPMG, 1995; Ford & Ramsay, 1996). There is no limit to the number of employee-shareholders (Ford & Ramsay, 1996). Proprietary companies may no longer be limited by shares and guarantee. They are now prohibited from engaging in any activity that would require lodgement of a prospectus under the Corporations Law as amended. This prohibition does not apply where shares are offered to existing shareholders or to employees of the company. According to Hardman (1966, p. 151):

> The most significant part of the changed proprietary company definition is the removal of the statutory requirement to restrict the right to transfer shares. There is some doubt as to any practical benefit arising from this deregulation as recent company incorporations appear to continue to allow directors to restrict the transfer of shares in their Articles and there does not appear to be any significant move to change the Articles of previously incorporated companies.

The distinction between exempt and non-exempt proprietary companies has been abandoned in favour of a distinction between small and large proprietary companies designed to link public financial accountability with enterprise size (Factor, 1995a; Govey, 1995; KPMG, 1995; Parker, 1996). Ford & Ramsay (1996, p. 6) indicate that 'Although the sole reason for the distinction is now regulation of financial reporting, future policy changes on other matters could well rely on the distinction'.

A proprietary company is considered to be small in a particular financial year if at least two out of the following three criteria relating to the company and the entities it controls (if any) are met:

- Consolidated gross operating revenues for the financial year amount to less than $10 million.
- Consolidated gross assets at the end of the financial year amount to less than $5 million.
- Employment at the end of the financial year is fewer then 50 persons, with part-time employees being counted as an appropriate fraction of a full-time equivalent.

These criteria must be applied in each financial year in order to ascertain whether a proprietary company continues to be classified as small. Consolidated data must include not only subsidiaries, but also any trusts, partnerships, etc. which the proprietary company controls (KPMG, 1995). Apparently, the ASC expects 98 per cent of Australia's 900,000 or so proprietary companies will meet the criteria for being classified as small (Govey, 1995; KPMG, 1995). It is recognised that the size criteria are somewhat

arbitrary and the ASC has been directed to review them and the new financial reporting provisions detailed below in 1997-98 (Parker & Reilly, 1995; Parker, 1996).

When invited to comment on the forthcoming *First Corporate Law Simplification Act 1995*, the Australian professional accounting bodies argued strenuously for application of the reporting entity concept instead of distinguishing, as described above, between small and large proprietary companies (Parker & Reilly, 1995). However, this was rejected on the grounds that it did not provide sufficient objectivity and certainty as to classification as do the size-related criteria eventually embodied in the amended Corporations Law (Govey, 1995; Parker & Reilly, 1995). This outcome is seen by some commentators as a significant threat to continued use of the reporting entity concept in both the accounting and the legal contexts of financial reporting. For the time being, however, the reporting entity concept still has the force of law through *Australian Approved Accounting Standard AASB 1025: Application of the Reporting Entity Concept and Other Amendments* (Australian Accounting Standards Board, 1991c). In particular, it influences the financial reporting which must be undertaken by large proprietary companies (Parker & Reilly, 1995). The future of the reporting entity concept is considered again later in this sub-section of the chapter.

Following the *First Corporate Law Simplification Act 1995* coming into force, the accounting and financial reporting demands on small proprietary companies are as follows (Factor, 1995a; Govey, 1995; KPMG, 1995; Parker & Reilly, 1995; Anon., 1996a; Ford & Ramsay, 1996; Govey, 1996; Hardman, 1996):

- The requirements regarding keeping of accounting records are as previously existed for all companies. Note that the accounting records must now also yield prompt and reliable estimates of consolidated gross revenues and assets at the end of a financial year in order to apply the full test for small proprietary companies. These estimates must be made in accordance with accounting standards in force at year-end, even if a company is non-reporting entity. According to Anon. (1996a, p. 56):

  > For operating revenue the appropriate Accounting Standard is AASB 1004 [Australian Accounting Standards Board, 1986]. Operating revenue includes sales revenue (or its equivalent) and the gross proceeds on the sale of non-current assets. Specifically excluded are duties, taxes and other amounts collected on behalf of third parties, and revenue relating to extraordinary items.
  >
  > Gross assets are total current and non-current assets measured at their carrying values. This means non-current assets net of depreciation, and receivables net of doubtful debt provisions. As the assets must be valued in accordance with accounting standards, non-reporting entities may have to recalculate their asset values for the size test. For example, finance leases must be capitalised, if they are material.

  Further guidance on applying the proprietary company size test is provided in Australian Securities Commission (1996) and KPMG (1996a).

- Small proprietary companies are not required to prepare financial statements or to lodge them with the ASC unless requested to do so by shareholders holding five per cent or more of the voting shares, or when requested in particular circumstances by the ASC itself. When financial statements are requested, they should be prepared in accordance with applicable accounting standards unless the request specifies they need not be applied. Financial statements need only be audited when the request specifies this. According to Anon. (1996a, p. 56):

  > If a company is requested to prepare financial statements by the shareholders, the financial statements must be in accordance with Schedule 5. The shareholders can specify that the statements need not comply with the accounting standards. If the ASC requests financial statements, it may or may not specify a Schedule 5 format or compliance with the accounting standards.

  It must be borne in mind that small proprietary companies might be required by their memorandum or articles of association to prepare financial statements, and that these may need to be prepared according to prevailing accounting standards and also be audited.
- Where a small proprietary company is an Australian subsidiary of a foreign company and is not consolidated into its parent's audited financial statements lodged with ASC, it is required to prepare and lodge its own audited financial statements with the ASC
- An Annual Return must still be lodged with the ASC, but this does not contain key financial data which would become available on the public record.

In exceptional circumstances, a small proprietary company may be designated by the ASC as a disclosing entity with enhanced financial disclosure responsibilities relating to certain material information. This status is imposed for the protection of those who have invested in a proprietary company other than by private financing, such as when a former public company's securities are, for some reason, still listed on the stock exchange (Ford & Ramsay, 1996). Possible amendments to the reporting requirements for small proprietary companies are foreshadowed later in this sub-section of the chapter.

As a significant attempt to improve understanding of their rights and responsibilities under the Corporations Law amongst those in smaller enterprises organised as companies, the *First Corporate Law Simplification Act 1995* has included an 18-page *Small Business Guide* as Part 1.5 of Chapter 1 of the legislation. This guide written in plain English forms part of the Corporations Law, but it does not include operative provisions (Factor, 1995a; KPMG, 1995; Ford & Ramsay, 1996). It is only intended to be an introduction to the requirements of the Corporations Law for small proprietary companies. Section 9.1 of the *Small Business Guide* identifies the criteria for eligibility as a small proprietary company, and then sections 9.2 and 9.3 set out the less onerous requirements regarding accounting records and financial reporting for small proprietary companies. Section 9.3 closes as follows (CCH Australia, 1996, p. 3392):

> Although the Corporations Law itself may not require a small proprietary company to prepare accounts except in the circumstances mentioned, the company may need to prepare the accounts for the purposes of other laws (for example, income tax laws). Moreover, good business practice may also make it advisable for the company to prepare the accounts so that it can monitor and better manage its financial position.

Clearly then, the Corporations Law places responsibility for implementing sound financial reporting practices for management purposes well and truly on the shoulders of those who own and manage small proprietary companies.

Any proprietary company which fails to meet the criteria for being classified as small is considered large and must meet more substantial financial reporting demands of the Corporations Law, except where it is granted relief as a wholly-owned subsidiary of another company (Anon., 1996a). A large proprietary company which is a reporting entity must provide to all members, and lodge with ASC, audited general purpose financial statements prepared annually in accordance with prevailing accounting standards. The financial statements and the Annual Return lodged with the ASC become available on the public record (Australian Accounting Research Foundation, 1995a; Factor, 1995a; Govey, 1995; KPMG, 1995; Ford & Ramsay, 1996; Govey, 1996; Hardman, 1996; KPMG, 1996b). A large proprietary company which is not a reporting entity has to prepare audited financial statements annually and lodge them with the ASC, but these can be special purpose statements not adhering to prevailing accounting standards (KPMG, 1995; Parker & Reilly, 1995; Anon., 1996a; KPMG, 1996b). However, the financial reporting provisions of Schedule 5 of the Corporations Regulations still apply.

There is a special 'grandfathering' arrangement for proprietary companies that were exempt on 30 June, 1994 under earlier provisions of the Corporations Law and continue to meet the former rules for exemption, but which have become large proprietary companies in the first year of the new provisions. If they have been audited by specified deadlines in financial years ending in 1993 to 1996, and if they give appropriate notification to the ASC, they do not have to lodge financial statements with the ASC (Factor, 1995a; KPMG, 1995; Parker & Reilly, 1995; Ford & Ramsay, 1996; Parker, 1996). Possible amendments to the reporting requirements for large proprietary companies are foreshadowed later in this sub-section of the chapter.

The audit requirement on large proprietary companies initially applied from the first financial year commencing after the *First Corporate Law Simplification Act 1995* came into effect on 9 December, 1995 (for example, a financial year beginning on 1 January, 1996). The ASC can, on prescribed grounds, order that a large proprietary company need not adhere to the auditing requirements of the Corporations Law (Parker & Reilly, 1995; Ford & Ramsay, 1996; Govey, 1996; KPMG, 1996b; Parker, 1996; Sadhu, 1996). Such an order may be issued taking into account such factors as unusual circumstances of the company, any difficulties the company may face in complying with the legislation, and also the expected costs and benefits of forcing the company to

comply with the legislation. Expected benefits in this context must take account of the number and position of creditors and potential creditors, as well as the nature and extent of liabilities of the company (Parker & Reilly, 1995; CCH Australia, 1996; Govey, 1996; KPMG, 1996b; Sadhu, 1996). Parker & Reilly (1995, p. 58) claim that 'The criteria identified in the legislation are similar to the criteria used to identify whether an entity was a reporting entity'.

In response to a call from the ASC for public comment on possible audit relief measures for large proprietary companies, the professional accounting bodies have in fact argued for application of the reporting entity concept for this purpose. Under their proposal, non-reporting entities would be relieved from the audit requirements of the Corporations Law (Anon., 1996a; Parker, 1996; Sadhu, 1996). Other possible approaches for granting relief suggested to the ASC are summarised and evaluated by Sadhu (1996). Parker & Reilly (1995), Govey (1996) and Parker (1996), amongst others, anticipated that the ASC would promptly publish a policy statement and class order for this area of its discretion which would be closely scrutinised by large proprietary companies seeking relief from demands that would otherwise be made of them. According to Govey (1996, p. 12):

> . . . the ASC will take into account any difficulties the company may face if it is likely to move between the small and large proprietary company categories from one year to another. It will not generally be necessary for companies to apply individually for an exemption, as it is expected that the ASC will make an order exempting specific classes of companies from the requirement to lodge audited accounts.

The anticipated class order from the ASC was issued in November, 1996 and applies to large proprietary companies that are not grandfathered proprietary companies, disclosing entities, borrowing corporations or guarantors of borrowing corporations; and which have not been audited since 1993 (KPMG, 1996c; Parry, 1997). Such concerns were given an additional year to comply with the audit requirements of the simplified Corporations Law (that is, audited financial statements need not be submitted until the first financial year beginning after 9 December, 1996). Furthermore, on-going audit relief is provided for the same type of large proprietary company provided certain stringent conditions continue to be met. Parry (1997) indicates that these are intended to ensure that directors and shareholders are unanimous in not requiring an audit; that, with appropriate monitoring and financial reporting, the directors can attest without qualification to the solvency of the company; that the company has not recently been in a loss-making situation; that liabilities do not exceed 70 per cent of tangible assets; and that the unaudited nature of any financial statements produced is clearly indicated.

The employment criterion now used to ascertain the size of a proprietary company for the purposes of the Corporations Law (fewer than the equivalent of 50 full-time employees) is low relative to the various employment benchmarks for manufacturing concerns mentioned so far in this study. This means that many smaller manufacturers organised as proprietary companies – their most likely legal form – will need to rely on

the other two size-related criteria to avail themselves of the less onerous financial reporting demands on small proprietary companies. In reality, given the capital intensive nature of manufacturing and the need to operate at reasonable scale, it is highly likely that many small and most medium-sized manufacturers will be large proprietary companies according to the Corporations Law as it now stands. If not relieved by the grandfathering provisions of the *First Corporate Law Simplification Act 1995*, such businesses may seek to invoke the reporting entity concept to ameliorate the financial reporting demands they face, but these remain significant compared to those previously imposed on exempt proprietary companies. This is presumably the intention of the legislators who have indicated that 'Financial reporting requirements under the Law have been reduced for most proprietary companies, but strengthened for companies which have a significant economic impact' (Ford & Ramsay, 1996, p. 3). Govey (1996, p. 11) justifies as follows the financial reporting demands on large proprietary companies now in place:

> The size and influence of large proprietary companies and the large number of trade creditors which a company of this size will often have make it appropriate that their financial statements be audited and lodged with the ASC.

In contrast, King (1995, p. 435) believes that 'creditors must realise that they should rely on their own private enquiries and scrutiny rather than on any mandatory reporting requirements'.

As indicated earlier, the reporting entity concept is considered by some commentators to be under threat; and so the position of large proprietary companies continues to be a major concern for the Australian professional accounting bodies. Parker & Reilly (1995, p. 57) report as follows the findings of a survey of such companies conducted in 1995 by the Institute of Chartered Accountants in Australia:

> The survey indicated that over 2000 large proprietary companies that are non-reporting entities would be forced to have an audit with average costs of around $12,600. Around 97 per cent of these companies would have five shareholders or fewer, and 69 per cent of these companies would fail the proprietary size test if the criteria for a company to be classified as 'large' were to be 'doubled' as follows: consolidated annual revenue $20 million (up from $10 million); consolidated assets $10 million (up from $5 million); and 100 or more employees (up from 50). Furthermore, 98 per cent of the accounting practices that responded to the survey indicated that they continued to support the reporting entity concept.

Parker & Reilly (1995) and Parker (1996) point out that the professional accounting bodies have argued, to no avail, for retention of the exempt/non-exempt classification of proprietary companies as a compromise between the new size-related classification and the reporting entity concept. As an alternative, Parker & Reilly (1995) suggest that having five or more members could be an appropriate benchmark for concluding that the public interest is best served by having large proprietary companies annually lodge with the ASC audited accounts prepared in accordance with prevailing accounting standards. King (1995) suggests amending the definition of a large proprietary company to include the requirement that it have at least 50 shareholders.

Following a review of the financial disclosure requirements of Schedule 5 of the Corporations Regulations, and after due consultation, the AASB issued in December, 1996 a new approved accounting standard *AASB 1034: Information to be Disclosed in Financial Reports* (Australian Accounting Standards Board, 1996). This standard replaces Schedule 5 and it applies to all entities that are required by some provision of the Corporations Law, as amended by the *First Corporate Law Simplification Act 1995* and as proposed to be amended by the *Second Corporate Law Simplification Bill 1995* (see below), to prepare and lodge financial statements with the ASC (Parker, 1996; KPMG, 1997; Wagner, 1996a, 1996b, 1997). Only disclosing entities designated by the ASC need adhere to Section 12 of the standard. Schedule 5 has been repealed and removed from the Corporations Regulations in 1997.

The new approved accounting standard applies to reporting periods ending on or after 30 June, 1997. The standard is to be applied regardless of whether a business is a reporting entity or not (Australian Accounting Standards Board, 1996). It has been indicated that the standard represents (Anon., 1996b, p. 7):

> . . . a move away from the reporting entity concept as the sole determinant for the application of accounting standards in the future, suggesting that non-reporting entities should prepare Corporations Law accounts in the same format as a reporting entity (ie, a listed company).

Parker (1996, p. 55) summarises the new circumstances for the reporting entity concept as follows:

> In essence, a small proprietary company becomes a surrogate for non-reporting entities in the proprietary company context and all other entities required by the Corporations Law to prepare accounts would have to apply the Accounting Standards.

and:

> It is likely that the reporting entity concept will find its role narrowed to the consolidation provisions, relief from accounts preparation for wholly owned subsidiaries and the application of Accounting Standards for small proprietary companies which are reporting entities.

In explanatory material attached to the standard, it is specifically indicated that large proprietary companies are covered by the standard. By way of example, Wagner (1997, p. 52) points out that 'large grandfathered exempt proprietary companies would be required to prepare financial statements in accordance with the requirements of the Standard'.

Even if other applicability criteria are not met, AASB 1034 applies whenever a business prepares a financial statement that it holds out to be a general purpose financial report. Where the new standard conflicts with some other approved accounting standard, the latter would prevail. Similarly, the Corporations Law and Corporations Regulations take precedence over the standard. A separate but equivalent accounting standard for non-corporate reporting entities is not anticipated; but extension of the requirements of the new approved accounting standard to these other types of entities

will be considered in due course (Australian Accounting Standards Board, 1996; Wagner, 1996a, 1996b).

On the issue of financial statement presentation, AASB 1034 reads as follows (Australian Accounting Standards Board 1996, p. 7):

> This Standard does not prescribe the format for the presentation of *assets, liabilities, equity, revenues* and *expenses* in *financial reports*. The most appropriate format should be developed having regard to the particular circumstances of the *entity* and the presentation of relevant and reliable information about its performance, financial position, and financing and investing activities.

Clearly, there is a view that preparers of financial statements are in the best position to ascertain the most appropriate format for the particular circumstances of their respective entities. It has been indicated that 'This approach would effectively mean the end of "special purpose" financial reports' (Anon., 1996b, p. 7). The implication here is that general purpose financial reports with flexible formats will become the norm for businesses required to prepare financial statements in accordance with the Corporations Law.

The standard goes on to establish principles for determining the manner in which items are to be classified and presented in financial statements. Specific disclosures are prescribed for particular assets and liabilities, equity, revenues and expenses, executives' remuneration, auditors' remuneration, economic dependency, dividends and franking account balances. Appendix 3 to the standard specifies those Schedule 5 disclosure requirements included in the standard (with amendments). Appendix 4 specifies those Schedule 5 disclosure requirements omitted from the standard, mainly because they are included in other applicable accounting standards. Appendix 5 specifies disclosure requirements additional to those of Schedule 5.

3.4.2.3 Anticipated Developments in Financial Reporting

There are two further developments currently in train in Australia which will have significant implications for financial reporting by proprietary companies, and for the standing of the reporting entity concept. These are as follows:

- The period for public comment on the *Second Corporate Law Simplification Bill 1995* has now passed, but the Bill (as amended so far, and with its name changed to the *First Corporate Law Reform Bill*) is not expected to be introduced to the Australian federal parliament until 1998. Amongst many other reforms, the Bill includes additional provisions relating to corporate financial reporting (Factor, 1995b; Govey, 1995; King, 1995; Parker, 1996). In a concession to contemporary plain English usage, all references in the Corporations Law to 'accounting records' and 'accounts' will be officially changed to 'financial records' and 'financial statements' respectively. Govey (1995, p. 24) indicates that 'financial statements will comprise a profit and loss statement, a balance sheet, a cash flows statement and any additional notes and disclosures'. Guidance on the preparation of these

financial statements, and rules on the applicability of accounting standards, are matters to be left to the prevailing accounting standards. Consolidated financial statements will be required where accounting standards mandate these. According to Parker (1996, p. 50):

> . . . the Second Bill suggests that all entities required to prepare and lodge audited [general purpose financial reports] with the Australian Securities Commission should apply the Accounting Standards. The extent of application of the Accounting Standards has been left to the AASB.

The audit provisions of the Corporations Law will be significantly strengthened, especially in reporting non-conformance with prevailing accounting standards; and the directors' report will need to contain more information explaining the present and prospective financial circumstances of the company. The Bill would permit companies to provide to shareholders a concise financial report comprising the general directors' report, information on the audit, and summary financial information prepared in accordance with applicable accounting standards. Where the Corporations Law requires this, detailed financial reports that have been audited would still need to be lodged with the ASC. These must also be made available to shareholders free of charge on their request (Factor, 1995b; Govey, 1995).

- On behalf of the AASB, the AARF has recently released for comment an exposure draft entitled *ED 72: Changes to the Application of AASB Accounting Standards to Reflect the First Corporate Law Simplification Act 1995* (Australian Accounting Research Foundation, 1996). The exposure draft proposes to 'amend most AASB Accounting Standards to extend their application to entities which are required by the Corporations Law to lodge financial statements on the public record but to which application of AASB Accounting Standards might not otherwise apply' (Australian Accounting Research Foundation, 1996, p. 5). A *rationale* for this proposal is provided in the following terms (Australian Accounting Research Foundation, 1996, pp. 7-8):

> It is implicit in Parliament's decision to adopt the objective tests set out in the First Act that financial reporting requirements should be uniform for those entities which are required to lodge financial statements on the public record, even though they may not all be reporting entities. Accordingly, the AASB proposes to extend the application of AASB Accounting Standards to entities which lodge financial statements, irrespective of whether they are reporting entities or otherwise prepare general purpose financial reports. The AASB is taking this approach because it would ensure that comparable information is presented in all financial statements which are made available on the public record.

The companies of interest to the present study that would be covered by the proposal are shown in Table 3.1 on the next page, adapted from the exposure draft, which also provides a useful summary of the Corporations Law as it presently applies to proprietary companies.

Table 3.1: Application of Corporations Law (CL) to Proprietary Companies

Type of Entity	CL requires preparation of financial statements	CL requires lodgement of financial statements with ASC	ED72 requires application of AASB accounting standards
<u>Large proprietary companies</u>:			
Grandfathered exempt	Yes	No	No[a]
Grandfathered exempt, and ASC requests lodgement	Yes	Yes	Yes
All other large proprietary companies	Yes	Yes	Yes
<u>Small proprietary companies</u>:			
Controlled by foreign company	Yes	Yes	Yes
Shareholders request financial statements be prepared	Yes	No	Yes[b]
Shareholders request financial statements be prepared, and ASC requests lodgement	Yes	Yes	Yes
Shareholders request financial statements be prepared and specify accounting standards which do not apply	Yes	No	Yes[c]
Shareholders request financial statements be prepared and specify accounting standards which do not apply, and ASC requests lodgement	Yes	Yes	Yes[d]
ASC requests financial statements be prepared	Yes	No	Yes[b]
ASC requests financial statements be prepared and lodged	Yes	Yes	Yes
All other small proprietary companies	No	No	No

[a] Unless a reporting entity or prepares general purpose financial reports.
[b] If a reporting entity or prepares general purpose financial reports.
[c] Excluding accounting standards specified not to be applied; if a reporting entity or prepares general purpose financial reports.
[d] Excluding accounting standards specified not to be applied.

In circumstances where the amendments to AASB accounting standards proposed by the exposure draft conflict with the requirements of the Corporations Law, the latter would prevail (Wagner, 1996c, 1996d; Australian Accounting Research Foundation, 1996). One example of such a circumstance is where a proprietary company's shareholders specifically direct that accounting standards should not apply in financial reports requested by them. Another example is where the ASC has issued an individual or class order that relieves a proprietary company from applying accounting standards (Wagner, 1996c, 1996d).

Parker & Reilly (1996a, 1996b), representing the two professional accounting bodies in Australia, believe the AASB's approach to financial reporting by large proprietary companies that are not reporting entities, as reflected in ED 72, is flawed on several grounds. First, they anticipate that this approach will impose significant additional costs on such businesses at a time when the Australian federal government is seeking to reduce administrative burdens on smaller enterprises. Second, they argue that, in introducing classification of proprietary companies using size criteria as a basis for reporting to the ASC, the federal parliament did not explicitly reject the reporting entity concept as a basis for deciding the applicability of accounting standards in financial reporting. Parker & Reilly (1996a, 1996b) point out that, in fact, the *Second Corporate Law Simplification Bill 1995* contemplates continued use of the reporting entity concept in appropriate circumstances.

Third, Parker & Reilly (1996a, 1996b) argue that it cannot simply be deemed that financial information provided by proprietary companies which are non-reporting entities, but that nevertheless would be compelled by ED 72 to prepare general purpose financial statements based on AASB accounting standards, will be used in the same way as that from reporting entities such as public companies. Rather, it must be demonstrated that there are, and will continue to be, significant external users depending on such information for decision purposes. Fourth, they point out that, if the proposals in ED 72 are implemented, a disparity will exist between AASB accounting standards for companies and prevailing accounting standards for unincorporated businesses to the extent that the latter continue to be premised on the reporting entity concept. Finally, they believe that, by adopting the proposals in ED 72, the AASB will be conflicting with its own conceptual framework for financial reporting which embodies the reporting entity concept.

An informed response to Parker & Reilly (1996a, 1996b) is provided by Lonergan (1996). He acknowledges the threat to the reporting entity concept posed by ED 72, and he reiterates the view that all business concerns required to report on the

public record by the Corporations Law should do so in the same manner, for reasons of comparability and usefulness. The reporting entity concept is then attacked on the grounds of imprecision or uncertainty in its dictates. It is pointed out that, after due process in hearing arguments supporting the reporting entity concept, this practical failing has strongly influenced judgements of the Companies and Securities Advisory Committee, the Corporate Law Simplification Task Force, the Parliamentary Committee on Corporations and Securities and the federal parliament itself in favour of the proprietary company size test.

Lonergan (1996) goes on to dismiss arguments that application of ED 72 will add significantly to the financial reporting costs of a substantial number of large proprietary companies. He estimates that little over 5,000 in more than 930,000 companies in Australia will face an additional financial reporting burden. He also believes that the incremental costs are unlikely to be as great as claimed by opponents of ED 72 since much of the information must be prepared anyway for taxation and other purposes, and because of the ASC class order granting audit relief to specified large proprietary companies. Finally, Lonergan (1996) considers various alternatives to implementation of ED 72 and pronounces ED 72 to be the 'least worst alternative' at the present stage of Corporations Law reform in Australia – providing exemptions are given for interposed holding companies, family companies with no unsecured external creditors, and guaranteed subsidiaries. Lonergan (1996, p. 56) concludes:

> It is important to put in perspective just how radical a reform the large/small company test is. As a result of the introduction of the large/small test, and the proposed downloading of Schedule 5 to the AASB, over 900,000 companies will no longer be required by the Corporations Law to either prepare or lodge accounts. If we assume a modest annual cost for accounts preparation and lodgement fees of between $500 and $1,000 per company, this Corporations Law Simplification initiative will result in annual savings for the Australian business community of between $450-900 million per annum.
>
> Against this background the relatively small incremental cost for the relatively small number of companies caught by ED 72, which would not otherwise by obliged to prepare and lodge accounts that complied with AASB standards, is immaterial by comparison.

Parker & Reilly's (1996c) rejoinder to Lonergan (1996) points out that 88 per cent of over 70 submissions made to the AARF on ED 72 opposed its approach, and that the AASB is consequently having to reconsider its options. Parker & Reilly (1996c) then go on to attack Lonergan's (1996) paper and ED 72 on several predictable grounds, and to once again doggedly defend the reporting entity concept. They do acknowledge, however, that 'some fine-tuning may be required in light of experience and to placate the need for preciseness desired by certain legislators and their advisers' (Parker & Reilly, 1996c, p. 57). It is also argued that 'For a very limited number of entities where there is some doubt at the margin as

to whether or not an entity is a reporting entity . . . the ASC as the responsible regulator must be the arbiter. It must also be enforced by the ASC' (Parker & Reilly, 1996c, p. 57).

Early in 1997, the Australian federal government announcement establishment of the Corporate Law Economic Reform Program with a commission to ensure that reform of the Corporations Law proceeds forthwith in a manner 'consistent with promoting a strong and vibrant economy' (Department of the Treasury, 1997a, p. 2). The new corporate regulatory regime is required to:

- Take full account of the federal government's economic objectives.
- Encourage companies to fulfill their basic role of facilitating investment, employment and wealth creation.
- Protect investors and maintain confidence in the business environment.

The ongoing corporate law simplification effort is to be subsumed within the Corporate Law Economic Reform Program. A Business Regulation Advisory Group has also been established to 'assist and advise the Government on proposals for change to Australia's corporate regulation arising from the Corporate Law Economic Reform Program' (Department of the Treasury, 1997b, p. 1). Apart from passage of the *Second Corporate Law Simplification Bill 1995* through federal parliament, the only financial reporting matter presently on the agenda of the Corporate Law Economic Reform Program is reform of Australian accounting standards so that they are more sympathetic to society's broader economic goals, and changes to the manner in which accounting standards are set (including the possibility of broadly adopting international accounting standards and adapting them to Australia's needs).

3.5 Strategic Management and Financial Reporting

3.5.1 Strategic Management Theoretical Framework

A conceptual framework for SME financial reporting that could be employed in this research is one derived from strategic management theory. Justification for exploring this possibility stems from three key features of the study:

- It is directed towards successful pursuit of a longer-term strategy of growth in smaller enterprises.
- It focuses on the potential contribution of general purpose financial reporting to sound financial management of smaller enterprises in an overall or whole-of-business sense.
- It contemplates personal use of historical and future-oriented financial reports by owner-managers as chief executives or senior managers of smaller enterprises.

Sympathetic to these features, strategic management is fundamentally concerned with managerial planning, control and decision-making activities undertaken in a business,

viewed holistically from its upper levels, which largely determine its longer-term direction and achievements.

For various stated reasons, strategic management perspectives on smaller enterprise development and growth are not fully taken up in Chapter 2 of the thesis. For similar reasons, scholarly views on the role and importance of financial reporting in strategic management of smaller business concerns are not wholly adopted in this study. However, it is believed that elements of strategic management research in the area can usefully inform this study, especially as regards broad organisational and managerial context. Because of this, both theoretical views and empirical evidence on financial reporting and strategic management are presented at some length below, essentially as background. Thereafter, the theoretical literature of economics and finance is primarily relied upon in developing a conceptual framework for financial reporting in the research.

Generally speaking, strategic management scholars are critical of what they consider to be blinkered perspectives on the functioning of businesses provided by finance paradigms. For example, Barton & Matthews (1989) argue that strategic management yields a much more insightful perspective on financing decisions in smaller enterprises than does the field of finance itself. With the exception of research reviewed below, relatively little explicit attention to general purpose financial reporting practices, as defined for the purposes of this study, can be found in the strategic management literature since these have not been outcome, predictor or contingent variables which have interested scholars in the area to any marked extent. At most, financial reporting of the type a the focus of the present research is apt to be mentioned as one of many tools available for achieving adequate managerial control. Where reference is made to financial reporting, it is most often what is styled earlier in this chapter as special purpose financial reporting.

In the relevant strategic management literature in which Anthony (1965, 1988) is acknowledged as a pioneer, the emphasis is very much on managerial planning and control seen very broadly. For example Simons (1991, p. 49) reviews prior literature dealing with strategic management and management control systems described as follows:

> . . . formalized routines and procedures that use information to maintain or alter patterns in organizational activity. These systems include formalized information-based processes for planning, budgeting, cost control, environmental scanning, competitor analysis, performance evaluation, resource allocation, and employee rewards.

Management control systems, so conceived, are believed to develop in response to strategic considerations and circumstances in an inevitably complex manner. Simon (1990) claims that research has established a link between how business concerns achieve competitive advantage and how management control systems are designed and used.

A review article by Moores (1990) usefully draws together recent strategic management thinking on contingent relationships between business strategy,

organisational structure and management control systems; a life-cycle perspective on business development and growth; and conceptual views on the evolution of formal accounting control systems, and thus financial reporting of all kinds, in growing businesses. Moores (1990, p. 63) begins by indicating that (italics added for emphasis):

> . . . writers adopting a contingency perspective have suggested technology, organisational structure, *size*, strategy and environmental uncertainty are important factors to be considered in designing effective control systems . . .

He goes on to claim that, hitherto in the strategic management literature, a business's stage of development has not been included amongst contingent factors in broad design of management control systems or specifically in design of accounting control systems.

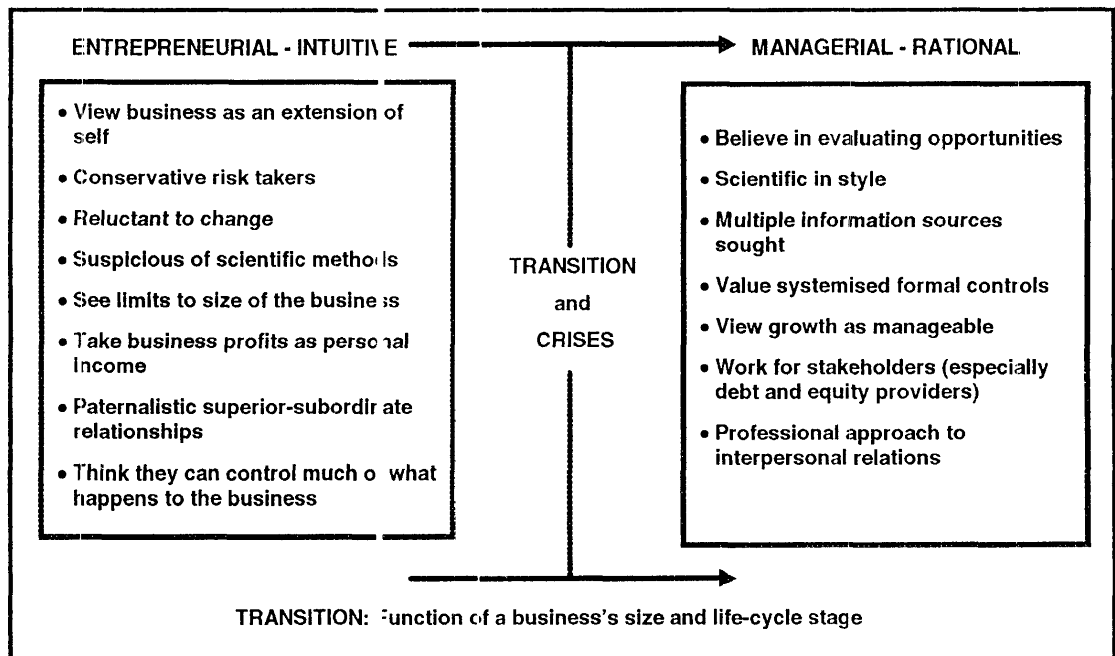
Moores' (1990) conceptual framework for understanding the accounting control needs of smaller business concerns focuses attention on the possible influence of their owner-managers' personal beliefs and style on financial reporting undertaken. Moores (1990, pp. 67-68) points out that:

> As firms move along the life stages, they move from informal to more formal organisational controls because of the accompanying growth. The information loads increase and there is an increasing degree of systematisation in the collection of information. Information is a commodity whose value and importance varies according to the degree of . . . sophistication of the entrepreneur's business ideology. Those entrepreneurs with a short term perspective, day-to-day preoccupation and a very pragmatic and intuitive problem-solving approach, tend to restrict the search for information to a few easily accessibly sources. On the other hand, entrepreneurs characterised by a managerial-rational business ideology tend to value information as an important element in the management of an organisation and tend to increase and diversify their sources of information. The more managerially oriented the entrepreneur, the greater will be the number of information sources used. Thus, depending on the stage of the organisation's life cycle, there will be a corresponding ideology on the entrepreneur-intuitive to managerial-rational continuum and an associated set of controls.

Moores (1990) represents the alternate business ideologies identified in the quotation above, and the possibility of transition from one to the other, as in Figure 3.2 on the next page (adapted from Moores, 1990, p. 68, Figure 1). Moores (1990) points out that, for many smaller enterprise owner-managers, changing their business ideology as their concern develops and grows, should this be required, is very difficult. If the necessary personal transition to keep pace with the evolving business cannot be made, or if the owner-manager is not willing to cede some control to professional managers or, indeed, step aside altogether, then the business may stop growing or succumb to one or more of the many crises inevitably associated with growth.

Moores (1990) goes on to identify accounting controls which tend to be dominant in the first six stages (from inception to maturity) in Adizes' (1979, 1989) 10-stage organisational passages model of business development and decline, as summarised in the Table 3.2 on the page after next (adapted from Moores, 1990, p. 65, Table 1). The table obviously includes both general purpose financial reporting and what is usually construed to be special purpose financial reporting associated with cost and management accounting activities. Nevertheless, Moores' (1990) accompanying

Figure 3.2: Owner-Manager Business Ideologies



comments on dominant accounting controls in the various life-cycle stages are useful to the present research:

- Courtship – any formal accounting controls at this stage would be too costly and counterproductive. Control is achieved through 'financial simulations' (for example, so-called business plans) for various scenarios envisaged by the owner-manager(s); and by reference to mainly external advisers such as public accountants, lawyers, bank managers, family, friends and business contacts.
- Infancy – formal accounting controls still tend to be too costly for businesses at this stage of development, they would not facilitate reactions fast enough to deal with problems faced, and decisions tend to be unique and outside the scope of most normal accounting controls. As Moores (1990, p. 66) indicates:

  > McNamara & Moores (1988) . . . found that use of formal systems and accounting based controls were limited in both successful and unsuccessful firms in their early stages of development. The tentative conclusion from this research is that it is an overall risk reduction strategy, rather than any specific control system (formal or informal), that will be most beneficial for infant organisations.

- Go-go – initially in this stage of development various means may be employed for forestalling introduction of formal accounting controls, but ultimately they become essential if the business is to be successful in following a growth strategy. Moores (1990, p. 67) suggests that (italics added for emphasis):

  > In stable environments, statutory and tax accounts will emerge as the dominant features of the control system. However, in the more likely turbulent environment of the *small growing firm*, accounting controls such as monthly profit and loss and balance sheet accounts, ratio analysis and flexible budgets will more effectively facilitate control.

Table 3.2: Strategic Management and Accounting Controls

Life-Cycle Stage	Strategy	Structure	Systems	Accounting Controls
Courtship	Solidifying commitment	No dominant feature	Not appropriate at this stage	Financial simulations
Infancy	Short-term pressure, no time to think tactically	Centralised with no managerial depth	No policies, systems, procedures, budgets	Risk reduction
Go-go	Short run, task to task, rates of growth in sales and profits helter skelter	Centralised but open	Establish workable policies, systems, procedures	Statutory and taxation reports, monthly profit and loss statements and balance sheets, financial ratio analysis, flexible budgets
Adolescence	Cool off growth	Decentralised	Meetings, training, computerisation	Responsibility accounting, actual or standard costing, cash-flow and manufacturing statements, operating budgets, break-even and industry analysis
Prime	Rates of growth stable and predictable	Decentralised and reorganised	Start to formalise systems	Responsibility accounting, operating and capital budgets, inflation accounting, long-run and strategic plans, contingency plans and models, simulations, executive information systems
Maturity	Integration and results orientation	Elaborate, decentralised, with options	Plans and procedures	

In the quotation, monthly profit and loss statements and balance sheets clearly amount to historical financial reporting. Flexible budgets are typically reflected in future-oriented financial reports. And financial ratio analysis is representative of various techniques available for the analysis and interpretation of financial statements. Thus, the focus here on financial reporting in smaller growth enterprises aligns in most respects with the principal research question for this study, as stated at the outset of Chapter 1 of the thesis. Note, in particular, that

the financial reporting of interest is primarily general purpose financial reporting as defined for this research.

- Adolescence – as second-tier managers are appointed because the increasing size of the business makes it impossible for the owner-manager(s) to personally oversee all aspects of its operations, an administrative or bureaucratic orientation develops in its management. According to Moores (1990, p. 68):

  > A responsibility based accounting system is the most suitable . . . control for adolescent firms and should initially incorporate elements of actual costing, cash-flow analysis and manufacturing statements.

  Ultimately, the business may need to employ standard costing, produce detailed operating budgets for all or most of its activities, and undertake break-even and industry analysis. In this stage then, special purpose financial reporting begins to become dominant amongst accounting controls.

- Prime and Maturity – generalisations about accounting controls for businesses in these stages are difficult to make for reasons detailed below. However, such concerns are more than likely to enhance accounting controls implemented in earlier stages of development; and it is conceivable they may place greater emphasis on controls which establish and maintain a longer-term direction for the business. Moores (1990, p. 70) believes that:

  > . . . if the operating environment is reasonably stable then . . . a responsibility accounting system . . . for the prime firm must focus on profits and profit centres. The bureaucratic control mechanisms will also expand with growth, and operational budgets, capital budgets, long-run plans, and strategic plans will prove to be useful control tools. If, on the other hand, the environment for the firm is extremely turbulent, then inflation adjusted accounts, contingency plans and models, simulations and/or executive information systems . . . may also be appropriate.

  The maturity stage is likely to be marked by ever increasing formality in control systems, and a growing emphasis on integration of the business's diverse activities. The seeds of the business's decline might also be sowed. The possibility arises that it could begin to become over-controlled and excessively bureaucratic, and so lose its entrepreneurial spark. Further, owner-managers may seek to enjoy the fruits of their labour, sometimes contrary to the interests of the business.

Moores (1990) completes his synthesis by presenting an integrated model of accounting control system design from a strategic contingency perspective – taking account of a business's life-cycle stage, the complexity of its organisational structure, and the degree of environmental turbulence it is experiencing. Implicit in the model is the presumption that, as a business grows in size, gets more diverse in its activities, and progresses to later stages in its life-cycle, it will necessarily become more structurally or organisationally complex. A widening product range, greater geographical spread in operations and markets, and consequent operational and functional specialisation all contribute to this process. Also implicit in the model is a belief that environmental

turbulence (creating or adding to uncertainty) is typically high when a business is newly formed and structurally simple. Environmental turbulence may remain high through a business's early growth stages because of competition; but it is difficult to generalise for maturer concerns because their circumstances can differ widely. Moores (1990, p. 74) indicates that 'depending on where an organisation lies in the [life-cycle/structural complexity/environmental turbulence matrix] there will be an associated set of appropriate accounting control tools'; and he adds the following important caveat mainly for young, growing businesses:

> . . . there are points in the life of a company where too much control could stifle creativity and hinder the development of the company. This is particularly the case if it is a form of control that directs attention to inappropriate areas, thereby misdirecting managerial action. This warning is particularly relevant to [those] in the accounting profession responsible for the design of . . . accounting information systems that not only keep the score but also direct attention and facilitate problem solving.

The warning is strongly echoed by Sweeting (1991) for financial planning and control techniques employed in new technology-based enterprises.

The research of Gul (1991) also suggests that the relationship between the level of environmental uncertainty and the appropriateness of particular accounting controls in smaller enterprises is not straightforward. Based on responses to a mailed questionnaire from owner-managers of 42 Australian manufacturing businesses with between 10 and 100 employees, Gul (1991) claims support for a view that more sophisticated financial control contributes to higher performance mainly in situations of high perceived environmental uncertainty. He believes that advanced control systems hamper performance when perceived environmental uncertainty is low because of the risk of unnecessary information overload and other possible dysfunctional effects such as preoccupation with the system itself.

3.5.2 Strategic Management Evidence from Overseas

Moores' (1990) conceptual and essentially contingent perspective on accounting control systems and financial reporting in growing SMEs is broadly supported by relevant empirical evidence from strategic management studies now to be reviewed. Khandwalla's (1972, 1973) work is identified by Simons (1990, pp. 29-130) as 'the first [empirical] study of its kind, focused on the relationship between formal accounting-based control systems and the type of competition in an industry'. Increased competition, particularly product competition, is found to lead to greater use of more sophisticated management tools such as cost controls and variance analysis, capital budgeting techniques and flexible budgeting.

Considering it to have been only minimally examined, Simons (1987) reports on an investigation into the relationship between business strategy and accounting control system attributes. The study is based on a Canadian manufacturing sample of 39 smaller businesses with between 250 and 600 employees and 37 larger concerns with

more than 600 employees. Simons (1987, p. 370) summarises the findings of his research as follows:

> This study considers control attributes which differ between Prospectors and Defenders and provides preliminary evidence concerning the relative importance of control systems in the two types of firms. High performing Prospector firms seem to attach a great deal of importance to forecast data in control systems, setting tight budget goals and monitoring outputs carefully. For Prospectors, cost control is reduced. In addition, large firms appear to emphasize frequent reporting and the use of uniform control systems which are modified when necessary.
>
> Defenders, particularly large firms, appear to use their control systems less intensively. In fact, negative relationships were noted between performance and attributes such as tight budget goals and output monitoring. Defenders emphasized bonus remuneration based on the achievement of budget targets and tended to have little change in their control systems.

The descriptors 'prospector' and 'defender' were coined by Miles & Snow (1978) to characterise the manner in which some businesses respond to their environment by way of competitive strategy. Prospectors tend to be more innovative; and they compete through new products and market development. Defenders offer a more limited and stable range of products; and they compete through cost leadership, quality and service. Not used in the Simons (1987) study is a third generic strategy styled by Miles & Snow (1978) as 'analyser', representing a hybrid of the other two.

More recently, Simons (1990, p. 140) describes his pilot research within two large businesses which, he claims, establishes reason for believing that 'interactive management control processes can be used to manage emergent strategy'. Interactivity in this context implies regular personal use of management controls by high-level decision-makers. Alternatively, management controls are described as being used diagnostically. Note that interactive use of general purpose financial reports by SME owner-managers is contemplated in this study. Note also that initiating growth can be viewed as an emergent strategy.

In a subsequent paper extending his research, Simons (1991, p. 52) specifically considers under the heading of 'profit planning systems' (one of five broad categories of management controls studied) what he describes as 'annual profit plans or budgets, second-year forecasts, [and] strategic operating and financial plans'. Such accounting-based and future-oriented tools, with historical reporting against plans, are of interest to the present study. Simons (1991) finds that profit planning systems are used interactively and alone by only five decentralised business units with relatively short planning horizons (maximum three years) in his sample of 30 such units in the same industry. Interactive use of profit planning systems together with other categories of management controls tends to occur in business units with low technological dependence, complex value-chains and shorter planning horizons. Five business units do not make interactive use of any category of management controls. Simons (1991, p. 60) comments on these as follows (italics added for emphasis):

> Generalizing from these five cases is difficult, but when organizations are *small* or shielded from the need to develop market strategies, there is probably little benefit in making selected systems interactive.

Simons (1991, p. 58) indicates that joint use of all five categories of management controls considered in his study is evident in six 'businesses in transition – undergoing revolutionary change'.

Paralleling the research described above, there is a relatively large literature on possible linkages between strategic planning and business performance. Previous inquiry in this area is critically reviewed by Hofer (1976), Armstrong (1982), King (1983), Shrader *et al.* (1984), Greenley (1986) and Pearce *et al.* (1987). More recently, a comprehensive meta-analysis of 21 prior studies of strategic planning and financial performance in businesses of all sizes is undertaken by Boyd (1991, p. 353) who indicates that 'Cumulation of previous studies found modest [positive] correlations between [strategic] planning and . . . performance measures'. However, with the minor exception of Rhyne's (1981, 1985, 1987) work examined below, this body of research tends to consider strategic planning in the broadest terms, with little attention given to particular tools and techniques employed. It is also inclined to treat future-oriented financial reporting of the type contemplated in the present study as merely a means of ultimately articulating a business's plans in monetary terms.

Rhyne (1981, 1985, 1987) is rare amongst researchers in the area in specifically examining the role of businesses' accounting systems as information sources in their strategic planning, and any evident linkage between use of accounting systems in this context and realised financial performance. In a sample of 89 large manufacturing concerns in the United States, Rhyne (1981) reports finding no statistically significant correlation between using an accounting system in strategic planning and various absolute and relative measures of financial performance. Rhyne (1985) indicates that accounting systems are less important to planning decisions amongst businesses that emphasise the adaptive aspect of planning (that is, responding to changes in the business environment). The adaptive aspect is contrasted with planning's integrative role which is concerned with coordination of internal resources – frequently perceived to be a *raison d'être* for accounting systems.

Rhyne (1987, p. 370) reports testing the proposition that 'Firms with a high level of performance will place less importance on the accounting system'. The accounting system is one of eight planning information sources considered. The study develops and employs a multi-item scale for 'planning integration' in which 'emphasis on projection of financial results' and 'emphasis on detailed financial statements' are two items of particular interest to the present research. In discriminant functions for contrasting between a total of 67 low-, medium- and high-performing businesses, use of the accounting system in strategic planning is included for absolute one-year financial performance, but is absent for other absolute and relative measures of financial performance. The integrative aspect of planning is included in discriminant functions for

all financial performance measures. Overall, Rhyne (1987, p. 380) concludes that his proposition on use of accounting systems in strategic planning is not supported and he comments:

> Both high and low performers identified the accounting system as an important source of information for [strategic] planning decisions, while high performers had been predicted to place less emphasis on the accounting system. In retrospect, the finding that high performers also view the accounting system as an important source of information for [such] planning decisions should not be surprising, since the measures of performance utilized in this study could likely be expected to respond to changes in accounting measures of performance.

Finally, Rhyne (1987, p. 381) observes that 'Since accounting reports were the primary means of communicating the success of an organization to financial markets, the accounting system remained an important source of information'.

There is a substantial number of published research studies of the relationship between strategic planning and financial performance in small and medium-sized enterprises. These include the works of Shuman (1975), Burt (1978), Kallman & Shapiro (1978), van Hoorn (1979), Robinson (1980), Unni (1981), Bracker (1982), Jones (1982), Robinson (1982), Robinson & Pearce (1983), Robinson *et al.* (1984), Ackelsberg & Arlow (1985), Orpen (1985), Sexton & Van Auken (1985), Shuman *et al.* (1985), Bracker & Pearson (1986), Robinson *et al.* (1986), Bahaee (1987), Gable & Topol (1987), Bracker *et al.* (1988), Cragg & King (1988), Wood *et al.* (1988), Shrader *et al.* (1989), Watts & Ormsby (1990), Naffziger & Kuratko (1991a), Flavel (1992), Ghosh *et al.* (1992), McKiernan & Morris (1994), Orpen (1994a, 1994b) and Risseeuw & Masurel (1994). Shuman *et al.* (1985) specifically consider strategic planning in smaller growth enterprises, but reveal nothing about the role of future-oriented financial reporting in this context beyond noting the incidence of preparation of once-off business plans. Broader studies on strategic planning in smaller enterprises include those of Steiner (1967a, 1967b), Still (1974), Sexton & Dahle (1976), Bhatty (1981), O'Neill (1983), Stoner (1983), Gibb & Scott (1985, 1986), Aram & Cowen (1990), Naffziger & Kuratko (1991b) and Dodge *et al.* (1994).

Robinson & Pearce (1984) provide a review of early research on (*inter alia*) the relationship between strategic planning and financial performance in smaller business concerns. More recently, Schwenk & Shrader (1993, p. 60) have conducted a meta-analysis of 14 individual studies of this relationship in smaller enterprises, and they claim that:

> . . . through the use of meta-analysis, we are able to provide straightforward support for the general assertion that strategic planning does have a significant, [weak] positive association with performance across studies.

It should be noted, however, that no evidence is provided by Robinson & Pearce (1984) or Schwenk & Shrader (1993) concerning specific future-oriented financial reporting practices followed in strategic planning. Possible associations between future-oriented financial reporting and smaller enterprise financial performance are revisited in Chapter 4 of the thesis.

3.5.3 Strategic Management Evidence from Australia

Examples of strategic management research dealing with managerial planning and control in Australian SMEs are a study undertaken by Romano (1990), and subsequently reported in Romano & Ratnatunga (1992, 1994, 1995), on the role of formal planning and control systems in growth of smaller businesses; and a study conducted by Moores & Mula (1993) focused on managing and controlling family-owned businesses for survival and growth. Since neither study is embraced by Schwenk & Shrader's (1993) meta-analysis, and because they share an Australian context with the present research, their findings are now reviewed

The Romano (1990) investigation is essentially qualitative, exploratory research based on case studies of 15 high growth businesses with fewer than 100 employees, distributed across a range of manufacturing activities, and a similar sample of 15 low growth concerns, all located in the metropolitan area of Melbourne, Victoria. Data were gathered through multiple interviews conducted in each business, guided by a semi-structured interview schedule. Characteristically for the *genre* of strategic management research to which it belongs, questions relating to managerial planning and control were very general. Romano (1990, p. 135) recounts the questions as follows:

- Since commencement has your firm developed any strategies?
- Is the development of your strategies market determined?
- What is the level of planning and control in your firm? Trace history of planning and control development.
- What factors make up your planning and control system?
- Can you identify at what point in time you introduced components of the planning and control system?
- What was the purpose of introducing the various components?
- Can you identify the development of the planning and control system in relation to your firm's growth?

While difficult to anticipate from these questions, the case study write-ups do include a little detail on use of some specific managerial planning and control tools such as historical and future-oriented financial statements.

Not uncommon for strategic management research, the Romano (1990) study is short on definitive outcomes and long on claims to explanatory power. Romano (1990, p. iii) summarises the results of his work as follows:

> The study provides empirical evidence to improve understanding of causality in the growth of small business by focusing on how formal planning and control systems are embedded within the external or internal contextual variables of small business and the characteristics of their management. Evidence is also provided as to the conditions and circumstances under which formal planning and control are likely to be most effective in controlling the effects of contextual variables. Also, evidence is provided as to the difference between high growth and low growth firms in the use of formal planning and control.