Accounting for Financial Analysis

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Structure of the Accounting Profession: Pressure for Change

In recent months the accounting profession has been under increasing pressure—from within the profession itself, from government and from the AICPA Commission on Auditors' Responsibilities—to improve accounting and auditing standards and performance. The critics' principal objectives are (1) improving accounting standards, partly by eliminating alternatives; (2) improving the quality of auditing; and (3) enhancing the independence and credibility of accountants and auditors reporting in financial statements. Below we summarize some of the proposed changes and comment on possible benefits for financial statement users.

Congress

The accounting profession and its organizations have been under attack in Congress, largely because of auditors' failure to detect and report on illegal payments. *The Accounting Establishment*, a report by the Senate Subcommittee on Reports, Accounting and Management (Metcalf Committee) criticized the profession in all its works and proposed a greatly enlarged role for government. The report recommends, among other things, government establishment of accounting objectives and accounting standards for publicly owned corporations; prohibition of such "creative" accounting techniques as income recognition based on percentage of completion and GPLA and current value accounting for inflation; government establishment of auditing standards; and oversight and periodic quality review of auditing practice by government.

Although the Senate report does contain some interesting new data about accounting firms, in general it is poorly researched, highly biased and relies heavily on innuendo rather than fact when accusing the accounting profession of dubious motives. To defend itself, the profession has devoted vast amounts of time and money to hearings before the Senate subcommittee in April, May and June. When FAF President Lilley testified before the Metcalf Committee on May 12, his testimony included these significant points:

> "Comprehensive, timely and accurate accounting and disclosure standards are indispensable to the professional practice of the financial analyst. The welfare and willingness of investors to supply capital to fuel the United States' and the world's economic systems depends upon sound principles of disclosure and accounting and, importantly, upon trust in the system.

> "From the point of view of users of financial information—investors and those serving them—the FASB must be rated a successful venture. There is steady progress toward narrowing or eliminating alternative accounting treatments and hence toward standards that reflect economic realism. There is also a willingness within the Financial Accounting Foundation and FASB to accept criticism and to change approaches where necessary. Thus those shortcoming that have come to light in the operation of the FASB do not appear to be permanent disabilities.

> "Analysts have not been uncritical of the FASB, however. It should be noted that analysts have taken the FASB to task for slowness, for inadequate communication with its various constituencies, and for not providing a basic accounting framework within which individual pronouncements can be determined.

> "Recent developments, however, are most encouraging. The excellent report of the Financial Accounting Foundation's Structure Committee sets forth concrete steps for speeding FASB output and improving communication. At the same time the FASB's discussion memorandum, Conceptual Framework for Financial Accounting and Reporting has been published and is now under study by the business, accounting, investing and academic communities.

> "The FASB was designed to be the arena in which the business, financial, government, accounting and academic communities could interact—pooling their knowledge, experience and expertise in the setting of accounting standards. The input to the process has been broad and indications are that the FASB will actively and continuously communicate with the public during the formulation of any standard. Under these circumstances, it seems difficult to fault the system.

> "In weighing the merits of the FASB as a standard-setting body for the future, a most important consideration must be the dynamic, changing nature of accounting itself. Standards will continue to change even as business changes and new theories of accounting develop. The FASB, with its extensive network of communications throughout the economic and government communities, would appear to be in an unrivaled position to learn of needs for change, to secure varied inputs and to test hypotheses among different groups. At the same time, we assume that the SEC will, quite properly, continue its oversight role in the setting of accounting standards.

> "While we recognize the rightful concern of the Congress in this vital area, we feel that significant additional roles for government at this time would be unwise. A change to government standard-setting would most certainly involve (a) some sort of hiatus or delay in rule-making, (b) the likelihood of creating at least temporary uncertainty in the investment markets, (c) the strong possibility of politicizing standard-setting and (d) unneeded new expense to taxpayers. Bearing in mind the highly technical nature of accounting standards, we also doubt that the government could assemble and maintain, on a permanent basis, the highly trained, specialized professional staff needed to create and continuously update standards to meet changes in business and in the state of the art itself. We would much prefer that accounting standard-setting remain in the private sector where

we perceive a record of steady and continuing progress."

Despite the confusion, contention and cost that they engender, the Congressional reports and hearings probably have a certain catalytic value for the accounting profession. They have generated additional momentum for change and improvement within a profession that has already demonstrated a greater capacity for self-renewal than any other with which this writer is familiar. It appears that there will be no legislation at this time and that the profession will have the opportunity to make changes without government encroachment. These changes will probably involve improvements in the standard-setting process, the independence of the auditor, auditing methods and procedures, communications with users of financial statements and methods for overseeing accounting firms—for "auditing the auditor." The Metcalf Committee will observe progress and call for follow-up hearings next year.

Setting Accounting Standards

The accounting profession, the business community and other interested parties, including the Financial Analysts Federation, have strongly advocated keeping the standard-setting process in the private sector, with the Securities and Exchange Commission in an oversight role. Private sector responsibility allows a more flexible approach—greater responsiveness to changes in business practices on the one hand and the needs of investors on the other—and perhaps even greater expertise.

Recognizing some of the problems of the Financial Accounting Standards Board, the Financial Accounting Foundation established a special Structure Committee to review the FASB's operations in its first three and one-half years. (Walter Stern, former FAF chairman and current president of the Institute of Chartered Financial Analysts, was a member of the Committee.) They found that the FASB had, in general, operated satisfactorily. On the other hand, the committee suggested that the decision process could be sped up by making a number of changes in staffing and methods of operations. It recommended measures to (1) expand the range of input to the Board that would involve a more active role for the Financial Accounting Advisory Council, which would have its own chairman; (2) provide a wider base of financing and thus ensure the Board's independence; and (3) open the deliberations of the Board to the public and thereby seek broader understanding and support for the standards it promulgates.

These recommendations were based on an understanding of the nature of accounting standards that is worth the attention of financial analysts. The Structure Committee stated that:

"Accounting Standards are not immutable truths that can be proved scientifically. Rather they are conventions which are accepted and used by those who are involved in the preparation, attestation and use of financial statements because they are understood to be in the best interests of all. There are a number of important implications that flow from this understanding:

- The process of establishing a new accounting standard requires careful consideration of the views of all elements of the constituency [the public, investors, creditors, the analyst, the investment advisers and underwriters, the preparers, attestors, educators and governments];
- The process requires research to assess the possible effects of a proposed standard;
- A successful standard cannot be imposed by the standard setter, it must be assimilated by the constituency;
- The assimilation process may require an educational effort to demonstrate the overall value of the proposed new standard.

The standard-setting body must be the ultimate decision maker, developing those standards that it perceives to be in the best long-term interests of the constituency as a whole. But the constituents must be involved in that development process."*

The recommendations of the Structure Committee are entirely constructive and some have already been implemented. They should help the FASB achieve broader support for its work. In the long run, however, the FASB's stature will still depend on the quality and consistency of its decisions. In this respect we believe that investors should be satisfied with the FASB's work for, as we noted in our January/February 1977 column, the principal standards it has published so far have been in the investor's interest. A statement submitted by the Financial Accounting Foundation to the Senate Subcommittee on Reports, Accounting and Management indirectly corroborates this belief, noting that the Financial Analysts Federation was the *only* organization among those providing input to the Board that supported the essence of the Board's standards on the five issues of major importance (Accounting for Research & Development; Contingencies; Foreign Currency Translation; Leases; and Segment Reporting) among the eight issues decided by the FASB.

One purpose of the Structure Committee's study was to show that recommendations to the FASB on controversial issues come from a wide variety of sponsoring organizations (i.e., the FAF or the Financial Executives Institute), major accounting firms and business firms, hence that the Board is not beholden to any one group, such as large corporations or large accounting firms, as the Senate subcommittee charges. The coincidence of FAF views with the final standards merely indicates that the Board gives very careful consideration to the needs of investors and users. In doing so, it is being consistent with the objectives of financial statements as stated first by the Trueblood Committee and more recently by the FASB's own *Tentative Con-*

* *The Structure of Establishing Financial Accounting Standards*, Report of the Structure Committee (The Financial Accounting Foundation, April 1977).

clusions on the Objectives of Financial Statements of Business Enterprises.

Commission on Auditors' Responsibilities

By late 1974, some celebrated cases of audit failure, including Equity Funding, Sterling Homex and National Student Marketing, had generated growing criticism of auditors' performance. The American Institute of Certified Public Accountants had appointed an independent Commission on Auditors' Responsibilities to study the role of auditors and to make recommendations designed to narrow an apparent gap between the needs and expectations of users of financial statements and the performance of auditors.

The commission's membership, drawn from several disciplines, ensures a broad perspective to its deliberations. The late Manual F. Cohen, former chairman of the SEC, was, until his death on June 16, chairman. Lee Seidler, professor of accounting and a member of the FAF's Financial Accounting Policy Committee, is deputy chairman. Other members include this writer, a corporate chief executive and three accountants in public practice. After more than two years of deliberations, the commission issued its 176-page *Report of Tentative Conclusions* in March and held public hearings in June. Its final report, which will be published before year-end, should significantly affect a wide range of auditing matters.

Auditing, a highly technical and detailed subject, is not usually of direct concern to financial analysts—unless problems emerge. The end result of the auditor's work is an opinion whether the financial statements prepared by management are fair representations of a company's financial position and results of operations, prepared in conformance with generally accepted accounting principles. Behind this opinion lie extensive reviews of the company's transactions, financial documents and accounting principles. The validity of the opinion expressed in the financial statements, on which investors rely, depends on the quality of these reviews.

The accounting profession has so far tended to believe that law suits took root in users' unreasonable expectations of what auditors could accomplish in their review process. The Commission concluded, however, that, while users have some misconceptions about the auditor's role and the nature of his services—for example, an auditor's report is not a guarantee of the complete accuracy of the financial statements—users' expectations are reasonable. The commission found, instead, that the gap between expectations and performance can be traced to auditors, and suggested improvements in auditing practice and in communication of auditor results to users.

In its *Tentative Conclusions,* the commission makes over 40 recommendations on 11 topics. Those of most direct interest to financial analysts follow.

An extended report should replace the auditor's short-form report, which tends to be regarded as a seal of approval. This report would comment on the matters examined, including not only the financial statements themselves, but the system of internal controls, management's preparation of interim statements and the company's policy statement on misconduct. In order to emphasize the responsibility of management as the preparer of the financial statements, the commission recommends an additional statement by management explaining its role in the preparation of the statements, its selection of accounting principles, the relationship of the auditor to the audit committee, and the work of the audit committee.

The Commission thinks that these dual statements will lead to a clearer delineation between management and auditor responsibilities and a better understanding of the limitations of auditing. This longer form of auditor's report could, of course, become merely a more elaborate seal of approval.

The standard phrase "present fairly" should be replaced by "all material respects." The meaning of the word "fairly" remains little understood, and the report recommends that the auditor, rather than try to determine whether statements are fair in some sense, use a number of decision steps to evaluate the appropriateness of the accounting principles management selects. Where accounting alternatives exist, the auditor should express a preference, if he has a basis for doing so. Finally (and importantly for users), at the end of this process the auditor should review the cumulative effects of the accounting principles selected to ensure that a misleading picture does not result. Certainly in a number of celebrated failures in the past, that final step was never taken. Much of these recommendations stress the role of judgment as an aspect of generally accepted accounting principles that has not been fully employed in the past.

"Subject to" opinions should be eliminated and replaced by a statement in the notes regarding all significant uncertainties in the financial statements. This statement would provide the user with much more information about all uncertainties. (The commission found that going-concern uncertainties are a frequent type of "subject to" qualification, but the auditor is not an especially good predictor in this regard.) Many users may question this recommendation, since the "subject to" opinion has heretofore provided a quick warning signal that may be lost in the expanded note.

Auditors should clearly accept responsibility for detecting fraud. (In the past, the accounting literature has been ambiguous.) However, since an auditor cannot be expected to uncover all frauds, the commission recommends that he follow due professional care, including a number of audit steps not taken in the past (some of which have recently been adopted in a new auditing standard by the AICPA).

Auditors should report on the quality of internal controls. This idea is controversial; auditors fear that they will be unable to make brief yet meaningful statements on the subject and therefore that any statement may be misleading. Nonetheless government and users want reports on internal controls, partly because of the illegal payments issue, which has involved "off balance sheet" funds in a number of cases. Differences in opinion here may be the result of differing

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definitions: Auditors tend to define internal controls in terms of adequate checks and balances on the approval and disbursement of funds and on accounting entries; users may encompass in their definition administrative controls, which are actually broader types of controls ensuring adequate consideration of capital expenditures, new ventures and the like, before final authorization. Lack of such administrative controls can lead to larger losses than would result from lack of the more narrowly defined internal controls.

Some Conclusions

Measures to alter and improve the structure of accounting and auditing should prove beneficial for investors. A more effective FASB should produce standards more rapidly, develop a conceptual framework and, in due course, eliminate remaining undesirable accounting alternatives. More consistent and comparable financial statements, more responsive to the needs of investors, should result. And improved, expanded auditors' opinions, together with a management letter, should enhance credibility of these financial statements.

Credibility of auditors' reports will be further enhanced by measures to assure the independence and competence of the auditor in the audit process. Such measures include further development of audit committees within boards of directors, proposals by the Commission on Auditors' Responsibilities and some type of oversight, either through peer reviews, public review boards, or both.

The substantial cost of these efforts will be borne by the issuers of financial statements initially and by the public in the long run. While the immediate objective of many of these efforts is to provide improved information for investors and other users of financial statements, they will not eliminate future losses on investments.

Beyond the immediate concern for investors, the current examination of the accounting profession is part of a larger attempt to make corporations more fully accountable to the public. Other proposals, such as those concerning the composition of boards of directors, are a part of this process. Investors should welcome increased accountability, provided the regulations achieve their objective without entangling corporations in so much red tape that their effectiveness is reduced.

SEC Industry Disclosure Guidelines

The Securities and Exchange Commission is moving toward accounting and disclosure requirements for specific industries designed to provide investors with more meaningful information. The SEC Advisory Committee on Corporate Disclosure has recommended to the Commission that 10K reporting guidelines similar to those already published for bank holding companies be prepared for selected industries. The Advisory Committee also recommended that users and preparers of information on these industries participate in formulation of the guides. The FAF Corporate Information Committee and its industry subcommittees, in particular, can have a very important role to play in this process.

The problem, of course, lies in developing meaningful standards for a specific industry without overriding the general standards of accounting and reporting applicable to all companies and necessary to achieve adequate comparability. The SEC has selected certain regulated industries for its initial efforts. Some of the proposed disclosure requirements are as follows:

Railroads: (1) line of business reporting, including a breakdown of freight and passenger contribution; (2) status of physical plant and equipment; (3) average return on invested capital; (4) competitive conditions and position; and (5) disclosure of deferred maintenance. This last item, while of great importance to railroad analysis, is not easy to define and measure for financial statement purposes.

The SEC also invites comment on a long-standing issue in railroad accounting—betterment (or replacement) accounting versus depreciation accounting for track structures. Many feel that betterment accounting results in an overstatement of earnings in periods of deferred maintenance, but in conservative estimates in periods of normal maintenance and rising prices (providing a kind of LIFO for track).

Utilities: (1) construction programs, financing arrangements for long-term capital programs and an explanation of the effect of the allowance for funds used in construction; (2) statistical data on utility rates; (3) sources of fuel supplies, environmental requirements and fuel adjustment clauses; (4) revenue growth—volume and rates; (5) supplier relationships; (6) asset valuation; and (7) line of business reporting.

Banks: The SEC has proposed amendments to SEC regulation S-X (registration statements) that contain new requirements about the form and content of financial statements for bank holding companies and banks. A response prepared by the Banking and Financial Industry Subcommittee of the FAF Corporate Information Committee and concurred in by the Financial Accounting Policy Committee stated that:

> "As a general comment, we believe it appropriate to point out to the SEC that a considerable burden is being imposed on banks, accountants and users of financial statements by the steady stream of new regulations being introduced. All must be studied carefully, and in cases where mistakes are made time and energy must be applied to try to bring revisions. Data collections systems of banks and analysts are under constant revision. We would have been much happier if our energies could have been channeled into digesting and streamlining the large amount of Guide 61 data so recently introduced rather than having to face so soon another onslaught of changes."

A good point, and one applicable in other contexts as well.

The principal change among the many the SEC proposes would eliminate the separate line after operating income for realized gains or losses on investment securities in the two-tier net income format that has been used for a number of years. The SEC would include these gains and losses in other revenue, but this seems a step backward since it seems likely that the thrust of the conceptual framework will be toward an income statement with two or more tiers reflecting different types of income. Gains and losses on securities are different from operating earnings, and bank stock investors tend to look at operating earnings more than at net income; the SEC proposal would result in less useful earnings information than is available today.

SEC Lease Disclosure Requirements

At the end of 1976, the FASB issued Statement 13 on lease accounting, which requires capitalization of financing leases. The requirement, retroactive for all existing leases, gives companies a five-year period to comply. This transition period allows companies time to collect the data and to renegotiate any loan or other agreement affected by the new accounting standard. The SEC has moved in, however, to require full conformance to the standard in 1977 financial statements unless there is a problem with loan agreements. In that case, the company would have to state that such restrictions preclude conformance to the standard. The FAF's Financial Accounting Policy Committee supported the SEC's proposal in a statement filed with the SEC in late June.

The Commission also proposed that regulated companies, including public utilities, disclose information regarding leases in accordance with FASB Statement 13. Statement 13 is unclear in its application to regulated companies. The FAPC supported the Commission's view, stating that "we share the Commission's concerns with such enterprises [regulated companies]. All too often, regulatory agencies mandate accounting practices whose cosmetic effects blur economic realities. It is only through disclosure that financial statement users are able to make the statements of such enterprises fully comparable with those prepared fully according to GAAP." ■

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passed) in its present form exempts advisers and associated persons from the Act if they have met "satisfactory alternative" qualification standards. This concept appears to have been used only once—under the SECO rules involving qualifying examinations for brokers and dealers (SEC Rule 15b8-1 (a)). H.R. 2105 would thus not involve establishment of a structure for the registration of private organizations with the SEC. Rather, it would recognize without regulating, private programs involving qualification standards. If the FAF and Institute of Chartered Financial Analysts qualification programs were so recognized it would have the effect of exempting FAF and ICFA members from regulation.

It might be argued that the power of the SEC to recognize a private program as a satisfactory alternative might give the SEC some indirect regulatory power over private programs such as the FAF's. The legislative history of the proposed amendments and the report of the Senate Banking Committee indicate that this is clearly not the intent of the legislation. Any subsequent legislative reports should contain statements to that effect.

There is little basis for the argument that the SEC will "take over" a private organization it recognizes for purposes of the "satisfactory alternative." It has no authority to do so. If there is ever enabling legislation to allow registration of private organizations as self-regulatory organizations in the advisory area, it would be just that—voluntary registration. It seems most unlikely that the SEC would request, or that Congress would entertain, a proposal that regulation and registration of existing private organizations of analysts or advisers be made mandatory. Neither Congress nor the SEC seems to have made such a suggestion. ■