In fact, the alleged insights stemming from Romano's (1990) work are as causally pretentious and every bit as convoluted (supposedly rich and context sensitive) as the quotation above might suggest. Other than reinforcing a contingent perspective on the development of managerial planning and control in smaller growth enterprises, Romano's (1990) findings provide little of value for this research.

Moores & Mula's (1993) exploratory study, while of the same strategic management *genre* as that of Romano (1990), is of considerably greater relevance and usefulness to the present research – building as it does on Moores' (1990) conceptual framework for contingent design of accounting control systems in smaller enterprises at various stages of development, outlined earlier in this section of the chapter. Moores & Mula (1993) set out to discover more about the role of managerial control systems, specifically including financial reporting, in survival and successful growth of family businesses that had been in existence for at least five years, and which had the involvement of second or later generation family members.

A total of 278 family businesses meeting the criteria provided useable responses to a mailed, self-administered questionnaire containing nearly 100 questions arranged in six sections covering key characteristics, business environment, business strategies, business structure, managerial control systems, and ownership structure and management. General characteristics of the respondents are as follows:

- Mean number of employees is 171, the mode is 50 employees, and the largest respondent has 4,600 employees.
- Fifty per cent of respondents have sales revenues in the range $5 million to $20 million per annum. The largest respondent has annual sales of over $500 million.
- Average age is approximately 50 years, with the oldest respondent having been in existence for 150 years.
- Respondents are spread across a range of industries, with manufacturing being over-represented (just over 40 per cent) in comparison to Australian Bureau of Statistics industry data at the time.
- Around 68 per cent of respondents are legally organised as companies. Sixty-three per cent are proprietary companies, with 44 per cent being exempt and 19 per cent being non-exempt for the purposes of financial reporting to the Australian Securities Commission.
- Forty-two per cent of respondents sell to one or more overseas markets; and some have physical facilities located overseas.

These characteristics suggest that there is a moderate degree of overlap between Moores & Mula's (1993) sample and that employed in the present research.

The management control systems section of the questionnaire used in Moores & Mula's (1993) study contains 13 questions related to content and 10 questions related to form. The content questions attempt to ascertain, on 7-point Likert scales, the extent to which mainly financial controls are used in management. Mean scores for scales of

interest to this research are, in decreasing order of importance to managerial control: computerised accounting system 6.1, monthly profit and loss statements 5.8, cash-flow statements 5.5, monthly balance sheets 4.9, participation in budgeting 4.6, external auditing 3.7, comparison with industry averages (presumably for financial ratios) 3.5, and manual accounting systems 2.6. Computerised accounting system, monthly profit and loss statements, and cash-flow statements are identified by Moores & Mula (1993) as the dominant financial controls in their research. The form questions attempt to ascertain, on 7-point Likert scales, the importance to decision-making of the scope, focus, quantification, futurity and timeliness of information. Its timeliness emerges as the key attribute of information for managerial decision-making purposes.

In subsequent factor analysis of responses to content questions in the management control systems section of Moores & Mula's (1993) questionnaire, two of five factors to emerge are labelled 'financial reporting' embracing monthly balance sheets (factor loading 0.88), monthly profit and loss statements (factor loading 0.85), and cash-flow statements (factor loading 0.48), with overall Cronbach's alpha 0.74 and variance explained 7.8 per cent; and 'accounting systems' embracing manual accounting systems (factor loading 0.80) and computerised accounting systems (factor loading 0.69), with overall Cronbach's alpha 0.50 and variance explained 6.5 per cent. In factor analysis of responses to form questions, one of two factors to emerge is labelled 'timeliness of information' embracing four scales (minimum factor loading 0.61) reflecting concern for the time delay between events occurring and reporting on those events, with overall Cronbach's alpha 0.67 and variance explained 14.8 per cent.

In subsequent simple correlation analysis, the factor 'financial reporting' has statistically significant associations with organisational structuring (Pearson product-moment correlation coefficient 0.172 with $p<0.01$) and pursuit of diversification strategies (Pearson product-moment correlation coefficient 0.136 with $p<0.05$). The factor 'accounting systems' has statistically significant associations with technological and economic stability (Pearson product-moment correlation coefficient 0.143 with $p<0.05$) and delegation of authority (Pearson product-moment correlation coefficient 0.149 with $p<0.05$). The factor 'timeliness of information' has statistically significant associations with technological and economic stability (Pearson product-moment correlation coefficient 0.138 with $p<0.05$), delegation of authority (Pearson product-moment correlation coefficient 0.130 with $p<0.05$), organisational structuring (Pearson product-moment correlation coefficient 0.162 with $p<0.01$), broad management controls (Pearson product-moment correlation coefficient 0.191 with $p<0.01$) and accounting systems (Pearson product-moment correlation coefficient 0.121 with $p<0.05$).

Summarising the findings of subsequent partial correlation analysis, Moores & Mula (1993, p. 68) indicate that (r is the partial correlation coefficient):

> The sophistication of *financial reporting* tends to be driven by the *structuring of activities* ($r=0.176$, $p<0.01$) and *diversification strategies* ($r=0.142$, $p<0.05$) and to a far lesser extent by the level of *competition and constraints* ($r=0.093$, $p<0.10$)

prevailing in the external environment and the internal *structuring of authority* ($r=0.092$, $p<0.10$). The development of computerised accounting systems is interestingly driven largely by an internal feature, the *structuring of authority* ($r=0.183$, $p<0.01$). Lesser drivers for such systems include internal *structuring of activities* ($r=0.097$, $p<0.10$) and external *technoeconomic* uncertainties ($r=0.095$, $p<0.10$).

The factor 'timeliness of information' has a statistically significant association only with technological and economic stability (partial correlation coefficient 0.081 with $p<0.10$).

In their study, Moores & Mula (1993) focus on the last three stages of Quinn & Cameron's (1983) four-stage business life-cycle model:

- Collectivity – combining the infancy and go-go stages in Adizes' (1979, 1989) model.
- Formalisation and control – combining the adolescence and early prime stages in Adizes' (1979, 1989) model.
- Elaboration of structure – combining the later prime and early maturity stages in Adizes' (1979, 1989) model.

The second of these is of particular interest to the present research since, as the name suggests, it is at this stage that more sophisticated managerial structures and practices are most likely to emerge in growing businesses. The following table summarises Moores & Mula's (1993) findings on enterprise size (in employment terms) and certain financial reporting characteristics (measured on 7-point Likert scales) in all three life-cycle stages (adapted from Moores & Mula, 1993, p. 77, Table 7.1):

Table 3.3: Enterprise Size, Financial Reporting and Life-Cycle Stages

Enterprise Size and Financial Reporting Measures	Collectivity Stage	Formalisation & Control Stage	Elaboration of Structure Stage
	Mean	Mean	Mean
Number of employees	72 (small)	177 (medium-sized)	323 (medium-sized)
Financial reporting scale	4.72	5.43	6.39
Accounting systems scale	4.15	4.35	4.45
Timeliness of information scale	4.70	5.15	5.42

Moores & Mula's (1993) results presented in the table above clearly indicate increasing emphasis on financial reporting as businesses grow in employment terms and progress through the last three stages of Quinn & Cameron's (1983) life-cycle model. Thus, they provide some support for Moores' (1990) conceptual framework presented earlier in this section of the chapter. Note that the means for the number of employees in each stage

align reasonably well with the definitions of small and of medium-sized enterprises adopted in the present study.

Moores & Mula (1993) summarise the principal findings of their research into management and control activities in family businesses as follows:

- Conventional historical profit and loss statements and balance sheets, largely prepared using computerised systems, are the primary managerial control tools used.
- Managerial controls, including financial reporting, are dynamically developed so as to be congruent with the external and internal environments, and with the stage of development reached
- When high uncertainty arises from a changing business environment, increased computerisation of accounting systems occurs in order to provide information in a more timely manner.
- When high uncertainty arises from external constraints and competition, greater reliance is placed on conventional financial reports for managerial control purposes.
- When pursuing diversification strategies, more sophisticated managerial controls, including financial reports, are introduced.
- When complex departmental or divisional organisational structures are introduced, more sophisticated computer-based financial reporting is developed to facilitate managerial control, and also to establish managerial accountability and permit managerial performance evaluation.

In closing, it must be pointed out that the literature dealing with financial reporting to meet operational or short-term management needs (that is, what is usually referred to as cost and management accounting) is not explicitly reviewed in the thesis. This follows from the earlier exclusion from consideration of specific purpose financial reports or statements of the kind usually advocated for cost and management accounting purposes in business segments. Note, however, that (*inter alia*) financial reporting of this broad type is considered in the review of the strategic management literature early in this section of the chapter. More is said in Chapter 5 of the thesis on the limitations of strategic management as a theoretical framework for various aspects of the present study.

3.6 Finance Perspectives on Smaller Enterprise Financial Reporting

3.6.1 Information Economics and Financial Reporting

Many books and other writings on financial accounting theory identify 'information economics' or 'the economics of information', an extension of statistical decision theory, as one of a number of conceptual building blocks for understanding, at least at a general or abstract level, financial reporting undertaken by business organisations (Feltham,

1984; Wolk *et al.*, 1991; Henderson *et al.*, 1992; Godfrey *et al.*, 1994; Mathews & Perera, 1996). According to this framework, information is seen as another type of economic good or commodity which can be subjected to customary supply and demand analysis. Accounting information is simply one subset of all procurable imperfect information with potential economic value. Mathews & Perera (1996, p. 68) describe the broad analytical/deductive approach adopted in information economics as follows:

> In constructing models, assumptions are made about the nature of the decision makers, the decision contexts they face and the systems that provide them with information. The models are then analysed to derive conclusions regarding the decision maker's demand for information and the impact of alternative information systems. For example, if an individual is uncertain about the consequences of a set of alternative actions he or she is likely to value information that reduces his or her uncertainty about the consequences, creating a demand for such information. To formally explore the nature of the demand for information, a model of choice when confronted with uncertainty is constructed.

Importantly, Mathews & Perera (1996, p. 68) go on to indicate that information economics rests on the assumed existence of single or multiple economically rational decision-makers.

Seminal works in the area of information economics include those of Marschak (1959), Stigler (1961), Marschak (1971) and Marschak & Radner (1972). Hirshleifer & Riley (1979) review the early development of information economics in the literature of economics. Beaver (1981), Feltham (1984) and Baiman (1984) all review the impact of information economics upon accounting thought. Feltham (1984) provides a comprehensive review of the debt owed by developing financial accounting theory to information economics, emphasising the implications of information economics for choices between alternative financial accounting systems and practices. Baiman (1984) reviews the implications of information economics research for understanding the impact of and demand for alternative management accounting systems within an agency context.

Seminal works on the application of information economics to financial reporting by businesses include those of Feltham (1968), Butterworth (1972), Feltham (1972) and Demski (1974). While these studies focus on single decision-makers and are primarily concerned with management accounting systems, they provide necessary foundations for later predominant interest in multiple decision-makers, especially those external to the business, and in the role and regulation of financial accounting. Regulation in this context raises the prospect that financial reporting practices may be imposed on a business by external parties (including government agencies), rather than being chosen by those within the business. A circumstance at the margin of such a scenario is one in which substantial financial reporting might not be undertaken at all without at least one external imperative – the apparent situation in many SMEs.

In information economics, the production and dissemination of information is recognised to be costly to the procuring economic agent. The benefits of information in terms of better informed decisions may accrue to the procurer; but are often also

enjoyed (sometimes mainly) by economic agents not involved in procuring the information, and who have borne none of the costs entailed. This possibility creates a conundrum in information economics: information can become a 'public good' with an associated 'free rider' problem for the procurer. Choices, with implications for the consumption of scarce resources, must be made regarding the amount and type of information supplied, and that demanded. The conventional condition for optimality applies: information is produced and disseminated to the point where the marginal cost of doing so just equals the marginal benefit to users of the information. Henderson *et al.* (1992, p. 42) place particular stress on the free rider problem in information economics, and also identify a necessary condition for regulation of the provision of accounting information by businesses, in the following terms:

> With the information economics approach, suggestions that certain items of accounting information should be made available are evaluated by comparing the costs of providing it with the benefits obtained from its provision. This comparison is difficult because the costs are incurred by people who are different from those who receive the benefits. The information providers incur costs but receive few benefits. The information users receive benefits but incur few costs. The information economics approach is potentially useful in considering the desirability of regulatory intervention in the accounting area. In this context, the costs of regulation should be compared with the resulting benefits.

In introducing information economics, Godfrey *et al.* (1994, p. 13) describe the nature and purpose of accounting in a regulated business environment, such as that now prevailing in Australia, as follows:

> . . . accounting standards impose compliance costs; regulation determines who bears the costs and who benefits; and accounting assists parties to monitor the performance of managers and assists managers to show how they have acted in the interests of those parties (e.g. shareholders and lenders) whose funds they control. It is assumed that management has chosen from alternative procedures to establish the original set of accounting methods which minimises the information costs of the entity. Any changes in acceptable accounting alternatives have an impact on managers, who may lobby policy makers to reverse the undesired changes, make discretionary changes in other accounting methods to mitigate the effects, or change the financing, production or investment activities of the firm.

Attempts in the literature to at least notionally weigh the costs and benefits of financial reporting by smaller enterprises in a regulated environment include those of Horwitz & Kolodny (1982), Nair & Rittenberg (1982, 1983), Friedlob & Plewa (1984), Hiltebeitel (1986) and Friedlob & Plewa (1992). Relations between stakeholders in business concerns, and the manner in which accounting information is used in the governance of their joint interests, are matters that receive further attention later in the chapter – particularly when introducing agency theory.

From the viewpoint of the present research, certain limitations of information economics as an explanatory framework for financial reporting by businesses must be recognised. Feltham (1984) and Wolk *et al.* (1991) point out that information economics:

- Does not practically lead to normative guidance on what sets of accounting information are optimal.

- Cannot really deal with the complex decision situations faced in the real world of business.
- Does not sufficiently recognise human bounds as far as the ability to process information is concerned.
- Does not comprehend 'satisficing' behaviour on the part of decision makers, focusing as it does on the maximisation of utility.
- Does not adequately handle heterogeneity amongst decision-makers, which makes it difficult to extrapolate any analysis for individuals to all decision-makers.

Thus, while acknowledging some explanatory benefits of information economics, writers on accounting theory, and organisations concerned with accounting practice, are largely dismissive of its potential for prescribing accounting procedures at a practical level for business concerns. For example, Henderson *et al.* (1992, p. 42) indicate that:

> The estimation of the costs and benefits of accounting information is likely to be very difficult. Consequently, this class of prescriptive theories is not as large as others.

Questioning the ability of information economics to justify and aid understanding of public regulation of accounting practices followed by businesses, Wolk *et al.* (1991, pp. 216-217) point out that:

> Information has also been deductively analyzed in a multiuser setting. This entails a market-level social welfare analysis of information supply and demand in which accounting information is treated as an economic good. This type of research is very abstract and is based on narrowly defined sets of assumptions concerning economic markets. Information is also treated in a nondescript manner – that is, the analyses are of information markets rather than of specific types of information; for this reason, the conclusions are of a very general nature. These types of deductive analyses try to evaluate market incentives for information production and consumption, as well as the effects on aggregate social welfare or optimality of resource allocation. Some of these studies also examine the effect of regulation on information markets, but again in a very generalized manner. Because of the abstractness and generality of these analyses, the multiuser setting of information economics has not yielded specific conclusions concerning the value of accounting information.

Finally, the influential American Accounting Association (1977, p. 25) has concluded:

> In summary, the information economics approach offers an explicit individual-demand-based analysis of accounting policy questions . . . The power of the approach is in isolating general relationships and effects of alternative scenarios. At present, however, the approach is still too general to provide definitive answers . . .

Notwithstanding the views presented in the previous paragraphs, an information economics perspective is considered to have value for the present research in providing a plausible framework for the following broad argument. For a number of reasons listed in Chapter 1 of the thesis, and expanded upon later in this chapter, SME owner-managers as a group appear to underutilise formal financial reporting in overall financial management of their businesses. Nevertheless, as indicated earlier in this chapter, there are in Australia a number of regulatory influences on financial reporting by small and medium-sized enterprises which are viewed by their owner-managers as imposing on

their concerns an unjustified cost burden. Most, if not all, of the benefits arising from such outlays are perceived as accruing to outside parties such as creditors, debt providers, competitors, support agencies and government. In other words, from the viewpoint of many owner-managers, a classic free rider circumstance appears to exist.

If it is accepted that there is a certain inevitability to financial reporting regulation for the foreseeable future in this country, a rational response by owner-managers of smaller enterprises would be to seek additional benefits accruing mainly to their businesses from whatever financial reporting is unavoidably undertaken for taxation authorities, the ASC, etc. This thesis argues that for SMEs in financially challenging circumstances such as growth these benefits could include better financial control and easier access to external financial support (Nair & Rittenberg, 1983; Friedlob & Plewa, 1984; Hiltebeitel, 1986; Friedlob & Plewa, 1992). Thus, the net cost of mandated financial reporting may be reduced quite significantly. Further development of this argument is undertaken later in the chapter when an attempt is made to summarise and synthesise elements of various theoretical perspectives on financial reporting by smaller enterprises identified in the literature of economics and finance.

3.6.2 Modern Finance Theory and Financial Reporting

Drawing upon widely accepted perceptions in the relevant literature, McMahon *et al.* (1993a, p. 4) describe financial management as a field of scholarship as being concerned with:

> . . . understanding the factors that determine the value of an enterprise's uncertain cash-flows over time, and with management of these factors in a normative sense.

and they indicate that:

> The broad purpose is to serve the best interests of those who have provided the enterprise with capital to finance its assets and activities, and who ultimately bear the risk that stems from an uncertain future. The essential task is to secure, through sound decisions returns that are sufficient in both amount and timing to reward the providers of capital for their initial and ongoing support.

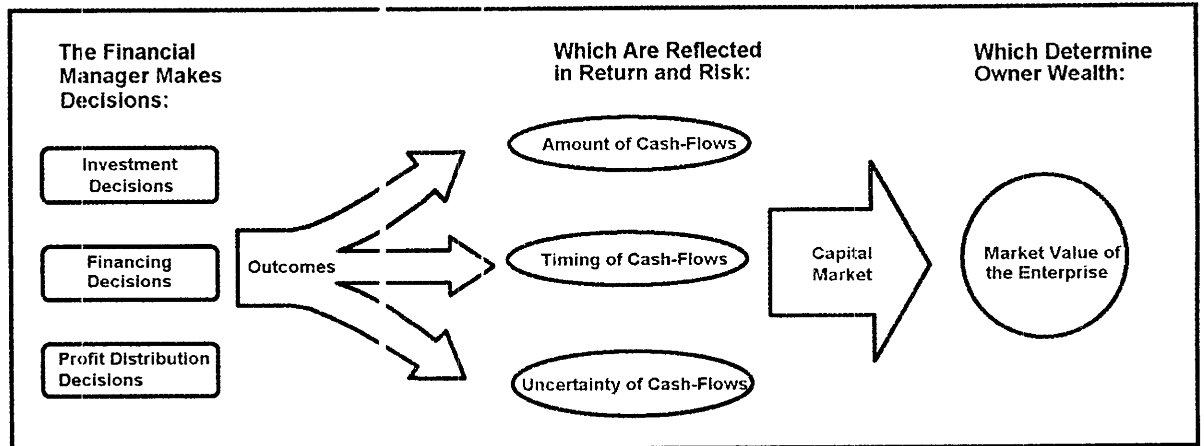
The domain of financial management is subsequently represented as in Figure 3.3 on the next page (McMahon *et al.* 1993a, p. 7, Figure 1.1).

Fundamentally, modern finance theory directs scholarly attention to the way in which the capital market enables allocation of scarce financial resources between individuals and business enterprises over time. The subsequent allocation of financial resources between competing uses within businesses is also a major preoccupation. In the words of McConnell & Pettit (1984, p. 97):

> . . . the theory of finance is especially concerned with the way in which capital markets provide signals to managers that help them in choosing among alternative production-investment opportunities and with the way in which capital markets facilitate fund raising by firms for the purpose of financing their production-investment decisions.

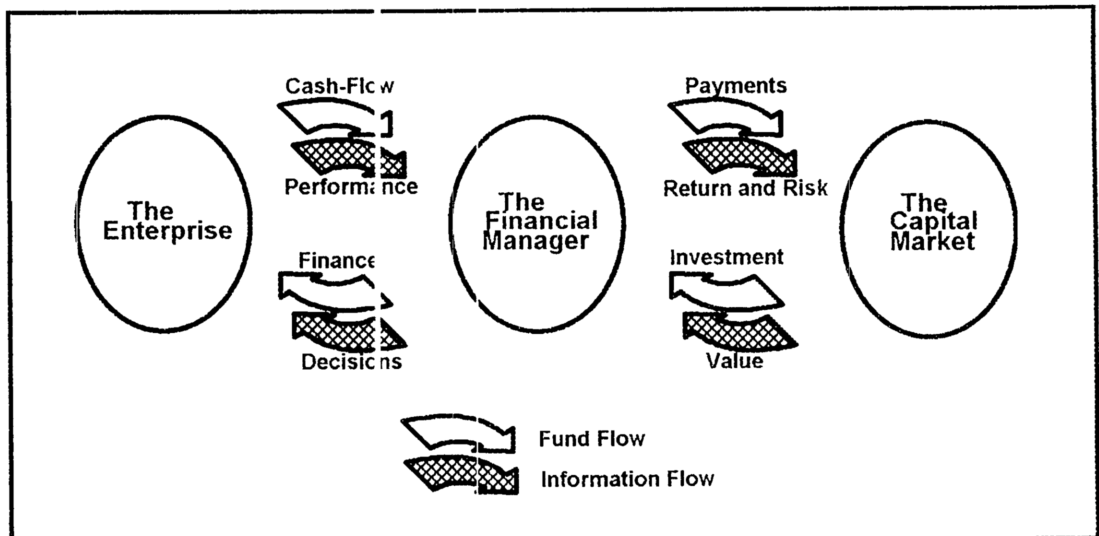
According to this perspective, the financial manager of a business plays an important intermediating role between the capital market and the enterprise. This view of financial

Figure 3.3: Normative Model of Financial Management



management is represented as in the following diagram (McMahon *et al.*, 1993a, p. 70, Figure 3.1):

Figure 3.4: Role of the Financial Manager



The diagram above indicates that flows of funds between a business enterprise and the capital market are necessarily matched by flows of essentially financial information. Full and accurate transmission to the capital market of information about the enterprise's return and risk characteristics through timely and relevant financial reporting, and subsequent receipt of reliable information on the market's valuation of the enterprise, are both vital to financial management as it is represented in modern finance theory. The Efficient Market Hypothesis provides confidence in the ability of the market to correctly interpret the significance of information which has been made available to it, and to appropriately reflect this in the judgments it makes. In its semi-strong form which has been widely supported by empirical research, the Efficient Market Hypothesis holds that all publicly available information about an enterprise is correctly, completely and rapidly impounded into capital market valuations (Watts & Zimmerman, 1986; Copeland

& Weston, 1988; Emery & Finnerty, 1991; Peirson *et al.*, 1995). However, in the discussion which follows it is indicated that for smaller businesses there is considerable reason to be concerned about the transmission of information to the capital market. To the extent that the information is inaccurate, incomplete or out-of-date, even an efficient market will fail in its allocative role.

The focus now turns to the use of financial information by owner-managers of smaller enterprises in the overall financial management of their concerns. A great deal of modern finance theory is steeped in neoclassical microeconomic theory which currently constitutes mainstream thinking amongst economists. Gibson (1992a, 1993) points out that, as far as smaller enterprise financial management is concerned, the most important assumption of neoclassical economics is that the owner-manager is a rational economic decision-maker. Rationality in this context means that an objective (usually economic profit maximisation) is specified, all possible courses of action are identified and evaluated, and the action which maximises the objective is chosen. Gibson (1992a, p.5) goes on:

> Because of the emphasis on profit maximisation or monetary rewards it follows that when alternative actions are evaluated they need to be evaluated in financial terms. Thus an important assumption, in the context of small firm financial management, is that decision makers will have access to financial information to facilitate the evaluation of available options. To the extent that possible alternatives are likely to be similar in many respects to those followed in the past, financial information from an accounting system which accumulates data about past events is assumed to be essential for rational economic decisions to be made.

Ray & Hutchinson (1985, p. 225) place a more balanced emphasis on the need for both historical and forecasted financial information in smaller growth enterprises:

> . . . it can be predicted that the implication for an appropriate financial control system is that the entrepreneur will require accounting information to be supplied quickly on a range of opportunities and as such the accounting information will be heavily future orientated. Accounting information on the immediate past will be required at very frequent intervals in order to satisfy the needs of the entrepreneur for feedback on performance to ensure that self imposed standards are being met.

The key question to be addressed in this research is whether these are accurate representations of the role and significance of financial reporting in smaller enterprises that are growing.

As the quotations in the previous paragraph suggest, a significant feature of modern finance theory as it has evolved is the prescriptive position it takes on the role of accounting information in financial management of businesses. The following words of Wolk *et al.* (1991, p. 39) aptly convey this perspective on financial information:

> This approach does not ask what information users want but rather concentrates on what information is useful for particular decisions. Thus, its orientation is normative and deductive. A premise underlying this [theory] is that decision makers must be taught how to use this information if they are unfamiliar with it.

These words also encapsulate prevailing attitudes amongst many researchers, educators, support programme managers and policy-makers towards education and/or

training of smaller enterprise owner-managers and their managerial employees in the general area of financial management, and on financial reporting for internal management purposes in particular.

A review of the empirical evidence available on financial reporting practices of smaller enterprises, substantially based on the work of McMahon & Holmes (1989, 1990, 1991, 1992), will be presented in Chapter 4 of this thesis. In the main, this evidence suggests that historical financial reporting by smaller enterprise is infrequent, with there being a heavy emphasis on annual statements to satisfy taxation and other statutory reporting requirements where these apply. There is also evidence that owner-managers of smaller enterprises do not consider the financial reports which are obtained to be particularly useful for decision-making purposes. It is concluded that, generally speaking, the financial reporting undertaken by smaller enterprises is not sufficiently timely and relevant when their owner-managers' real needs for the purposes of sound financial management are properly considered. At this stage, it is useful to supplement this broad impression with the findings of a recent Australian study which suggests a contingent nature for financial reporting in smaller enterprises.

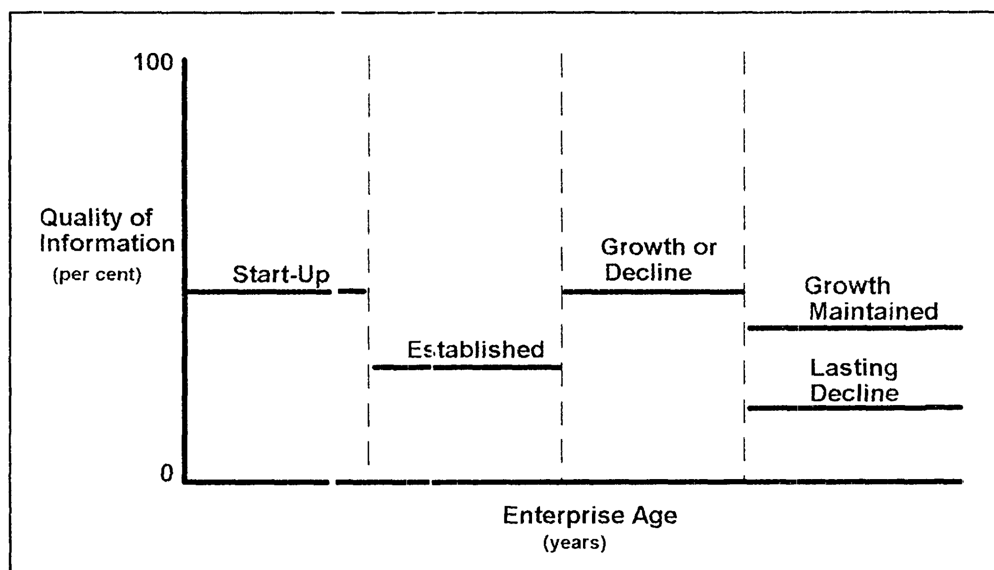
Holmes *et al.* (1991a) propose and find empirical support for a financial information cycle arising from a modified stage or life-cycle model of smaller enterprise development. They argue that a model of financial information use in smaller business concerns should incorporate plateaus – static or settling or levelling-off periods – between each major stage of development; and they suggest that such periods might be expected following significant growth, new investment activity, or deterioration in an enterprise's fortunes. Holmes *et al.* (1991a, pp. 43-44) go on to describe the posited financial information cycle as follows:

> Firms which commence and experience a period of significant growth will normally acquire increased information to assist in coping with business decisions associated with a growth period. However, when the business enters a stabilised period the information level will revert to feedback level, although this may be at a higher level than previously . . . This indicates that at 'crisis point' information is sought . . . in one accession or closely timed series of accessions, rather than a slow steady increase in the information prepared or acquired.

Thus, it is claimed that increases in the level of financial information obtained are clustered around particular points in the smaller enterprise development life-cycle.

The financial information cycle proposed by Holmes *et al.* (1991a) can be represented as in Figure 3.5 on the next page (McMahon *et al.*, 1993a, p. 119, Figure 4.2 adapted from Holmes *et al*, 1991a, p. 44, Figure 2). The high level of financial information use in very young enterprises is explained in terms of the critical need for such information in the start-up phase. As smaller enterprises subsequently develop, the level of financial information required decreases as owner-managers retain information initially obtained and acquire skills necessary to manage their enterprises. The level of financial information use increases subsequently when and if an enterprise experiences growth or decline, because of the attendant financial stresses.

Figure 3.5: Smaller Enterprise Financial Information Cycle



Based on their research, Holmes *et al.* (1991a) believe that the exact nature of the financial information cycle is likely to vary with enterprise-specific characteristics such as:

- Enterprise size – owner-managers of bigger businesses in employment terms are found to have greater financial information needs, presumably because this enables them to cope with the larger scale of operations.
- Industry – owner-managers of enterprises in the manufacturing, wholesale, business/finance and service sectors are found to have greater financial information needs than those in transport, construction and retailing.
- Owner-manager education – owner-managers with post-secondary technical and tertiary education are found to make greater use of financial information than those with just a secondary education.

More consideration is given to the financial information cycle model of Holmes *et al.* (1991a) in Chapter 4 of the thesis.

Further discussion on modern finance theory's perceptions of the role and importance of financial reporting in management of smaller enterprises is presented in the following two sub-sections of this chapter. The discussion focuses mainly on the availability or otherwise of timely and relevant information on a business's financial affairs. In particular, the impact of and remedies for informational asymmetries typically existing between stakeholders in smaller business concerns are addressed. This is done within two emergent conceptual frameworks which have done much to enrich the insights of modern finance theory across a range of matters in financial management practice. These frameworks are agency theory and signalling theory.

3.6.3 Agency Theory and Financial Reporting

Agency (or costly contracting) theory considers a business enterprise from the viewpoints of the various stakeholders it might have, and it explores how their financial interests are furthered and protected in their dealings with each other through explicit or implicit contracts. Possible stakeholders in a business include owners, owner-managers, managers, trade creditors, lenders, customers, employees, family members and the general community – with the first five of these being most prominent as far as financial management is concerned. The stakeholder relationships that receive greatest attention in the literature are those between:

- Managers and owners.
- Owner-managers and other owners.
- Insiders (primarily owners and/or managers) and outsiders (mainly creditors and debt providers).

The central dilemma in agency theory is that day-to-day control of a business enterprise's activities and financial fortunes is very often in the hands of only some stakeholders who are usually owner-managers or managers, depending on the type of enterprise. Yet all stakeholders have a legitimate expectation that their interests will be well served. By analogy with legal notions of agent and principal, those who exercise control are seen as being agents for the other stakeholders who are considered to be principals. Relations between agents and principals are seen as being governed by contracts which, as indicated above, may be explicit or implicit.

In their textbook, Emery & Finnerty (1991, p. 20) provide a useful summary of the cornerstones of financial management theory and practice in the form of what they refer to as 'the first principles of finance'. They go on to indicate that these principles are:

> . . . a set of fundamental tenets that form the basis for financial theory and for decision-making in finance. They are based on logical deduction and/or empirical observation.

Even if every principle is not absolutely correct in every instance, it is generally accepted that each principle is a valid characterisation of an important aspect of the financial world. Amongst others, Emery & Finnerty (1991) identify the Principle of Self-Interested Behaviour according to which investors act in an economically rational manner and will therefore choose the course of action that is most financially advantageous to themselves. The same may be said of managers of a business enterprise who should, but may not, simultaneously act in the best interests of those who invest in the enterprise. Emery & Finnerty (1991) also allude to the Principle of Two-Sided Transactions which holds that any financial transaction involves two parties, both acting in their own best interests, but with different expectations. Most financial transactions are zero-sum games in which one party gains at the other's expense when the expectations of the former are realised and those of the latter are not.

If the two principles identified above are faithful representations of financial management as it is practised then there is good reason to be concerned about the

agent and principal relationships mentioned in the opening paragraph to this sub-section of the chapter. Will agents always promote the financial welfare of their principals foremost, or will they look after their own well-being above all else? Do the financial interests of agents and principals necessarily coincide and, if they do not, could some congruence be achieved? Can both agents and principals gain without detriment to each others' financial good? It is answers to such questions that agency theory seeks to provide.

The most significant problems which may arise from agency relationships in a business enterprise are as follows:

- Information asymmetry – a situation in which agents have information on the financial circumstances and prospects of the enterprise that is not known to principals. If all such information was available to every stakeholder at no cost, then agency-related difficulties could not arise because it would always be known when agents are acting against the best interests of principals who would respond appropriately to discourage this behaviour. However, obtaining information is inevitably costly and may indeed be impossible for principals without the access and resources at the disposal of agents.
- Moral hazard – a situation in which agents deliberately take advantage of information asymmetry to redistribute wealth to themselves in an unseen manner which is ultimately to the detriment of principals. This behaviour can take the form of excessive consumption of perquisites, or it may involve shirking by failing to carry out designated duties with reasonable diligence.
- Adverse selection – a situation in which agents misrepresent the skills or abilities they bring to an enterprise. This problem can arise because a principal is not in a position to judge whether an agent actually possesses the competencies required by the position for which he or she has been hired. Thus, the principal's wealth might suffer because the agent lacks the technical ability to make sound wealth maximising financial decisions.

The seminal work in the literature of agency theory is that of Jensen & Meckling (1976) who place a great deal of their emphasis on an agency perspective of owner-managed business enterprises. Fama (1980), Fama & Jensen (1983), Demsetz (1983) and Demsetz & Lehn (1985) are also recognised as having made important contributions to the development of agency theory. These works focus on the economic issue of separation of ownership and control in business enterprises, and they contrast the agency relationships and problems that might be encountered in smaller owner-managed enterprises, in which ownership and control are typically merged, with those experienced in larger enterprises in which the separation of ownership and control is usually greatest.

The relevance and application of agency theory to the particular circumstances encountered in smaller enterprise financial management have been considered by Hand

et al. (1982, p. 30) who express the opinion that 'Although agency relationships exist in all businesses, their effect is likely to be most significant if the businesses are small'. Among the points made by Hand *et al.* (1982) which have a bearing on agency theory as it applies to smaller enterprises are:

- The primary agency contest is not between owners and managers, but between insiders and outside suppliers of funds. Stanger (1992) argues that agency relationships amongst owner-managers, and between owner-managers and owners who do not participate in management are also important.
- The many opportunities owner-mangers have to divert enterprise resources to themselves make monitoring costs high. Thus, outside suppliers of funds tend to be restricted to those who are particularly adept at monitoring the enterprises to which they lend, such as trade creditors and banks.
- Because of the imperfect market for ownership stakes, owner-managers may not bear all agency costs and therefore have limited motivation for reducing them through monitoring or bonding.
- Conflicts amongst stakeholders are not easily resolved by a disgruntled party selling out at a fair market price. Hence, the only viable alternative is to remain and contest which might divert financial and managerial resources from more productive uses, inhibit decision-making and put the enterprise's solvency at risk.
- The most important means of averting agency conflicts between insiders and outside interests is an appropriately drawn up agreement covering such matters as managerial compensation and other employment terms, profit distribution policy, reorganisations, sale of ownership stakes to others, and relations with associated enterprises.

These points have subsequently been reinforced and expanded upon by Pettit & Singer (1985), Ang (1991), Hutchinson (1991), Ang (1992) and Stanger (1992). Recent works which consider agency theory and smaller enterprise financial management in specific circumstances include those of Brickley *et al.* (1991), Yazdipour & Song (1991) and Meyer & Shao (1992). Recent empirical studies of smaller enterprises which make use of agency theory include those of Murali & Welch (1989), Constand *et al.* (1991), Easterwood & Singer (1991), Keasey & Watson (1991), Norton (1991) and Apilado & Millington (1992).

One rational response to the inherent risk posed by self-interest on the part of agents, and other behaviours detrimental to principals in agency relationships, is for each stakeholder to increase the reward expected in return for participation in the enterprise. For example, debt providers may increase the interest rates they demand in order to compensate for agency-related risk. Owners may insist on higher levels of profit distribution to remove wealth from the control of managers, *ceteris paribus* causing the enterprise to rely more heavily of external sources of funds. Other possible responses are of two broad types:

- Monitoring – this response is a direct attempt to overcome the difficulties posed by asymmetric information by improving the access of principals to reliable facts and figures which would allow them to judge the performance of agents, and thus detect whether agents are acting in a manner contrary to the principals' interests. Examples of monitoring arrangements include scheduled meetings of agents and principals (for example, board meetings or meetings with financiers), the provision of financial statements on a regular basis, and internal and external audits conducted by independent parties.
- Bonding – this response involves devising means by which congruence between the goals of agents and those of principals may be promoted. One approach to doing this is through contracts which formally bind the parties to agreed types of behaviour, and which provide for sanctions should actual behaviour deviate from that specified in the contracts. Examples of bonding arrangements involving contracts include partnership agreements, memoranda and articles of association of companies, loan agreements and trust deeds containing restrictive covenants, and employment contracts.

  Another means of bonding agents and principals to achieve congruence in their goals is through incentive schemes which encourage mutually acceptable behaviour without requiring it, and without explicit sanctions. The possibility of failing to realise the benefits specified in the incentive scheme provides the motivation for the desired behaviour. Examples of bonding arrangements involving incentives include salary bonuses, profit sharing plans, employee stock ownership plans and managerial stock options plans. Whether contracts or incentives are used for bonding purposes, there is always the implicit sanction of principals dispensing with the services of agents if dissatisfied with their integrity and performance. Agents who exploit their position, or who make poor decisions, may face dismissal and the subsequent prospect of seeking another position while hampered by an unfavourable track record.

An important point about any of the responses to agency-related risk identified in the previous paragraph is that they are not costless. The out-of-pocket costs of maintaining an agency relationship may therefore include higher costs of financing, costs entailed in overcoming information asymmetries to achieve better monitoring of agents' activities, transaction costs incurred in setting up formal contractual arrangements with agents, and costs of incentive payments to agents. There are, in addition, less evident residual agency costs (wealth effects of ultimate divergences of interest between principals and agents) such as excessive perquisite consumption and shirking by agents, and also opportunity costs arising from non-optimal investment, financing and profit distribution decisions made by agents. Agency costs in total are the incremental costs incurred over those that would be experienced in a perfect capital

market situation, and these must ultimately be borne by the owners of the business concerned. Against these costs the owners must weigh the perceived benefits of agency relationships like access to finance and management expertise they do not themselves possess. In balancing the costs and benefits in this way, it is not inconceivable that the optimum response to agency problems is to do nothing at all to mitigate them.

As indicated in Chapter 2 of the thesis, Holmes & Zimmer (1994) underscore the need for owner-managers to be willing to enter agency relationships with debt and equity providers if the growth potential of their businesses is to be realised. On the basis of an exploratory study employing their definitions of growth and non-growth small enterprises, Holmes & Zimmer (1994, pp. 110-112) arrive at a number of propositions for further investigation which have a bearing on the financial reporting dimension of the present research:

- Growers are more likely to use decision tools, such as financial plans, compared to non-growers. Growing smaller enterprises are more likely to regularly prepare historical financial statements used for assessing financial position and performance. They are also more likely to prepare future-oriented financial statements, particularly cash-flow forecasts. Holmes & Zimmer (1994, p. 110) point out that non-growers tend to rely on cheque books and bank statements as primary financial management tools; and that 'This is likely to be "rational" in terms of the ownership objectives, as the investment in time and training would not be cost effective if growth is not actively sought'.
- Growers have higher educational qualifications than non-growers. In particular, owner-managers of growing smaller enterprises are more likely to have university degrees. They are also more likely to attend training courses.
- Growers are more likely to comply with government regulations than non-growers.
- Growers are more likely to seek specialist business advice than non-growers. In particular, growing smaller enterprises are more likely to employ in-house bookkeepers or accountants. They are also more likely to seek the advice of larger public accounting practices, often with national affiliations. Both growers and non-growers are likely to use public accountants for compliance work, including preparation of taxation returns and corporate reporting. Sometimes, public accountants assist with preparation of a business plan when an enterprise is seeking external finance.

This study provides an opportunity to examine such propositions in the context of smaller manufacturing enterprises that are growing.

Adopting an agency theory perspective on the financial reporting dimension of the present research, the function of financial reporting can be specified simply as the reduction of agency costs (Watts, 1977; Whittred *et al.*, 1996). According to Whittred *et al.* (1996, p. xv), accounting can be characterised as having:

> . . . an important role in regulating the relations between contracting parties – both *ex ante*, as part of the mechanism by which inherent conflicts of interest between contracting parties can be controlled, and *ex post* as part of a monitoring and performance evaluation mechanism.

The *ex ante* role of accounting here is intended to assist with defining property rights between contracting parties to the extent of achieving an equitable distribution of wealth amongst them. The *ex post* role of accounting is intended to facilitate key decisions on continuance of relations between the contracting parties on existing or changed terms (for example, the decision by a business's owner(s) to continue or discontinue employment of its professional managers).

For either role identified in the previous paragraph, specific accounting practices to be adopted for the purposes of a contract might be negotiated between parties to the contract in the light of what they consider to be their respective best interests. It may be that management is left to decide on appropriate accounting practices, possibly guided by accounting standards and reporting requirements of the Corporations Law. Managerial discretion over accounting practices could be granted by principals in full knowledge that the managers may act opportunistically in their selections. Moreover, according to Whittred *et al.* (1996, p. 40):

> If financial information is useful for monitoring purposes and if management has a comparative advantage in collecting this information, it will pay it to prepare financial reports and even have them independently audited.

These words highlight the possibility that it may be rational to prepare and disseminate financial statements even when no regulation requires this, or to exceed mandated disclosure requirements where these exist. Whatever is done in determining accounting practices, it must be clear that the choices made have the potential to influence firm value (that is, principals' wealth). To the extent that appropriately selected accounting practices serve to minimise agency costs, they may consequently lead to maximisation of the value of the business concerned.

Whittred *et al.* (1996, p. 18) point out that the agency perspective on financial reporting which has been outlined is not unlike the stewardship perspective traditionally associated with accounting, but that it is 'more specific and rigorously articulated'. It is also claimed to be consistent with the decision role for accounting information articulated earlier in this chapter. Finally, it is considered operational from a scholarly viewpoint in the sense that it can plausibly assist with predicting and explaining observed accounting practices

3.6.4 Signalling Theory and Financial Reporting

Another of 'the first principles of finance' alluded to by Emery & Finnerty (1991) is the Signalling Principle which holds that observed actions with financial outcomes convey the most useful information about the circumstances, expectations and plans of those undertaking the actions. In other words, actions can speak louder than words in a financial context. Signalling theory provides useful insights into the availability of

information about a business enterprise to various stakeholders, and particularly into circumstances of asymmetric access to information. The following discussion examines smaller enterprise financial reporting from a signalling theory perspective.

The importance of signalling theory arises from the fact that, in reality, the capital market fails to meet the important condition that all information relevant to determining the appropriate rate of return on funds made available is obtainable by every market participant at no cost. In other words, asymmetric access to information exists. This asymmetry is particularly evident between those inside an enterprise, notably owner-managers and managers who are privy to all information about its fortunes, and those outside the enterprise such as investors and financiers who generally have access only to information which owner-managers or managers choose to make available or are compelled to supply by regulatory influences such as the financial reporting standards promulgated by professional accounting bodies, stock market listing requirements, and the provisions of corporations legislation.

The resolution to the problem of asymmetric information between those inside an enterprise and external parties with a justifiable interest in it suggested by signalling theory is explained by Emery & Finnerty (1991, p. 107) as follows:

> . . . the term signaling refers to using actual behaviour to infer things you can't observe directly or find out in other ways. Thus, signaling involves inferences concerning asymmetric information; actions convey the information and in so doing eliminate the asymmetric information.

The type of action undertaken by management which might be seen as conveying information about an enterprise's financial circumstances and prospects to the capital market could be decisions to:

- Acquire or not acquire (alternatively sell or not sell) a certain asset or group of assets.
- Raise or not raise equity or debt finance in a particular amount from a specific source.
- Make or not make (alternatively accept or not accept) a merger or takeover offer at a particular price.
- Make a bonus issue (that is, pay a stock dividend) or undertake a share split.
- Repurchase outstanding shares and thus return capital to the owners.
- Pay out a certain proportion of profit to owners, especially if the distribution is in some way different from that in previous periods.

Useful signals about an enterprise may also emanate from financial actions undertaken by outsiders. For example, decisions by:

- A particular investor or financier to provide or withhold a certain amount of equity or debt finance.
- A certain stockbroker or merchant banker to underwrite or not to underwrite a particular fund raising effort.

- A particular enterprise to make or not to make (alternatively to accept or not to accept) a merger or takeover offer at a specific price.

Signals about an enterprise's current position and future directions need to be interpreted with considerable care. Some might be routine and frequent and therefore unremarkable, while others may be non-routine and infrequent and so command special attention. Some are intentionally sent by managers for reasons which serve their best interests; while others are inadvertent and possibly more telling. Particular signals may be interpreted as positive (that is, good news), negative (that is, bad news) or neutral (that is, indifferent news) depending on the circumstances. Some signals can be seen as unequivocal information, while others might require considerable intuition or speculation to judge their meaning and importance. The quality of a signal as a prompt or guide for an appropriate response will usually depend on how current it is and how many others have received it. The more timely a signal the more costly it may be to obtain and the fewer might be the other recipients.

The seminal works in the literature of signalling theory are those of Leland & Pyle (1977) who focus on the signalling implications of entrepreneurs retaining a significant stake in their enterprises when others are invited to take equity positions, and of Ross (1977) who is concerned with capital structure decisions made by management acting as signals of enterprise value to outside parties. The decisions in financial management which have received most attention in signalling theory are those relating to financing and to profit distribution.

The questions to be addressed now are whether signalling theory has any relevance to smaller enterprise financial management; and, if so, whether there is reason to believe that it applies differently to smaller enterprises. On the first question, if the *raison d'être* for financial signalling is the existence of asymmetric information between those within and without a business enterprise, there can be little doubt that signalling theory has something to offer smaller enterprise financial management. As indicated in the previous sub-section of this chapter, agency theory suggests that the information asymmetries which exist in smaller enterprises are non-trivial. Furthermore, McMahon & Holmes (1989, 1990, 1991, 1992) and McMahon *et al.* (1992c) point out that it is well established in the empirical literature that the level of external financial reporting undertaken by smaller enterprises is limited because there are few imperatives for doing this.

On the question of whether signalling theory applies differently to smaller enterprises than to large enterprises, it could be reasonably ventured that financial signalling is likely to be more important to smaller enterprises for the reasons already stated. This might become even more so when smaller enterprises reach a stage in their development where they need to rely more heavily on external sources of finance in order to progress further. A glimpse of the argument is provided by McConnell & Pettit (1984, p. 115) who point out that:

> For small businesses, where there is possibly a greater level of difference between the information about the firm held by managers and that held by potential lenders, the costs of signaling may tend to dictate less debt for the small firm.

In other words, smaller enterprises might be inclined to use less debt than larger enterprises because the cost of overcoming the greater asymmetry in information which exists between smaller enterprise owner-managers and outsiders is higher.

What of the evidence for these speculations? Until recently there has been no substantial and reliable empirical evidence that signalling theory accurately represents particular situations in small enterprise financial management, or that it adds insights that are not provided by other strands of modern finance theory. Referring specifically to the circumstances of smaller enterprises seeking to make initial public offerings, Keasey *et al.* (1992, pp. 15-16) comment that:

> A theoretical literature has developed which considers how entrepreneurs might signal the value of their firm to potential investors . . . In contrast, the published empirical work has lagged somewhat behind and seems to have concentrated on large firms . . .

However, as smaller enterprise financial management is evolving as a distinct field of scholarship, some evidence is now becoming available. Recent empirical studies of the application of signalling theory to smaller enterprise financial management include those of Constand *et al.* (1991), Krinsky & Rotenberg (1991), Norton (1991), Keasey & McGuinness (1992) and Keasey *et al.* (1992). The emerging evidence on the relevance of signalling theory to smaller enterprise financial management is mixed.

3.6.5 Austrian Economics and Financial Reporting

A departure from the role ascribed to financial reporting within smaller enterprises by modern finance theory, rooted as it is in neoclassical microeconomics, is provided by the so-called Austrian school of economic theory. The part played by financial reporting in smaller enterprise financial management in the Austrian view of the world is explained by Young (1987) and Gibson (1992a, 1992b, 1992c, 1993). Justification for considering this alternative perspective is furnished by Gibson (1992b, p. 221) on the grounds of dissatisfaction with the assumptions of neoclassical microeconomics:

> Substantial relaxation of these assumptions is often necessary to provide plausible explanations for many observed practices such as the irregular use of financial information in small firm decision contexts. Rather than seeking to justify these departures within the extant framework, understanding may be better accommodated by adopting a different perspective.

The Austrian perspective emphasises the role of the entrepreneur in economic activity and holds that actions undertaken by entrepreneurs are mainly the outcome of alertness to opportunities found by scanning the business environment for what Cheah (1990, p. 343) describes as 'profitable discrepancies, gaps, and mismatches in knowledge and information that others have not yet exploited'. In this scenario, the financial information provided by a conventional accounting system is likely to have less importance to decision-making by owner-managers of smaller concerns.

Gibson (1992b, pp. 228-229) describes the role of financial information in the Austrian model in the following terms:

> Decision makers do need financial information to help them determine if their capacity to generate future profit (i.e., take a particular action) has been impaired. There is no assumption that financial information has any other role. It is not assumed that future oriented information will be used in evaluating the means by which desired ends can be achieved (although such use is not precluded). Austrian economics offers no opportunity to prescribe a use for information in the decision making process.

Thus, the principal role of financial reporting is essentially retrospective and confirmatory. In other words, financial information is useful mainly in evaluating the success of past decisions and in determining present position. In this context, the financial reporting requirements of taxation legislation and/or corporations regulation legislation are more than likely to be sufficient to satisfy the information needs of small enterprise owner-managers. Their apparent disregard for more timely and decision-relevant financial information is therefore explicable.

Some empirical support for the Austrian perspective on financial reporting in smaller enterprises is provided by Carsberg *et al.* (1985) who asked owner-managers in their sample of 50 small companies in the United Kingdom what benefits, if any, they derive from producing annual statutory financial reports. Management uses received some mention and Carsberg *et al.* (1985,p. 31) indicate that a significant proportion of these (italics added for emphasis):

> . . . were expressed to be *confirmation* of the results. Directors seem to have a rough idea of the results of the business over the period, but find the annual accounts useful in dispelling the uncertainty about profitability.

Further underpinning for the Austrian view is forthcoming from McCahey (1986) who describes the financial reporting practices of a sample of 40 Australian smaller enterprises. Although owner-managers appear to be the primary users of statutory reports, the researcher considers it unlikely they have the ability to properly interpret them. McCahey (1986, p. 123) suggests that (italics added for emphasis):

> Managers review the financial statements to ensure that their expectations of the company's performance, based on knowledge of the business, are *confirmed* by the formally presented results.

Finally, Gibson & Wallschutzky (1992, p. 10) find as follows on the basis of in-depth interviews with owner-managers of 12 Australian small enterprises concerning the role of accounting information in their strategic and operational decision-making:

> Few of the participating small businesses in the case studies analysed . . . identified access to accounting information and/or accountants as important when making decisions affecting growth and opportunity. However, in the routine control of their business, while accountants did not play an important role, business data with an accounting connotation was used in a variety of ways. Overall, the results support the alternative view of accounting information use in small firms: accounting information is not used because it has no implicit utility in making decisions. This view is strongly supported in respect of planning decisions. In making control decisions however, accounting data (but not accounting information) may have some utility although the quality and source of data used does appear to vary extensively.

In the call for further research at the end of their paper, Gibson & Wallschutzky (1992, p. 11) indicate that 'Also necessary is a greater understanding of the role of accounting information has in managing small organisations and its association with performance'.

All three studies cited immediately above provide what amounts to anecdotal evidence of a confirmatory rather than a decision role for financial information obtained in smaller enterprises, and in this respect uphold the Austrian position. However, given the present state of scholarship in the field, it is not yet possible to choose unequivocally between this perspective and that of neoclassical microeconomics. Having made this point, it should be acknowledged that, for many researchers and professionals who have worked closely with smaller enterprises, the dynamic disequilibrium model of Austrian economic thought has an intuitive appeal over the static equilibrium representation of neoclassical microeconomics. As Gibson (1992a, 1993) implies, this might be so for no other reason than the former view does not require a conclusion of irrational behaviour on the part of economic agents generally recognised for their pragmatism and self-interest.

In closing, it is appropriate to augment the theoretical concerns about the role and significance of smaller enterprise financial reporting which have just been expressed with two of a more practical nature. Those who have reason to make use of the financial reports of smaller business concerns may be well advised to heed the caution of Levin & Travis (1987, p. 30) that:

> . . . standard financial statements tell only half the story about private companies. After all, when wealth flows freely between the owner and the business, personal finances are really part of the organization. Yet financial records look only at corporate operations.

Even if the portrayal of a smaller enterprise's financial position and performance in its financial statements has integrity, there is the further issue of whether its owner-managers are sufficiently skilled to be able to meaningfully interpret the information presented. Commenting on the findings of their research into use of financial ratio analysis in smaller enterprises, Thomas & Evanson (1987, p. 570) venture that:

> The lack of association between financial ratio use and either survival or profitability may . . . indicate that the level of sophistication in use of ratios has not reached a high enough level . . . to make a discernible difference between those who use them and those who do not.

3.7 An Attempted Synthesis on SME Financial Reporting

3.7.1 Frameworks for Understanding SME Financial Reporting

The intention in this penultimate section of the chapter is to summarise, synthesise and extend elements of various theoretical perspectives on financial reporting by business concerns drawn mainly from the literature of economics and finance, as reviewed in the preceding section. The aim is to sketch as succinctly as possible the likely financial reporting scenario for small and medium-sized enterprises in a less than perfect world, with a particular concern for internal use of general purpose financial reports (as defined

earlier for this study) by owner-managers. The resulting portrayal is intended to establish a conceptually sound but realistic backdrop against which to view existing empirical evidence on financial reporting practices in SMEs reviewed in Chapter 4 and, of course, new evidence on practice provided by this study which is presented in Chapters 6 and 7 of the thesis.

Based on the preceding discussion, the research described in this thesis could usefully adopt either of two specific theoretical paradigms for understanding and explaining financial reporting in smaller business enterprises:

- That provided by neoclassical microeconomics which is reflected in modern finance theory, including agency theory and signalling theory, and which represents mainstream thought on financial management of businesses, including those that are small or medium-sized. According to this paradigm, historical and future-oriented financial reports, and analysis and interpretation of such reports, have considerable decision usefulness.
- That provided by Austrian economics which has not been widely supported to date, but which is assuming greater significance as small and medium-sized enterprises become more central to scholarly and policy-related deliberations. According to this paradigm, historical and future-oriented financial reports, and analysis and interpretation of such reports, have little decision usefulness.

In fact, both these perspectives are contemplated in this study as they point to markedly different possibilities for findings on financial reporting practices amongst the smaller enterprises investigated. Significantly, the differences are most likely to be reflected in what is discovered on use of financial reports for internal financial management purposes by owner-managers and, to a lesser extent, managerial employees. In a broad sense, the present research tests the veracity of these competing perspectives.

3.7.2 How SME Financial Reporting May Be Limited

Some evidence has already been provided in both Chapter 1 and this chapter that, as a group, owner-managers of SMEs make considerably less use of standard financial reports, whether historical or future-oriented, in financial management of their businesses than would be proposed or predicted by neoclassical microeconomics and modern finance theory. Moreover, financial reporting practices in smaller enterprises seem to fall well short of what is dictated by various external financial reporting imperatives that exist for them. Owner-managers appear particularly reluctant to procure financial reports which might become accessible to outside parties either directly or through the offices of regulatory authorities. More substantial existing evidence supporting these impressions is presented Chapter 4 of the thesis.

One means of anticipating what might be broadly found in the way of financial reporting systems actually employed amongst smaller business enterprises is via a continuum devised by Friedlob & Plewa (1984, 1992) as follows:

- Strictly cash based accounting with no accruals.
- Income tax basis accounting (in compliance with income tax legislation) which includes accruals for inventories, receivables and depreciation.
- Basic full accrual accounting with no compliance to accounting standards.
- Basic full accrual accounting with footnote disclosures of departures from accounting standards.
- Full accrual accounting for private companies in which certain accounting standards are considered irrelevant, and therefore are not required to be complied with (for example, an accounting standard dealing with consolidated financial statements).
- Full accrual accounting as for public companies with compliance to all accounting standards unless it can be demonstrated that adherence to a certain accounting standard would result in misleading financial reports being produced.

A key issue is the extent to which external auditors are permitted/are able to attest to the veracity of the financial reports produced using these various financial reporting systems.

The discussion thus far suggests it is realistic to anticipate that the financial reporting practices found in the SMEs at the focus of this research may not accord with mandated, recommended or preferred practices in some or all of a number of specific respects:

- Not all financial statements may be prepared – preferably balance sheets, profit and loss statements and cash-flow statements should all be obtained, and both historical and future-oriented reports should be prepared.
- Financial statements may not be prepared with sufficient detail – preferably financial data should be provided on major segments of business.
- Financial statements may not be prepared appropriately – preferably generally accepted accounting principles should be followed, and the specific requirements of applicable accounting standards, taxation law and corporations law should all be met.
- Financial statements may be prepared irregularly and/or infrequently – preferably financial statements should be routinely prepared at least annually, with monthly or quarterly reporting intervals being more appropriate.
- Veracity of financial statements may not be appropriately established – preferably financial statements should be validated by an independent external auditor at annual intervals.
- Financial statements may not be provided to all parties with reasonable expectations of receiving them – preferably financial statements should be supplied to non-managing owners, owner-managers, managers, key employees, creditors, financiers, advisers, taxation authorities and corporate regulatory bodies as needed, requested or mandated.

- Financial statements may not be used appropriately – preferably financial statements should be routinely analysed and interpreted using accepted techniques for this purpose such as inspection of key figures, trend analysis, inter-firm comparisons and variance analysis.

Of course, in reaching judgments on the adequacy of financial reporting practices in particular SMEs, the recommended or preferred practices identified above must be moderated to some degree by the distinctive characteristics and circumstances of the businesses concerned.

3.7.3 Explaining Limited Financial Reporting in SMEs

In addition to inevitable claims of insufficient time from owner-mangers, limited financial reporting undertaken in smaller enterprises could arise for one or more of the following reasons:

- Owner-managers are not rational economic decision-makers and do not seek to be better informed on the financial consequences of their decisions. This is the position taken by many researchers, but it may not stand up to closer scrutiny. It is nevertheless the easiest explanation for less assiduous and probing researchers to invoke.
- Owner-managers are rational economic decision-makers but have correctly assessed that the circumstances of their businesses are so undemanding that extensive financial reporting is not needed. Self-employment, very small enterprises, home-based concerns and life-style ventures, especially where they are not growing and are fully self-funding, are examples of businesses in which direct observation and only rudimentary cash-based reporting might be perfectly adequate for financial control purposes. This explanation could be seen as an extreme case of the next, but its separate recognition is considered justified.
- Owner-managers are rational economic decision-makers but believe, often wrongly, that the costs of being better informed on the financial consequences of their decisions outweigh the benefits. The costs would include those involved with preparation of standard financial reports (including set-up costs for a bookkeeping/ accounting system), as well as those associated with education/training in their use. Perceived uncertainty may make the cost of preparing future-oriented financial reports appear prohibitive. These costs tend to be fixed in nature and are therefore more of a burden, in relative terms, for smaller enterprises (Horwitz & Kolodny, 1982; Nair & Rittenberg, 1982; Abdel-Khalik, 1983; Nair & Rittenberg, 1983; Friedlob & Plewa, 1984; Knutson & Wichmann, 1984; Carsberg *et al.*, 1985; Hiltebeitel, 1986; Friedlob & Plewa, 1992).

  By and large, the direct benefits of financial reporting to financial management of a business tend to be less tangible and more difficult to identify and measure than necessary out-of-pocket expenditures on financial reporting. Some benefits of

more extensive financial reporting are likely to become most evident when a business experiences financial stress, such as when growth leads to cash-flow difficulties – making cash-flow forecasting and cash-flow statements particularly helpful. The full benefits of comprehensive financial reporting may only be recognised when and if, in pressing circumstances such as securing essential growth funding, an owner-manager seeks to attract and retain outside financial support from new equity holders and/or medium- to long-term debt providers. The costly consequences of refusal or withdrawal of such support are usually readily apparent. The assessed benefits of financial reporting are unlikely to include avoidance of the probable societal costs of poor decisions leading to a moribund or failed business and/or losses to external stakeholders, even though these externalities should rightly be considered.

- Owner-managers are rational economic decision-makers but believe that standard financial reports prepared conventionally do not provide sufficiently reliable information on the financial consequences of their decisions. The accounting profession's continued adherence to the historical cost convention in preparation of standard financial reports could partially explain such a position. Real or perceived technical complexity of modern accounting practices may lead to misconceptions as to the reliability of financial information obtained, as could numerous elective treatments of financial transactions and mutually exclusive inconsistencies between financial reporting imperatives.
- Owner-managers are rational economic decision-makers but believe that standard financial reports do not provide them with the type of primary information they really need to carry out their function effectively and efficiently. The Austrian school of economic thought would suggest that this might be the case. Recall, however, that historical financial reporting may still play a confirmatory role in an Austrian world; and, strictly speaking, use of future-oriented financial reports is not precluded.
- Owner-managers are rational economic decision-makers but are so preoccupied with concealing the financial consequences of their decisions from those they consider to be free riders (for example, taxation authorities and corporate regulatory bodies; and possibly also competitors, through public access to financial information provided to corporate regulatory bodies) that they inevitably conceal financial information from themselves. It may be considered more morally acceptable, less costly or less risky to truthfully indicate that certain financial information has not been collected and reported than it is to obtain the information and then deny its existence. For this behaviour to appear rational, the likelihood and quantum of sanctions for not undertaking mandated financial reporting to legitimate authorities, or for not meeting contractual obligations to report to outsiders, must be perceived as insufficient to motivate compliance.

An intention in identifying these possible reasons for owner-managers of smaller enterprises not facilitating more comprehensive financial reporting on their businesses is to establish that irrational behaviour in an economic sense on the part of the owner-managers is not essential to explaining this phenomenon. In the smallest concerns, extensive financial reporting simply may not be required. Where financial management demands are more stringent, human failing on the part of owner-managers in not recognising this is so, in not acknowledging their limited financial management competence, and in not choosing to remedy this through education/training, or by securing expert advice, may also be a factor. Furthermore, deficient and conflicting accounting practices, poorly functioning regulatory frameworks, limited recourse to affordable legal enforcement of contracts, and misconceptions as to the role of financial reporting (that is, faulty assumptions), may all contribute explanations in which economic agents other than owner-managers also play a significant part.

3.7.4 Regulation of SME Financial Reporting

The point has already been made in this chapter of the thesis that, in a less than perfect world, information is unlikely to be freely and equally available to all stakeholders in a smaller enterprise. Most importantly, there is likely to be a significant information asymmetry between those who manage a business from within and those, if any, who support the business financially from without. This may create both the opportunity and the incentive for owner-managers to act against the interests of outside stakeholders, in the pursuit of what they perceive be to their own interests. Keasey & Watson (1993, p. 45), in a summarisation of the economics of procuring and disseminating reliable financial information on smaller enterprises in an imperfect world, capture as follows the implications of this circumstance for financial reporting by SMEs:

> Different ownership forms and the manner in which firms are financed largely determine the nature and quality of the financial and other information required by external contracting parties to monitor, control and evaluate the risks associated with their involvement in the small firm. To fulfil its role, information has, of course, to be perceived to possess a number of characteristics -- it has to be seen as credible, reliable, relevant and timely. However, much of the information produced in the course of economic activity does not possess these characteristics. Even information produced explicitly for monitoring purposes may be seriously deficient in terms of one or more of the desired attributes. This is largely because information is an economic good that is often asymmetrically distributed, costly to produce, verify and analyse, and which may be used in ways which are not perceived to be in the interests of the party which possesses the information and/or has a responsibility to disclose it. Hence, the possessor of information may have incentives either to not reveal his or her private information or to reveal only partial or distorted information.

Keasey & Watson (1993, p. 45) go on to explain, in the following terms, intervention by society in the United Kingdom, principally on behalf of external stakeholders, through regulation of financial reporting by smaller enterprises:

> The published financial statements which detail the firm's assets, liabilities and past performance are widely used by contracting parties since, despite their many

> and well-known limitations, the information disclosed is subject to regulation and perceived to be, at least to some degree, objective and verifiable. Moreover, both managerial monitoring and the production and disclosure of financial information have 'public good' characteristics which render it difficult to exclude free-riders. As with other public goods, if left to the operation of the market, the inability to exclude free-riders leads to an under-production of the good in question. Consequently, both activities are subject to public regulation in order to ensure that some minimum amount of both is undertaken. For example, the requirement to file annual audited financial statements is seen to aid in monitoring and to reduce uncertainty by ensuring that the financial information needed for this purpose conforms to certain minimum standards relating to what is disclosed, its frequency, the assumptions on which it has been based, the methods by which it has been obtained and computed and the manner in which it has been verified.

Such views provide a *raison d'être* for the complex legal context of historical financial reporting by Australian SMEs organised as proprietary companies, especially those that are classified as large, described earlier in the chapter. These words also reveal the background to some of the explanations presented above for owner-managers of smaller concerns being less than willing to procure comprehensive financial reports on their businesses which might become more widely accessible in the public arena.

3.7.5 Incentives For More Comprehensive SME Financial Reporting

Earlier in the chapter it is suggested that, if there is a certain inevitability to financial reporting regulation for the foreseeable future in this country, a rational response by owner-managers of smaller enterprises would be to seek additional benefits accruing mainly to their businesses from whatever financial reporting is unavoidably undertaken for taxation authorities, the ASC, etc. For SMEs in financially challenging circumstances such as growth these benefits could include better financial control and easier access to external financial support. Thus, the net cost of mandated financial reporting may be reduced quite significantly.

The incentive for more comprehensive financial reporting created by a need for better financial control in smaller enterprises has already been explained at some length and will not be further laboured here. However, it must be acknowledged that, based on the empirical evidence provided in Chapter 4, it is still difficult to demonstrate a strong nexus between the presumed outcomes of better financial control – possibly higher achieved growth and/or improved financial performance – and more comprehensive financial reporting. A key purpose of the present research is to explore further for such a connection. However, the persistence of claims that a finance gap exists for smaller growth enterprises seeking external medium- to long-term funding logically lends support to suggestions for improving their access to such finance, of which more timely and relevant financial reporting to non-managing owners, creditors and lenders must be considered a real opportunity (Hutchinson, 1989; Marsden Jacob Associates, 1995; Australian Manufacturing Council, 1996; Ernst & Young and Centre for Innovation and Enterprise, 1997). Before contemplating this incentive in more depth, it should be recognised that it has a linkage with the better financial control incentive. Other things

being equal, debt providers are more likely to lend to SME owner-managers who can demonstrate superior financial control, possibly through procuring and themselves using timely and relevant financial reporting on their concerns.

In reviewing the contribution of information economics to understanding of external financial reporting by business concerns, Feltham (1984, p. 199) identifies two broad purposes for such reporting as the 'decision-informativeness' role and the 'contract-implementation' role, and he comments on the first of these as follows (italics added for emphasis):

> To fulfill this role external accounting reports must provide, to decision makers external to the firm, information that has not been obtained from other sources and which reduces the decision makers' uncertainty about the consequences of their actions. Investors and creditors are the most obvious potential users of accounting reports, and accounting reports are likely to be an important source of firm specific information *if the firm is relatively small and of interest to only a limited number of investors and creditors.*

The suggestion here is that information asymmetry between insiders and outsiders is likely to be greater for smaller enterprises, and that formal financial reporting to outsiders assumes particular significance because other means for dissemination of information on financial position and performance are less developed for smaller concerns. Albeit for smaller publicly listed companies, Zeghal (1984, p. 300) claims to provide:

> . . . evidence to support the hypothesis that, because less information is available on small firms, their financial statements have a greater informational content than those of large firms In this analysis, firm size is a surrogate for the amount of information available on the firm.

Zeghal (1984, p. 299) goes on to propose an explanation for the widely observed 'small firm effect' on stock exchanges around the world by suggesting that 'investors require premiums as an inducement to bear the estimation risk associated with stocks of firms about which less information is available'.

On the contract-implementation role of financial reports, Feltham (1984, p. 199-120) indicates that:

> To fulfill this role accounting reports must provide information which can be used as a basis for enforcing contracts that permit individuals to make mutually acceptable agreements as to the actions each will take and the sharing of the outcomes from those actions. Reports that provide information with respect to actions are termed incentive-informative and those that provide information with respect to outcomes are termed insurance-informative. Accounting reports have both of these characteristics, and verification by an independent third party, the auditor, reduces managements' opportunities to manipulate this information. Consequently, accounting reports are key elements in the agreements made among managers, investors, and creditors.

Of particular importance to the contract-implementation role of accounting is the extent to which management reveals to outside parties private or inside information with significant financial implications in required or voluntary financial reports, especially those that are future-oriented. According to Feltham (1984, p. 198):

> In some situations it appears that managers send messages about their private information without taking any action to confirm the validity of what they are saying. For example, management often makes *unverified* financial forecasts as well as less formal statements about their firm's prospects. The extent to which these statements have information content and the process by which investors have confidence in these statements is not well understood.

The key point for this study is that, in the absence of regulation and/or formal contractual arrangements, the privacy of key financial data is more likely to be sustainable in smaller businesses than in larger concerns which are required to make extensive public disclosures, are subject to greater scrutiny by investors, debt providers and their professional advisers, and are governed by stringent laws against insider trading (Feltham, 1984).

Owner-managers of smaller enterprises with significant external funding, or who are seeking such funding, may actually have an incentive to be more expansive with respect to financial reporting if failure to do so is likely to impose non-trivial costs of other kinds on their concerns (Jensen & Meckling, 1976; Watts, 1977; Feltham, 1984; Watts & Zimmerman, 1986; Keasey & Watson, 1993). The background to this belief is captured by Godfrey *et al.* (1994, p. 235) as follows:

> Prior to any regulation requiring their provision, accounting reports were provided by many firms. Further, they were audited. Both the preparation of accounts and their auditing consume real resources, and rational managers would not allow firms to incur the costs if they did not perceive that there was a net benefit from the provision of accounting information.

Building on the contracting and agency analyses of Jensen & Meckling (1976) and subsequent writers, Watts & Zimmerman (1986) examine incentives for undertaking financial reporting in owner-managed businesses with non-managing owners or external debt providers. In each case, the conclusion reached is that owner-managers may have an incentive to voluntarily undertake financial reporting in order to secure and hold the support of external financiers on reasonable terms.

By providing regular financial reports prepared according to generally accepted accounting principles, preferably audited, owner-managers may be able to convince outsiders that self-interest will not result in sub-optimal investment, financing and profit distribution decisions which are likely to compromise the outsiders' interests. If this can be achieved, the price any non-managing owners might be willing to pay for their stake may be higher; and the interest rate charged by any external debt providers may be lower. In a sense, potential external stakeholders do not care whether financial reporting is undertaken because they can compensate or protect themselves, either by making the terms of support more advantageous to themselves (and therefore disadvantageous to the business), or by declining support altogether and making their investments elsewhere. Keasey & Watson (1993) point out that if, because of limited liability, creditors of proprietary companies are inclined to put in place tight constraints on the autonomy of owner-managers in order to minimise risks (that is, put in place restrictive

covenants), then making comprehensive financial reports available to creditors on a regular basis might be perceived by owner-managers as the lesser of two evils.

3.7.6 Lenders' Expectations for SME Financial Reporting

Research studies such as those conducted by Falk *et al.* (1976), Pace & Collins (1976), Abdel-Khalik (1983), Stanga & Tiller (1983), Hiltebeitel (1985) and the Australian Manufacturing Council (1996) suggest that the initial and on-going information a smaller enterprise might be required to provide in order to obtain and maintain debt financing is considerable, and that it may not be markedly different from that required from larger concerns for the same purpose. Of course, in light of the forgoing discussion, it needs to be borne in mind that lenders may ask for a great deal of financial information because they do not bear the cost of its preparation, because they are inexperienced at assessing the risk of lending to smaller enterprises, or because they are excessively conservative. The point is that the amount of financial information actually sought concerning smaller borrowers may well be difficult to justify if the debt provider is not truly competent in evaluating such loan applications.

The need in smaller enterprises for substantial historical and prospective financial reporting in support of debt financing is underscored by the research of Stanga & Tiller (1983, p. 64) who, at the time, were unable to discover any prior empirical studies which had 'systematically compared the information needs of those who use the financial statements of large public companies with the needs of those who use the financial statements of small private companies'. Two-hundred and thirty bank lending officers from throughout the United States who between them independently evaluate term loan applications from both large and small enterprises were asked to rank and rate the importance of 40 financial information items concerning typical applicants. Rankings ranged from 1 (highest) to 40 (lowest), and ratings were made on a five-point scale ranging from 'not important' (mean in range 0.000 to 0.499) to 'extremely important' (mean in range 3.500 to 4.000). The rankings and ratings of selected financial information items likely to be found in either conventional historical financial statements or prospective financial reports are shown in Table 3.4 on the next two pages (adapted from Stanga & Tiller, 1983, pp. 66-67, Table 1).

In all, only 10 amongst 40 financial items examined by Stanga & Tiller (1983) are found to be statistically significantly different in importance between large and small enterprise loan applications at the $\alpha=0.05$ level or better. Furthermore, the Kendall's tau correlation coefficient which compares rankings for financial items between large and small enterprises is reported to be 0.78 and statistically significant at the $\alpha=0.001$ level. In other words, there is substantial agreement between the rankings of financial items for the two groupings. Stanga & Tiller (1983, p. 69) conclude that 'the informational needs of bank loan officers do not differ substantially between large public companies and small private companies'. Reporting on his broader research study of small

Table 3.4: Importance of Financial Information to Bank Loan Officers

Financial Information Item	Large Enterprises		Small Enterprises		Statistically Significant Difference (α=0.05)[b]
	Mean Ranking	Mean Rating[a]	Mean Ranking	Mean Rating[a]	
<u>Historical cost basis</u>:					
1. Sales revenue	3	3.604 (EI)	4	3.555 (EI)	No
2. Cost of goods sold (FIFO basis)	5	3.541 (EI)	6	3.395 (VI)	No
3. Depreciation expense (straight line basis)	7	3.478 (VI)	13	3.219 (VI)	Yes
4. Operating income or loss	2	3.757 (EI)	2	3.840 (EI)	No
5. Extraordinary gains or losses	9	3.432 (VI)	15	3.193 (VI)	Yes
6. Net income	1	3.856 (EI)	1	3.857 (EI)	No
7. Earnings per share	40	1.351 (SI)	40	1.210	No
8. Inventory (FIFO basis)	10	3.396 (VI)	13	3.219 (VI)	No
9. Total current assets	16	3.279 (VI)	5	3.445 (VI)	No
10. Property, plant & equipment	16	3.279 (VI)	10	3.294 (VI)	No
11. Total current liabilities	12	3.369 (VI)	3	3.580 (EI)	No
12. Deferred income taxes	23	2.820 (VI)	21	2.790 (VI)	No
13. Dividends per share	22	2.856 (VI)	25	2.580 (VI)	No
14. Working capital from operations	19	3.189	8	3.387	No
15. Cash from operations	8	3.460 (VI)	6	3.395 (VI)	No

[a] EI is extremely important (mean in range 3.500 to 4.000), VI is very important (mean in range 2.500 to 3.499) and SI is slightly important (mean in range 0.500 to 1.499).
[b] Ascertained using Mann-Whitney test.

enterprise managers, bankers and public accountants in the United States, Abdel-Khalik (1983, p. 13) supports this finding by indicating that 'In general, bankers believe that information needs for decision making are similar for both types of companies. They do

not seem to support different financial reporting by private companies than by public companies'.

Table 3.4 (cont.): Importance of Financial Information to Bank Loan Officers

Financial Information Item	Large Enterprises		Small Enterprises		Statistically Significant Difference (α=0.05)[b]
	Mean Ranking	Mean Rating[a]	Mean Ranking	Mean Rating[a]	
Forecast basis:					
16. Forecasted sales revenue	15	3.288 (VI)	17	3.101 (VI)	Yes
17. Forecasted net income	10	3.396 (VI)	10	3.294 (VI)	No
18. Planned amount of financing	6	3.505 (EI)	9	3.378 (VI)	No
19. Planned capital expenditures	13	3.342 (VI)	18	3.084 (VI)	Yes

[a] EI is extremely important (mean in range 3.500 to 4.000), VI is very important (mean in range 2.500 to 3.499) and SI is slightly important (mean in range 0.500 to 1.499).
[b] Ascertained using Mann-Whitney test.

In his research, Hiltebeitel (1985) provided 138 bank lending officers in the United States with a typical small enterprise loan application for evaluation. Financial statements provided in support of the borrowing request varied between loan officers in terms of their comprehensiveness and their adherence to generally accepted accounting principles. Hiltebeitel (1985) believes that more comprehensive financial statements adhering more closely to generally accepted accounting principles were found most useful amongst the lending officers studied. A statistically significant correlation is found amongst the lending officers' perceptions of the usefulness of the financial statements, their risk assessments of the applicant, and the lending officers' need for more information. According to Hiltebeitel (1985, p. 20), 'As perceived usefulness of the financial statements decreased, the [bank lending officers] assessed the business as being more risky, and they requested more information on which to make a final loan decision'. This finding is in broad agreement with the research of Stanga & Tiller (1980) and Abdel-Khalik (1983) mentioned above.

In Chapter 1 of the thesis, it is indicated that the AMC's *Best Financial Practice* study, conducted in 1995, actually involved two mailed questionnaire surveys – one for Australian manufacturing SMEs and another for financial institutions in this country that can provide debt finance to such concerns (Australian Manufacturing Council, 1996). The primary focus in this thesis is, of course, the findings of the SME survey. However, it is useful here to give some attention to the results of the survey of financial institutions (15 replies from 42 mailings giving a response rate of 35.7%) for light they may shed on

expectations of lenders regarding the initial and on-going provision of financial information by smaller businesses that seek to borrow. Financial institutions surveyed indicate that the main problems they experience with small and medium-sized manufacturing enterprises in this country are as follows (Australian Manufacturing Council, 1996, pp. 50-51):

- Poor financial reporting and management systems – often high-quality, up-to-date information is not available on a regular and timely basis, but is provided months in arrears.
- Poor understanding of financial information – especially the significance of debtors, creditors and stock cycles and their impact on cash-flow and ability to service debt.
- Lack of business plans or financial forecasts – suggesting that no strategies exist to underpin cash-flow projections and that, therefore, the credibility of those projections, and management competence generally, is questionable.

Amongst the reported consequences of these problems related to the limited availability, usefulness and reliability of financial information is 'uncontrolled growth' amongst many manufacturing SMEs approaching financial institutions.

The following information is reported by the financial institutions responding to the *Best Financial Practice* study to be the minimum documentation that must be attached to an application from a potential borrower:

- Profit and loss statements and balance sheets for the last three years, possibly audited by an independent professional accountant.
- Current year cash-flow statement and cash-flow forecasts for the term of the debt.
- Budget projections for the next 12 months.
- Aged debtors, creditors and stock schedules.
- Statement of assets and liabilities of the principals (owners and owner-managers).

Of the types of financial information identified above, cash-flow statements and forecasts are reported to be most critical in determining the outcome of a loan application. Examining the sensitivity of cash-flow projections to changing enterprise, industry and economy-wide circumstances is indicated to be a vital step in evaluating a borrowing proposal. Also most important is information that will allow the lender to ascertain certain financial ratios for an applicant which are then compared to industry and institutional benchmarks to ascertain competitiveness and creditworthiness. Other information that could be sought includes a statement of Directors' loans and assets, a statement of future capital expenditures, and relevant personal and company taxation returns. As suggested earlier, the ready availability and reliability of all such financial information is apparently taken as a key indicator of managerial competence in the borrowing enterprise.

3.7.7 Financial Information Signalling by SMEs

In his review of the contribution of information economics to understanding of financial accounting practice, Feltham (1984, p. 195) indicates that:

> In the process of operating a firm, management is likely to acquire considerable private information about the factors that affect the outcomes of the firm's activities. Some of that private information is ultimately revealed by required and voluntary public reports, and some may be revealed by observed management actions (e.g., product prices, investment projects undertaken, dividends declared, securities issued, etc.). To understand the information content of accounting reports and the reporting choices made by management, we must understand the market forces that create incentives for management to acquire and then reveal or disguise private information.

Thus, consideration needs to be given to the possibility that significant private information held by owner-managers of smaller enterprises is revealed to outsiders not in financial reports, but through actions of the owner-managers. These may serve as signals as to the existence, nature and implications of private information not otherwise divulged. The more apparent these signals and their meaning, the less important formal financial reporting to outside parties may become in overall monitoring of the financial position and performance of SMEs.

Feltham (1984) goes on to indicate that those who manage businesses may have cooperative relations with some outsiders, but non-cooperative relations with others. The extent and quality of cooperative interaction may determine the significance and value of signals sent and received. Feltham (1984, pp. 197-198) observes that:

> In general, owners and managers are motivated to communicate good news (and thereby increase the market value of their firm), but they would prefer to disguise bad news. The potential investors, on the other hand, would like to know the bad news.

Outsiders presumably understand management's propensity to fully or partially disguise bad news, and may reflect this insight in the attractiveness (or non-attractiveness) of terms for their support, including the extent and frequency of formal financial reporting demanded. Managers may comprehend this behaviour and choose to deliberately send good news signals in order to secure more advantageous terms. For example, in raising equity capital from others (perhaps from a venture capitalist or through second board listing), an SME owner-manger may retain a higher proportion of his or her business than is otherwise optimal (that is, assume greater than necessary exposure to firm-specific risk) in order to convey good news to outsiders.

It appears then that the relative importance of means employed in smaller enterprises for conveying financial information, and for signalling good or bad financial news, outside of formal accounting reports needs to be better understood before sound judgments on the adequacy or otherwise of SME financial reporting practices can be made. Some examples of mechanisms for this purpose that are not uncommon in smaller business concerns include:

- Regular meetings with bank managers and other creditors or lenders. Sometimes, these meetings are held on the premises of the SME concerned, thus increasing

the opportunity for direct observation of developments (especially investment activity) in that business

- Inclusion of non-executive directors on the boards of a smaller proprietary companies who represent and promote the interests of external financiers, both by directly observing the activities of the business and through provision of management advice.
- Preparation and presentation of once-off business plans, typically containing both historical and prospective financial information, in support of applications for external financing. In recent years, business plans have become *de rigueur* for attracting funding for growing SMEs from outside sources; and much owner-manager training and professional advisory support has been focused on their preparation in good order. An audited prospectus supporting listing of an SME on a stock exchange second board (where this facility exists) may be considered to be a business plan in this context.

On use of such mechanisms for dissemination of private financial information in businesses of all size, Feltham (1984, p. 198-199) indicates that:

> Additional analytical and empirical research is required if we are to understand the *extent* to which managers communicate private information outside of the financial reports, their *motivation* for doing so, and the *process* by which it is accomplished.

3.8 Chapter Review

This chapter of the thesis has sought to describe the institutional context for financial reporting by smaller enterprises in Australia, and to establish a theoretically sound but pragmatic conceptual framework for SME financial reporting in general. Strategic management views and empirical evidence have been presented which suggest that financial reporting undertaken in smaller growth enterprises is, or should be, contingent upon (*inter alia*) the external and internal environments experienced, the strategies pursued and the organisational structures employed. Particular emphasis has been placed upon possible changes to financial reporting brought on as a business grows and progresses through successive stages of its life-cycle.

It appears there are a number of external imperatives on financial reporting by smaller business concerns that are likely to significantly influence the nature and frequency of preparation of general purpose financial reports for internal use by their owner-managers and managerial employees. It is suggested that owner-managers might be well advised to make more extensive use of financial reports that are unavoidably prepared to meet the external imperatives which exist, most especially when their concerns are financially challenged by growth strategies. Achieving better internal financial control, and enjoying greater ease in securing and maintaining external financial support, are identified as two potentially important bases for this advice.

Notwithstanding the above, there are apparently a number of plausible reasons – some more defensible than others – why SME owner-managers may be less inclined to procure standard financial reports, whether historical or future-oriented, than would be proposed or predicted by neoclassical microeconomics and modern finance theory. Some essentially contingent theoretical perspectives have been presented, according to which it may be rational for smaller enterprise owner-managers to obtain and/or disclose less financial information on their concerns in some circumstances, and obtain and/or disclose more financial information in others. Most importantly, irrationality on the part of owner-managers is questioned as a comprehensive explanation for minimal financial reporting on their businesses. Various respects have been identified in which financial reporting practices found in smaller enterprises might fall short of those that are recommended or mandated. The existing and new empirical evidence on general purpose financial reporting undertaken in small and medium-sized enterprises presented in Chapters 4, 6 and 7 of this thesis needs to judged in the light of these observations.