Accounting Standards and Small Firm Debt and Equity: An International Research Agenda

Brian Gibson
Murdoch Business School
South Street Murdoch WA 6150 Australia
T +61 8 9360 6580
F +61 8 9310 5004
e-mail b.gibson@murdoch.edu.au

Abstract

Notwithstanding exemptions provided through professional accounting bodies around the world, standards and procedures applicable to publicly traded firms are often used to identify and analyse financial information about privately held firms. Such approaches may not always be applicable.

In an environment of emerging international standardisation and differential reporting for small enterprises, the focus of this paper is on one potentially inappropriate procedure that relates to the identification of debt and equity. In many instances the debt reported in the financial reports of privately held firms is provided to the firm only because the owner's personal assets have been provided as debt collateral. Such a circumstance means the amount involved has more of an equity characteristic than a debt characteristic because the owner's personal wealth is put at risk for an uncertain return. For this reason the existence of debt secured by personal collateral is often referred to as quasi-equity.

The presence of unrecognised quasi-equity generates two significant types of problem. Firstly, a potential investor analysing the financial reports of a firm in which reported debt is really quasi-equity may assess the firm to be a poor investment opportunity because it has an apparently high reliance on debt in its financial structure. The second problem is that there is an increasing reliance on the content of the financial reports of privately held firms by researchers gathering and analysing data to inform and guide policy. By aggregating that data without recognition of the quasi-equity characteristic of such debt, invalid understandings of the nature of the equity and debt funding of privately held firms might be emerging.

Unfortunately the accounting profession has not recognised the existence of these problems and, apart from the special reporting requirements in the United Kingdom, there does not appear to be any attempt to ensure reports prepared for privately held firms identify the presence of quasi-equity.

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Introduction

Accounting information about business entities is mandated through the standards promulgated by various professional bodies to be prepared and presented in a consistent and comparable manner. However, reporting requirements are often relaxed to provide exemptions for certain classes of business, of which small privately held firms are a significant class. Notwithstanding this relaxation, procedures applicable to publicly traded firms are often used to report and analyse financial information about privately held firms, even though such procedures may be inappropriate. The focus of this paper is on one such inappropriate procedure that relates to the identification of debt and equity. In many instances the debt reported in the financial reports of privately held firms is provided to the firm only because the owner's personal assets have been provided as debt collateral. Such a circumstance means the amount involved has more of an equity characteristic than a debt characteristic because the owner's personal wealth is put at risk for an uncertain return. For this reason the existence of debt secured by personal collateral is often referred to as quasi-equity. Despite its potential importance in interpreting the real financial status of a firm, accounting standards are often silent on an appropriate treatment.

This paper initially provides a commentary on the applicability of accounting standards to small firms and the arguments for and against differential reporting. It then identifies the nature of debt and equity and explores the use of quasi-equity in small firms before identifying the treatment suggested in financial reporting standards. Some conclusions and suggestions for further research are then presented.

Revisiting the Differential Reporting Debate

The introduction of International Financial Reporting Standards (IFRS) have led to a renewed debate about the use of a differential reporting approach that reduces costs of compliance for firms where the benefits of complying with accounting standards do not appear to justify the greater cost associated with compliance.

Many countries have existing methods for dealing with the issue. In Australia, for example, there is an established "reporting entity concept" and the majority of small or medium enterprises (SME's) are defined as non-reporting and therefore are exempt from most accounting standards

(ICAA, 2006). As Jarvis (2003) reports, the United Kingdom also has a history of differential reporting that has culminated in the issuance of the Financial Reporting Standard for Smaller Entities (FRSSE), last updated in April 2005 (Blyth, 2005). In the USA, according to Williams (2005), relief from some of the more complex reporting requirements of "Generally Accepted Accounting Principles" (GAAP) has been facilitated through the use of special reports based on an alternate "Other Comprehensive Basis of Accounting" (OCBOA). In that country the Sarbanes-Oxley Act also appears to be adding to the complexity of accounting in SME's (Fletcher and Miles, 2004). In Europe, other than for the consolidated financial statements of listed companies there still appears to be a high level of country specific differentiation for all firms regardless of size (Jermakowicz and Gornik-Tomaszewski, 2006).

Following the worldwide move to international harmonisation of accounting and the introduction of IFRS's, the International Accounting Standards Board (IASB) also has a project designed to develop global accounting standards for small and midsized entities (Cheney, 2004). According to Cheney (2004), "the goal of the project is to reduce the burden of disclosure for smaller companies, while preserving the recognition and measurement principles of international standards". Colson (2005) reports that the focus of the project has changed to non-publicly accountable entities (NPAE's). One of the concerns of the IASB is to minimise the impact of member countries having different exemptions from IFRS's (Cheney, 2004).

A significant issue in this debate on differential reporting is how to define the entities to which exemptions might apply. Bases that have been suggested as appropriate for granting exemptions (either alone or in combination) include (ICAA, 2006, p.9):

- The size of an entity (defined by combinations of turnover, assets and number of employees) where small firms would be exempted; and,
- Ownership characteristics (private ownership v public ownership) where privately owned firms would be exempted.

Interestingly, the IASB seems to have rejected a size test and is proposing qualitative factors such as public accountability but is also focusing on user needs (Cheney, 2004). In that context, there are three groups who collectively have an important stake as a consequence of the existence or otherwise of differential reporting:

a) the preparers of financial reports of non-reporting entities - accountants;

b) the working owners of non reporting entities who use financial reports for planning control and decision making (Jarvis, 2003); and,
c) the main external users of the financial reports of non reporting entities – financial institutions who use the reports in making lending decisions and monitoring loan agreements (Jarvis, 2003).

The absence in these groups of external investors is an explicit recognition by accounting standard setters that the major importance of financial reports to value firm equity does not apply to NPAE's (Colson, 2005).

The current status of differential reporting therefore appears to be an acceptance that privately held entities should be exempt from compliance with the same set of standards that apply to publicly traded entities. Exemption assumes no users will be disadvantaged. As expanded in the following section, the difficulty of distinguishing debt from equity may disadvantage all three user groups and there may be a need for a standard that applies to small firms but not to large firms.

The significance of quasi-equity

As suggested by Gibson *et al.* (2004) there is, in large publicly traded firms, a clear distinction between financial resources obtained through equity and financial resources obtained through debt. For these large firms, as indicated in the upper panel of Figure 1, the nature of equity is such that owners put at risk a fixed amount as their contribution to the firm's financial resource needs in return for a variable dividend stream. Debt for large publicly traded firms is normally secured by collateral associated with the firm's assets and is sourced primarily from (i) bank lenders, (ii) non-bank private lenders (generally institutional lenders that provide debt that has qualities associated with both bank and low grade public debt), and (iii) public debt offers such as debentures (Denis and Mihov, 2003).

Notwithstanding this apparently simple distinction there is often debate about whether certain financial instruments represent debt or equity. In Australia, for example, Bourke (2004) outlines several different approaches to the classification of debt versus equity from the perspective of Australian taxation rules. Accounting standards in Australia and New Zealand (that are now identical to IFRS's) provide definitions that are made from the perspective of the business entity and debt is generally recognised if a contractual obligation to deliver cash or other financial assets exists (Bourke, 2004; Yeoh, 2005).

The relationship between debt and equity in small privately held firms is even more complex (Gibson *et al*., 2004). As portrayed in the lower panel of Figure 1, the financial institution debt of a small firm is often fully supported by the personal guarantee and collateral of the owner and not the business (Cosh and Hughes, 1994). As the debt is often issued to the entity, which then has a contractual obligation to make interest and capital payments, it is generally recorded as debt in the entity's financial reports. Such an approach is potentially misleading. For example, consider an individual who uses personal assets as collateral to borrow money. If that money is used to purchase shares in a public company, the borrowing is regarded as personal and the company in which the investment is made does not record the borrowing as its debt. However, if the money is to be invested in a privately held firm it seems it is often regarded as appropriate to redirect the loan to the entity and record it as a debt of the business. If it is appropriate to record this borrowing in the business' accounts, then there is a need to qualify its classification. Because the owners' personal wealth is put at risk for an uncertain return, such debt has more of an equity characteristic. The existence of collateral from outside the business assets to secure business debt should be reported in the financial reports of the business.

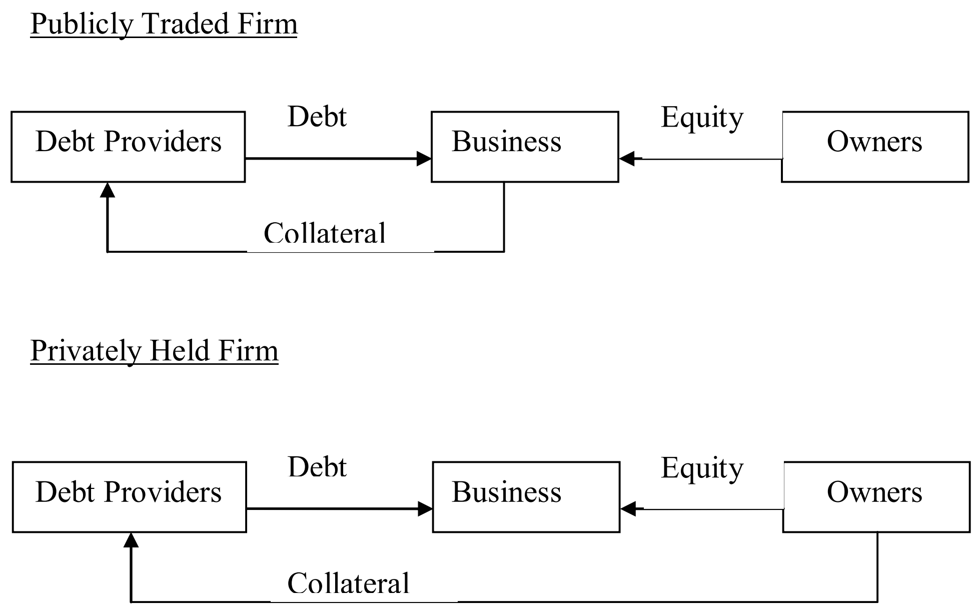

Figure 1. Debt, Equity and Collateral

A large proportion of the research supporting the presence of quasi-equity in privately held firms has been conducted in the United States. Avery *et al*. (1998), for example, suggest "personal commitments appear to be substitutes for business collateral [and that] personal commitments have generally become more important to small business lending since the late 1980s" (p.1019). They also conclude "firm owners able to make these sorts of personal commitments can probably negotiate better credit terms … [and this may] … imply that many firms cannot be viewed as financial entities that are entirely separate from their owners" (p.1020). Other research has explored associated issues. While concentrating on business rather than personal collateral, Manove *et al*. (2001) examine the agency theory implications of collateral in lending and suggest it may be "particularly relevant to small business … [because] … in the United States, approximately 40% of small business loans and almost 60% of their value are guaranteed and/or secured with personal assets" (p.727).

There is also some Australasian research that has directly considered this important question. Gibson *et al*. (2004) for example, suggest that financial institution debt reported by a small firm is commonly fully supported by the owners' personal guarantee and collateral and consequently has the characteristic of equity rather than debt, and Gibson (2006) indicates the proportion of debt instruments supported by owner collateral is over 75% for borrowings from mainstream financial institutions. Zoppa and McMahon (2002) identify, in a range of explanations for variations in financing phenomena, the "common usage of so-called 'quasi-equity' by SMEs" (p.39). Forsaith and McMahon (2002) identify directors' loans (or quasi-equity) as a significant form of financing for smaller enterprises. Gibson (2002) expresses the possibility that a potential limitation of the reported research findings was "the lack of clarity in the interpretation and recording of bank loans secured by owner's personal assets and contributions to the firm from owners" (p.13).

In Europe there seems to be little research that identifies the extent of these practices (at least from a crude analysis of library data base searches). However, emerging from Europe is the contribution to the issue associated with the Basel I and Basel II accords that influence the governance requirements on financial institutions that might provide debt to small firms. As Altman and Sabato (2005) suggest "concerns have been raised that the new Basel Capital Accord (Basel II) will change the way banks analyse credits, introducing new credit risk management techniques and possibly reducing the lending activity toward SMEs" (p.16). This concern arises in part because SME's are ill prepared and financial statements are "generally geared towards a tax avoidance strategy rather than a business and investment strategy" (Bartels, 2002, 48). However, as Altman and Sabato (2005) conclude the fears may be ill founded and "access to bank financing is likely to become easier and possibly cheaper, since large banks will find SME lending more profitable" (p.34).

While issues such as the Basel accords and the Sarbane-Oxley Act are changing the financial environment for small firms, it is clear that a significant proportion of debt reported by small firms is in reality quasi-equity because the collateral for the debt is provided by the personal assets of the business owner.

The Importance of the Distinction

There are several issues that make the clarification of the existence and magnitude of quasi equity important. Firstly, from a practical perspective, decisions by third party financiers and suppliers often consider the existing level of debt. While such an investor is likely to be able to demand specific reports in which the true relationship is identified, there is no indication of how often this happens. Consequently, there may be adverse decisions being made about the financing of small firm activities because of a belief that they have overcommitted to debt when in reality the debt is secured against non-business collateral and as such operating and/or default risks for non secured lenders are significantly protected.

Second, research outcomes in many fields of small business and entrepreneurship seek to measure structural and performance dimensions related to the debt and equity funding sources used (see, for example, Hall *et al.* (2000), and Cassar and Holmes (2003)). Such results are heavily biased because they rely on reported debt and equity to assess performance or financial structure and, as the above interim results from Australia and the more extensive North American results indicate, much of the debt is more of the nature of equity. Confirmation and quantification of the inherent bias in relying on reported debt without considering its underlying equity nature as identified in this paper challenges most extant research into financial management of small firms. Especially challenged are the results related to capital structure outcomes and risk return relationships.

Finally, the small firm sector of the economy is an important sector with respect to economic growth, employment and taxation (Holmes *et al.* 2003). There is a significant investment of funds into firms in the sector that justifies attempts to understand their financing and financial management outcomes. Especially to the extent that the ideas presented in this paper challenge some extant understandings about such activities in small firms they represent an issue of major importance in the policy area.

The Accounting Profession Response

If the identification of quasi-equity (business debt secured by the owners' personal assets) is important, then how do the accounting standards that govern the preparation of financial reports deal with the possibility of the existence of quasi-equity? In countries where IFRS's apply, they don't. As indicated earlier, IFRS's provide definitions that are made from the perspective of the business entity and debt is generally recognised if a contractual obligation to deliver cash or other financial assets exists (Yeoh, 2005). There appears to be no provision to recognise externally guaranteed debt either within the balance sheet classifications of debt and equity or in the notes to accounts.

The only exception appears to be the FRSSE in the UK which provides that "personal guarantees given by directors in respect of borrowings by the reporting entity shall be disclosed in the notes to the financial statements" (Accounting Standards Board, 2005, p.92). Even here, a problem exists for entities that are not companies and therefore do not have directors or where family and friends guarantee loans without taking a directors position.

Clearly existing accounting standards make it extremely difficult to identify in the financial reports of most small enterprises the existence of any external collateral provided for the debts paid for by the business.

Conclusions and Further Research

Results from the limited research that has been reported in this paper do appear to support the expectation that the personal assets of the owner of a business often secure a large proportion of the debt of a small firm. The suggestion that there are such high levels of quasi-equity in privately held firms suggests the need for an increased research focus that:

- examines the need for the accounting standards that govern the preparation of financial reports to require more explicit recognition of this relationship;
- assesses the consequence of the absence of information on the decision processes of investors (especially institutional lenders and venture capitalists); and,
- facilitates a clearer understanding of the aggregate financial structure of the privately held firm sector, and enhances understanding of the relationship of that structure to risks and returns.

In the meantime, investors, researchers and policy makers need to be careful about the way they react to the often high reported debt and low reported equity of privately held firms.

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