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AN EVALUATION OF SELECTED CORPORATION ANNUAL REPORTS FOR COMPLIANCE WITH CERTAIN RECOMMENDATIONS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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CHAPTER I

INTRODUCTION

Historical Development of Problem

In a speech made in 1968, Mr. Robert O. Whitman, Vice-President and Treasurer of American Electric Power Service Corporation, made the following statement:

> " . . . It is generally recognized that the users of American corporate [annual financial] reports receive more and better information than their counterparts in other countries. Since this has been the result of a continuing evolutionary process, it is a matter of particular concern that there are to be heard in some quarters allegations of a "crisis" in financial reporting and agitation for abandonment of proven principles and methods of development in favor of an enforced uniformity imposed by some form of centralized authority. Since confidence and acceptance are indispensable to effective reporing, charges of crisis tend to be self-fulfilling, and in such an atmosphere hasty action may be taken without regard for its immediate practical

effects and long-run economic consequences."[1]

In contrast, in an address given November 19, 1970, Mr. Philip L. Defliese, the new chairman of the Accounting Principles Board (APB), made the following statement:

> "The profession is now agreed on the need for specifics in defining accounting principles and reporting practices and is rapidly moving in that direction. The alternatives are being reduced and abuses eliminated. Flexibility, as a basic concept, is dead.
>
> . . . The profession is not only united in its intention to follow APB Opinions but both the SEC and the major stock exchanges have also indicated their intent to back us with the full strength of their regulatory powers."[2]

The American Institute of Certified Public Accountants (AICPA) years ago recognized the need to develop a code of accounting principles. With the formation of the Securities and Exchange Commission (SEC) in 1934, the accounting profession was faced with the possibility that a uniform set of accounting rules would be prescribed by a governmental agency. However, the Commission made it evident that the accounting profession was expected to assume the major role in the determination of accounting rules by requiring "that generally

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[1]Robert O. Whitman, "A Financial Executive Views Accounting Developments," Corporate Financial Reporting: Conflicts and Challenges, Ed. John C. Burton (New York: American Institute of Certified Public Accountants, 1969), p. 126.

[2]Philip L. Defliese, "The APB and Its Recent and Pending Opinions," The Journal of Accountancy, February, 1971, p. 67.

accepted accounting principles be observed as they evolved and became clarified."[3]

In order to meet these new responsibilities the Institute established the Committee on Accounting Procedure in 1938. The stated objective of the Committee was:

> " . . .to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies."[4]

Until it was superseded in 1959 by the Accounting Principles Board, the Committee issued fifty-one "Accounting Research Bulletins." Although the Bulletins were instrumental in abolishing many undesirable practices, in the late 1950's there was criticism of the profession that there were still too many alternative accounting methods available to those reporting under similar circumstances. Many accountants felt that some renovation in the efforts of the Institute in the area of accounting principles was needed.

Leonard Spacek suggested that an accounting court be

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[3]"Standardization in Accounting and Individual Professional Judgment," The Journal of Accountancy, January, 1954, p. 37.

[4]Committee on Accounting Procedure, Committee on Terminology, Accounting Research and Terminology Bulletins: Final Edition (New York: American Institute of Certified Public Accountants, 1961), p. 8.

established to hear and decide issues relating to accounting principles.[5] Alvin R. Jennings, in his acceptance speech as President of the Institute in October of 1957, called for the establishment of an expanded and independent Institute research program.[6] As a result of these and similar suggestions, a special committee of the Institute was organized and after a year's study the committee recommended the formation of the Accounting Principles Board (APB) and an Accounting Research Division.

The Accounting Principles Board was organized on September 1, 1959, to replace the Committee on Accounting Procedure. Its purpose was to ". . . advance the written expression of generally accepted accounting principles . . . determine appropriate practice . . . narrow areas of difference and inconsistency in practice . . . with persuasion rather than compulsion."[7] As of December, 1972, the Board had issued twenty-seven Opinions and four Statements. (The Statements are for the information and assistance of members of the Institute and others interested in the subject, and do not have the authority of the Opinions.)

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[5] Leonard Spacek, "The Need for an Accounting Court," Accounting Review, XXXIII, No. 3 (1958), 368-79.

[6] Alvin R. Jennings, "Present-Day Challenges in Financial Reporting," The Journal of Accountancy, January, 1958, pp. 28-34.

[7] "Report to Council of the Special Committee on Research Program," The Journal of Accountancy, December, 1958, pp. 62-63.

As the two quotations that began this chapter indicate, the direction that the APB has chosen to take over the past few years is controversial. As Ernest L. Hicks said,

> "The record of the APB, like a silver dollar, has two sides. If you toss a silver dollar in the air and watch it spin, you can see different images. Sometimes you can see the obverse, sometimes the reverse; sometimes you see a blurred combination of the two. In much the same way, different people see different images of the APB."[8]

In March, 1971, in response to widespread criticism of the accounting profession's system of developing, enunciating, and applying accounting principles, Marshall S. Armstrong, President of the AICPA, appointed the Study Group on Establishment of Accounting Principles. The purpose of the Study Group was "to examine the organization and operation of the Accounting Principles Board and determine what changes are necessary to attain better results faster."[9]

In March, 1972, the Study Group in its report suggested that the Accounting Principles Board be replaced by a new group called the Financial Accounting Standards Board, which would consist of seven full-time, salaried members appointed to terms of five years, including at least four Certified Public Accountants (CPA's).

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[8]Ernest L. Hicks, "APB: The First 3600 Days," The Journal of Accountancy, September, 1969, p. 58.

[9]Establishing Financial Accounting Standards, Report of the Study on Establishment of Accounting Principles (New York: American Institute of Certified Public Accountants, 1972), p. 2.

In contrast, the Accounting Principles Board is composed of eighteen members, all unpaid and part-time. All are CPA's, one from each of the so-called "Big-Eight" accounting firms, six from smaller accounting firms, two university accounting professors, and two from industrial corporations. One of the sharpest criticisms of the APB by the Study Group was in relation to the Board's research efforts. The research was pictured, in general, as laggard and haphazard. The Group's report stated, "By no standard that we can think of can this [research] program be called a striking success."[10]

Regardless of the criticism at this writing, "generally accepted accounting principles" for financial statement presentation are represented by the _Accounting Research and Terminology Bulletins Final Edition_ and the twenty-seven Opinions of the Accounting Principles Board issued as of December, 1972.

Originally the pronouncements of the Committee on Accounting Procedure were looked upon by the accounting profession as recommendations for courses of action in making decisions regarding accounting procedures, classifications, disclosures, and financial statement presentation. The Committee stated that " . . . the authority of opinions reached by the committee rests upon their general acceptability."[11] The Committee also stated " . . . the burden of

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[10] _Ibid._, p. 29.

[11] Committee on Accounting Procedure, Committee on Terminology, _Final Edition_, p. 9.

justifying departure from accepted procedures to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment."[12]

In October, 1965, the Accounting Principles Board issued _Opinion No. 6: Status of Accounting Research Bulletins_, which contained a statement from the Council of the Institute that pronouncements of the Accounting Principles Board (as well as effective Accounting Research Bulletins) are " . . . intended to have the force and effect of . . . a standard of reporting practice."[13] The Council further stated that commencing with financial statements whose fiscal year began after December 31, 1965, "departures from Opinions of the Accounting Principles Board [and effective Accounting Research Bulletins] which have a material effect should be disclosed."[14]

Each Opinion of the Accounting Principles Board published subsequent to Opinion No. 6 has contained the following statement (with slight changes in wording over the years):

> "Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports on independent auditors when the effect of the departures on the

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[12] _Ibid._

[13] Accounting Principles Board, _Opinion No. 6: Status of Accounting Research Bulletins_ (New York: American Institute of Certified Public Accountants, 1965), p. 51.

[14] _Ibid._, p. 50.

> financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements . . . Members of the Institute must assume the burden of justifying any such departures."[15]

Statement of Problem

Based upon these statements it seems reasonable to assume that an independent auditor is referring mainly to the Institute Bulletins and Opinions when he states that, in his opinion, the financial statements of a given corporation present fairly the financial position and operating results:

> ". . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."[16]

This study will attempt to determine if this assumption of the source of "generally accepted accounting principles" is fully justified: and, if not, what are the effects of the Institute's pronouncements?

In its report, the Study Group on Establishment of Accounting Principles indicated that in the final analysis the success of any accounting principles standard-setting board depends upon "acceptance of its standards by the business

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[15]Accounting Principles Board, Opinion No. 21: Interest on Receivables and Payables (New York: American Institute of Certified Public Accountants, 1971), pp. 424-25.

[16]Committee on Auditing Procedure, Statements on Auditing Procedure No. 33: Auditing Standards and Procedures (New York: American Institute of Certified Public Accountants, 1963), p. 57.

community, practicing accountants, the SEC, and the public."[17] The Study Group stated that such acceptance would be forthcoming provided that, among other things, "[t]he members of the accounting profession support the standards in attesting to the fairness of financial information."[18] However, at this time, there is no basis upon which a reasonable estimate can be made concerning the degree of acceptance of the Opinions and Bulletins by the profession.

Justification for the Study

A study of a national sample of financial statements might provide some insight into the profession's acceptance of the Opinions of the Accounting Principles Board. The Board, or the American Institute of Certified Public Accountants, has no real or implied powers of enforcement. Consequently, it is one thing for the Board to become more dictatorial, more procedural, more explicit in its Opinions and have the accounting profession adopt these opinions; it is quite another matter if the profession, or a large part of it, ignores or circumvents these opinions.

The demand for greater comparability of financial statements, and a corresponding reduction in alternative

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[17] Establishing Financial Accounting Standards, p. 23.

[18] Ibid., p. 24.

procedures, has never been more intense or widespread than at the present time. The Accounting Principles Board is currently charged with the responsibility of resolving these controversies.

If the profession does not make progress toward the solution of these problems, the alternative is direction from the outside; the Securities and Exchange Commission, Congressional action, or a quasi-judicial body are some of the alternatives that have been suggested.

If the profession is going to solve these problems, an evaluative study of the acceptance and non-acceptance of the APB Opinions and the directive of the Council related to these Opinions is desirable.

This study should contribute to the development of the Accounting Principles Board's procedures and policies and should enable the Board (or its successor) to be more responsive to the needs of the profession as well as to the needs of other concerned parties. A detailed description of the study is presented in Chapter II.

Other Relevant Studies

A similar study with different objectives has been made annually since 1946 by the American Institute of Certified Public Accountants and published as Accounting Trends and Techniques. However, Accounting Trends and Techniques is an attempt only to illustrate how various financial items are presented in annual reports. No attempt is made to ascertain why a particular method is becoming more or less widely adopted. No judgments are made as to acceptability of presentations used. Nor is there any investigation into apparent departures from recommendations of the Institute.[19]

An examination of accounting literature indicates no extant study and evaluation of acceptance and non-acceptance of the Opinions of the Accounting Principles Board as evidenced by financial statements, audited by Certified Public Accountants, beginning after December 31, 1965. In addition, the literature contains the results of only two such studies taken from national samples, both unpublished doctoral dissertations. The first, written in 1957 by Edgar Ben Yager was an examination of 270 annual reports for apparent non-compliance with Institute recommendations in five areas. These five areas were concerned with inventories, depreciation and high costs, depreciation and emergency facilities, contingency reserves, and comparative statements. The second study taken from a national sample was written by Lloyd Vann Seawell in 1958. This study was an examination of the annual reports of 255 corporations for each of three consecutive years for compliance with recommendations in eight areas: comparative statements, working capital, inventories, contingency reserves,

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[19]See: Louis H. Gilles, Jr., "An Evaluation of the Effectiveness of Accounting Trends and Techniques in Revealing Significant Accounting Practices" (unpublished Ph. D. dissertation, University of Missouri, 1969), pp. 251-262.

depreciation and high costs, depreciation and emergency facilities, net income, retained earnings and income taxes, and long-term leases.

Both of these studies examined financial statements dated prior to January, 1958, using only Bulletins issued by the Committee on Accounting Procedure. The authors, in each case, incorporated qualitative levels of acceptance: full compliance, substantial compliance, partial but unsatisfactory compliance, and non-compliance. The present study does not consider such measures as meaningful because they are significantly subjective in application, and as a consequence use only two evaluative classifications. In addition these studies were written prior to the statement of responsibility published by the Council of the AICPA in Opinion No. 6 quoted above.[20] Both authors asked the auditors to explain apparent departures from the standards contained in the Bulletins. After adjustment for these explanations, these studies indicated a range of rates of compliance with the specific Bulletins from a high of 97.2 per cent[21] to a low of 49.1 per cent.[22]

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[20] Accounting Principles Board, Opinion No. 6, p. 51.

[21] Edgar Ben Yager, "An Evaluation of Annual Reports of Selected Industrial Corporations for Compliance with Certain Standards of Accounting Research Bulletin Number 43" (unpublished D.B.A. dissertation, Indiana University, 1957), p. 112.

[22] Lloyd Vann Seawell, "An Evaluation of Selected Industrial Corporation Annual Reports for Compliance with Accounting Research Bulletins of the American Institute of Certified Public Accountants" (unpublished D.B.A. dissertation, Indiana University, 1958), p. 138.

Another study was completed in 1968 by Leon M. Ennis, Jr. This thesis examined 140 corporate financial statements for compliance with eight recommendations contained in the Bulletins and in four of the first five Opinions of the Accounting Principles Board. However, Professor Ennis' study contained both annual reports and unpublished financial statements of only corporations considered to be North Carolina firms rather than from a national sample. Like the other two studies, the reports and statements examined were not considered subject to the Council's statement on the auditor's responsibility. This study indicated a range of compliance with specific recommendations from 100 per cent to a low of 50 per cent for those companies publishing annual reports.[23]

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[23]Leon M. Ennis, Jr., "An Evaluative Study of the Acceptance and Non-Acceptance of Certain Recommendations of the American Institute of Certified Public Accountants" (unpublished Ph. D. dissertation, School of Business Administration, University of North Carolina at Chapel Hill, 1968), p. 191.

CHAPTER II

STRUCTURE OF THE DISSERTATION

ELEMENTS OF THE PROBLEM

The introductory chapter indicated that developments of the past half century have produced new economic relationships and more complex business entities. These developments have caused many groups to attempt to persuade the accounting profession to adopt greater uniformity in financial reporting. Because of these pressures various committees of the American Institute of Certified Public Accountants have issued statements intended to be accepted by the accounting profession as generally accepted accounting principles and procedures.

The objective of this study was to evaluate the influence and acceptance of certain Opinions of the Accounting Principles Board (APB) combined with the statements of the Council of the AICPA in relation to audited financial statements and to obtain information as to the justification and/or reasons advanced by those independent auditors for not taking exception to what appeared to be the application of accounting principles and disclosures which are other than those recommended by the APB. The steps in the research methodology consisted of: the selection for study of certain Opinions of the APB; the establishment of criteria for the evaluation of compliance with each recommendation selected; the selection of the sample and the securing of the annual financial reports; the evaluation of these reports by application of these criteria; attempting to obtain a justification from the independent auditor for apparent divergent treatment; and the evaluation of the replies.

Selection of Recommendations

The factors considered in the selection of the recommendations of the AICPA to be used in the evaluation were: 1) select those which were stated with sufficient clarity and precision, thereby excluding those subject to various degrees of interpretations; 2) include those Opinions which by their nature could be evaluated and conclusions drawn without making assumptions; 3) include those recommendations which were applicable to a substantial number of financial statements; and 4) include only those which were generally capable of having a material effect on the expression of an independent accountant's opinion based on the financial statements. In addition, as this was to be a general study of the Opinions, the decision was made to select earlier ones as well as the more recent ones applicable to the published financial statements. Also, to be able to relate this study to the earlier ones, a selection should be made from the pronouncements of the Committee on Accounting Procedure previously evaluated in 1958. Finally, the decision was made to exclude, except for disclosure requirements, those Opinions judged so complex as to recommend a separate study.

Using the above criteria as a guide, the following paraphrased recommendations from the Bulletins and Opinions of the AICPA were selected: These recommendations will be discussed in greater detail in Chapters III through VIII of this study.

1. The balance sheet, the income statement, and the statement of retained earnings should be presented in comparative form with at least the statements of the preceding year. (ARB No. 43, Chapter 2)

2. The financial statements or their accompanying notes should disclose the minimum annual lease rentals, the outlay period, the types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements. (APB Opinion No. 5)

3. The financial statement or notes should disclose the depreciation expense for the period, balances of major classes of depreciable assets at balance sheet date, and a general description of method or methods used in computing depreciation with respect to the major classes of depreciable assets. (APB Opinion No. 12)

4. The income statement should disclose on its face the earnings or net loss per share; the earnings per share data should be presented for all periods covered in the statements. In addition, the financial statements should include

a description sufficient to explain the pertinent rights and privileges of the various securities outstanding, and a note explaining the basis upon which both primary and fully diluted earnings per share are calculated. (APB Opinion No. 15)

5. A statement of source and application of funds should have been presented in the financial reports. (This recommendation was for fiscal periods ending after October, 1963, and before October 1, 1971). (APB Opinion No. 3)

6. The financial statements or notes of corporations with extant pension plans must disclose: that such a plan exists and identifying the employee groups; the company's accounting and funding policies; the provision for pension cost for the period; the excess of the value of vested benefits over the total net pension fund and accruals; and the notice of significant matters affecting comparability for all periods presented. (APB Opinion No. 12)

Establishment of Criteria of Evaluation

Criteria were established in each of the six study areas for the purpose of evaluating the presentations in corporate annual reports for compliance with the requirements and recommendations of the AICPA.

In order to have qualified for an initial evaluation of Apparent Satisfactory Compliance, the financial statement must have revealed that the recommendation was followed as stated by the criteria. For an initial evaluation of Apparent Unsatisfactory Compliance the financial statements must have appeared not to have complied with the stated criteria. When evaluating lease disclosures and pension plan disclosures, Apparent Non Coverage was used to classify those situations where either of these items seemed not to exist. These evaluation criteria are discussed in more detail in the specific chapters related to each general recommendation.

Selecting and Securing the Sample

A random sample of corporate annual financial reports was drawn from the alphabetical listing in Moody's Manual of Industrial Corporations, 1970 Edition.[1] Public utility, financial and transportation companies, were eliminated from the alphabetical listing because the annual financial reports of these regulated corporations must conform to the standardized rules of certain regulatory agencies. Alien corporations, corporations controlled by other corporations, and corporations whose stock was closely held were also removed from consideration. The corporations remaining in the alphabetical listing formed the population from which the sample was selected on a random basis.

The confidence level was specified at .95 and the desired precision was set at $\pm$5 per cent. Since no prior knowledge of the population was assumed, a 50 per cent occurence

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[1]John Sherman Porter, ed., Moody's Industrial Manual (New York: Moody's Investors Service, 1970).

rate was specified. For these specifications and for a population estimated at 3,500, a table provided by Arkin indicated a required sample size of 346.[2] To compensate for the possibility that not all firms would respond to requests for copies of their annual reports or would for some reason not qualify for evaluation, 400 requests for a copy of their latest annual report were mailed.

Requests for the annual reports were mailed on September 20, 1971 to each of the firms chosen from Moody's Industrial Manual. A second letter was mailed on October 12, 1971 to those companies that had not responded to the first request. (Reproductions of the two letters may be found in Appendix A, Exhibits 1 and 2.)

Annual reports were received from 356 corporations, which represented 102.8 per cent of the required sample size. An alphabetical listing of the 356 sample firms is provided in Appendix B.

Evaluation of the Financial Reports

Each of the 356 annual reports was examined to determine the extent to which the statement appeared to comply with each of the six recommendations chosen for this study. In addition to examining the financial statement and the opinion of the

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[2]Herbert Arkin, Handbook of Sampling for Auditing and Accounting, Volume I - Methods (New York: McGraw-Hill Company, Inc., 1963), p. 370.

auditor, the whole report was examined for additional pertinent information which may not have been disclosed in the formal financial statement.

On the basis of the examination of the annual reports, an initial evaluation rating of either Apparent Satisfactory Compliance or Apparent Unsatisfactory Compliance with each of the recommendations was assigned. In a few instances the evaluation was Apparent Non-Coverage.

In order to establish some comparisons within the study, which would provide insight into possible factors which might influence the compliance with recommendations of the AICPA, the financial reports were evaluated according to the following sub-classifications:

a) financial statements audited by "Big-Eight" accounting firms. This is the traditional reference to what are considered the dominant firms in the profession of public accounting vis-à-vis financial statements audited by "other" accounting firms.

b) financial statements issued by relatively large corporations vis-à-vis financial statements issued by relatively smaller corporations.

In the first of the subclassifications, "Big-Eight" is the traditional reference to what are considered the international accounting firms that dominate the profession of public accounting. They are: Arthur Andersen & Co.; Arthur Young & Company; Ernst & Ernst; Haskins & Sells; Lybrand, Ross Bros.

& Montgomery; Peat, Marwick, Mitchell & Co.; Price Waterhouse & Co.; and Touche Ross & Co. The "other" accounting firm classification refers to all other public accounting firms. (A list of the accounting firms auditing the financial statements used in this study is presented in Appendix C.)

The second subclassification was based on size of the reporting corporation in terms of total assets. The 356 reports were classified into 22 groups according to total assets ranging from over $1 billion (16 corporations) down to $1 to $2 million (3 corporations). 177 of the corporations had total assets of $40 million or more and were classified as "larger" corporations; the remaining 179 corporations had total assets of less than $40 million and were classified as "smaller" corporations.

Communication with Auditors

Following the initial evaluations, in each instance of a tentative rating of Apparent Unsatisfactory Compliance, a letter was directed to the auditor of the statements requesting his justification or explanation through a supplied questionnaire of the treatment that appeared contrary to the recommendations of the AICPA. (The letter and questionnaires appear in Appendix A, Exhibits 3 through 10.) If no immediate reply was received, a maximum of two follow-up letters were sent in an attempt to obtain an answer (Appendix A, Exhibit 11). If no reply was received from a third letter, it was assumed that the apparent divergency was not justifiable and the tentative evaluation became final, on the basis that the auditor had not assumed the burden of justifying departure.

At the time that the initial correspondence was directed to the independent auditors requesting justifying the apparent divergencies, a general question was also posed concerning the respondents' feelings toward the opinions of the Accounting Principles Board in general, and specifically in relation to the Board's approach to flexibility as a basic concept. (See Appendix A, Exhibit 10.)

The purpose of this question was to obtain opinions of these members of the profession to determine if they were in agreement with the direction the Accounting Principles Board was taking "generally accepted accounting principles."

Evaluation of Auditors' Replies

Two broad general classifications were used in judging the replies from the auditors:

Acceptable justification. An acceptable justification took one or both of the following forms:

1. An explanation that the item in question was immaterial in amount or effect, and thus excluded from the coverage of the recommendation.

2. An explanation that the item or situation was other than that assumed by the researcher, and therefore not subject to the recommendation, or in fact had been in accord with the recommendation.

Unacceptable justification. Examples of the general type of replies considered as unacceptable:

1. An explanation that the item in question had been

treated properly in the published report other than the statements, notes, and opinions.

2. Inclusion in the reply material that should have been in the financial report, or the statement that the recommendation had been followed in statements and forms filed with the Securities and Exchange Commission.

3. An explanation that the divergency was the result of disagreement by management of the company under audit with the recommended treatment.

Final Evaluation Results

The satisfactory replies of auditors were used to revise the tentative evaluation ratings initially assigned to determine the final evaluation ratings. For the other corporations the initial ratings became the final ratings. The conclusions of this study, based on the final evaluations, are presented in each of the six chapters dealing with a specific area, and are summarized in the final chapter.

CHAPTER III

COMPARATIVE STATEMENTS

Introduction

The presentation of financial statements for a single year is of limited value to most users. In such a presentation there is a tendency to over-emphasize the importance of the reported results of current operations and financial position. The one-year accounting period for which financial statements are normally prepared is but a brief time period in the life of most corporations, and single year statements are merely periodic installments in a continuing financial history.

The practice of presenting comparative financial statements is helpful in the determination of the trends of particular features of a business enterprise, and of the enterprise as a whole, since it provides a reference to past fiscal performance which places the current statements in perspective. The comparison of financial position at the beginning and end of a fiscal period and/or of income statements for several consecutive years, is in most cases, more valuable than the statement of financial position as of a given date and the income statement for a single year. In many cases the changes in financial position and result of operations are of more significance than the absolute amount of assets, equities, and results of operations.

An interesting analogy in respect to this is made by Roy C. Foulke in Practical Financial Statement Analysis.

> "If a train is moving forward at a known rate of speed, it is reasonable to assume that it will continue to move at approximately the same rate unless some obstacle interrupts its progress abruptly, or the motive power is increased or decreased. Similarly, it is reasonable to assume that unless some drastic change takes place in a business, it will continue to move in the same general direction as indicated by its comparative trends."[1]

In recognition of the utility of comparative financial statements, the American Institute of Certified Public Accountants through its Committee on Accounting Procedure issued Accounting Research Bulletin (ARB) No. 6 in April, 1940. This bulletin, restated in ARB No. 43, made the following recommendations:

> 1. The Presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise. Such presentation emphasizes the fact that statements for a series of periods are far more significant than those for a single period and that the accounts for one period are but an instalment of what is essentially a continuous history.

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[1]Roy A. Foulke, Practical Financial Analysis, 6th ed., (New York: McGraw-Hill Book Company, 1968), p. 445.

2. In any one year it is ordinarily desirable that the balance sheet, the income statement, and the surplus statement be given for one or more preceding years as well as for the current year. Footnotes, explanations, and accountants' qualifications which appeared on the statements for the preceding years should be repeated, or at least referred to, in the comparative statements to the extent that they continue to be of significance. If, because of reclassifications or for other reasons, changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, information should be furnished which will explain the change. This procedure is in conformity with the well recognized principle that any change in practice which affects comparability should be disclosed.

3. It is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out.

4. Circumstances vary so greatly that it is not practicable to deal here specifically with all situations. The independent accountant should, however, make very clear what statements are included within the scope of his report.[2]

In June, 1940 an editorial appeared in The Journal of Accountancy supporting the recommendations of ARB No. 6 as follows:

"The use of such statements is recommended as an aid to understanding the financial position of corporations, and suggestions are offered to make comparisons between periods more helpful and informative. In this case no new principle is enunciated, but the committee signifies its approval of what it regards as a desirable practice."[3]

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[2]Committee on Accounting Procedure, Committee on Terminology, Final Edition, p. 15.

[3]"Two New Research Bulletins," The Journal of Accountancy, June, 1940, pp. 427-28.

EVALUATION CRITERIA

The criteria for the evaluation of the presentations of financial statements in comparative form are based on the requirements of ARB No. 43, Chapter 2, Section A, as quoted above, and were interpreted to the balance sheet, the income statement and the statement of retained earnings. The criteria were not assumed to apply to a statement of sources and uses of funds because such a statement was not required by the AICPA at the time these statements were published. (See Chapter VII)

To receive an evaluation rating of Apparent Satisfactory Compliance, the financial statement presentation was required to meet the following criteria:

1. <u>The balance sheet, the income statement, and the statement of retained earnings must be presented in comparison with those of at least one immediately preceding year. Comments or footnotes supplementing the statements covered by the auditor's opinion must give the same information, if applicable for each other year in the comparison. However, the absence of comparative statements may be satisfactorily explained by the auditor as being due to a lack of comparability of the information in the statement.</u>

2. <u>The auditor's opinion must specifically name the statements covered by that opinion and these must be the statements presented.</u>

Tentative Evaluation Results

The initial evaluation of the presence of comparative financial statements is presented in Table III-1. Only 5 of the 356 reports examined failed to meet the first criteria given above. Two of the reports failed to present comparative statements of retained earnings, one failed to present a comparative balance sheet, one contained only a comparative income statement, and one report had no comparative statement at all.

This was an overall tentative compliance rate of 98.6 per cent for this recommendation (Criteria 1).

In contrast, the initial evaluation of Criteria 2 indicated that only 260, or 73.0 per cent, of the 356 (See Table III-2) reports examined clearly indicated the statements included in the auditor's opinion.

A strict and narrow interpretation was used in the evaluation of this criteria. For example, if two years' comparative statements were presented in the annual report and only the latest balance sheet date was mentioned in the scope paragraph of the auditor's report, that item was judged not to meet Criteria 2.

In several instances an auditor's opinion similar to this was presented:

> In our opinion, the statements appearing on page . . . through . . . of this report present fairly the consolidated financial position of . . . . . and its consolidated subsidiaries at

TABLE III-1

INITIAL EVALUATION

COMPARATIVE STATEMENTS - PRESENTATION

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation to present comparative balance sheets, income statements, statements of retained earnings. (Sub-classifications based on size of independent auditing firm and relative size of corporation.)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	158	99.4	18	100.0	176	99.4
Unsatisfactory Compliance	1	0.6	0	-	1	0.6
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	129	97.7	46	97.9	175	97.8
Unsatisfactory Compliance	3	2.3	1	2.1	4	2.2
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	287	98.6	64	98.5	351	98.6
Unsatisfactory Compliance	4	1.4	1	1.5	5	1.4
	291	100.0	65	100.0	356	100.0

TABLE III-2

INITIAL EVALUATION

COMPARATIVE STATEMENTS - COVERED IN OPINION

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation that the independent accountant make very clear what statements are included within the scope of his report. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	123	77.4	11	61.1	134	75.7
Unsatisfactory Complaince	36	22.6	7	38.9	43	24.3
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	99	75.0	27	57.4	126	70.4
Unsatisfactory Compliance	33	25.0	20	42.6	53	29.6
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	222	76.3	38	58.5	260	73.0
Unsatisfactory Compliance	69	23.7	27	41.5	96	27.0
	291	100.0	65	100.0	356	100.0

> December 27, 1970, the results of their operations and the supplementary information of funds for the fifty-two weeks then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Our examination of these statements was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In each case, the statements presented on the pages mentioned were for two or more years. Such presentations were also judged not to meet Criteria 2. Such a presentation does not make clear what statements are included within the scope of the report.

An example of an auditor's opinion that accompanied comparative statements which was judged to <u>clearly</u> indicate the statements covered is presented below:

> We have examined the consolidated balance sheet of . . . and subsidiaries as of January 1, 1971 and January 2, 1970, and the related consolidated statements of operations and retained earnings and source and application of funds for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the consolidated financial statements referred to above present fairly the financial position of . . . and subsidiaries at January 1, 1971 and January 2, 1970, the results of their operations and the source and application of funds for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Another example of an auditor's opinion that was judged to satisfy Criteria 2 is as follows:

> We have examined the consolidated balance sheet of . . . and Subsidiaries as of December 31, 1970, and the related statement of income and retained earnings and the statement of source and application of funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We previously examined and reported upon the consolidated financial statements of the Company for the year ended December 31, 1969.
>
> In our opinion, the aforementioned financial statements present fairly the consolidated financial position of . . . and Subsidiaries at December 31, 1970 and 1969, and the consolidated results of their operations and the source and application of their funds for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

The standard short-form report recommended by the AICPA's Committee on Auditing Procedure is presented below for illustrative purposes.

> We have examined the balance sheet of X Company as of June 30, 19__ and the related statement(s) of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of X Company at June 30, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[4]

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[4] Committee on Auditing Procedure, <u>Statements on Auditing Procedure No. 33</u>, p. 57.

In those cases where an auditor's opinion similar to the standard short-form report was presented with comparative statements, it was judged not to meet Criteria 2. The justification for this evaluation was that, taken together, the statements for more than one year and the opinion for only one year could not present a clear indication to the reader of exactly which statements were included in the report.

An examination of Tables III-1 and III-2 provides support for the following tentative observations regarding the AICPA recommendation on the presentation of, and the disclosures related to comparative financial statements.

One, the presentation of comparative financial statements, in published annual reports, with very few exceptions, is completely accepted by the accounting profession. This appears to be true of both relatively large and small companies audited by either "Big Eight" independent accounting firms or "Other" independent accounting firms.

Two, in many instances the financial statements combined with the auditor's report were confusing as to which statements were included in the reports. It appeared that this occurred at an increasing rate for these four sub-classifications: (a) large corporations audited by Big-Eight firms, (b) small corporations audited by Big-Eight firms, (c) large corporations audited by non-Big-Eight firms and (d) small corporations audited by non-Big-Eight firms.

Summary of Replies From Correspondents

Letters were written to the auditors of 101 companies whose annual reports were given an evaluation rating of Apparent Unsatisfactory Compliance. Replies were received from firms representing 63 of these companies.

One auditor stated that; "The AICPA, the Missouri Society of CPA's, and the Accountancy Laws of Missouri have Codes of Ethics dealing with the confidential relationship which exists between the CPA and his client, that would in any event preclude the candid answers requested in your letter." For the same general reasons, six other auditors refused to answer the questions related to comparative statements. In addition, another auditor refused to answer on the basis that the corporation concerned had changed auditors "and it would not be appropriate to do so under these circumstances."

Only one of the five auditors of the annual reports that failed to present complete comparative financial statements (Table III-1) replied to the questionnaire. However, his answer was interesting.

> "I do not believe that the AICPA's statements constitute generally accepted accounting principles. I agree with the AICPA that comparative financial statements are desirable and that when given, should be accompanied with all footnotes, explanations, etc. necessary to understand such statements. However, I believe that a significant distinction exists between categorization of comparative statements as desirable and categorization as required in accordance with generally accepted accounting principles."

This auditor made no further statement supporting his position such as non-comparability or other acceptable justification.

Ninety-six of the annual reports examined were assigned the rating of Apparent Unsatisfactory Compliance in relation, only, to Criteria 2. The auditors of sixty-two of these statements answered the enquiry about the apparent lack of clarity of the statements covered in the auditor's opinion. This was the highest rate of response (64.6 per cent) by any individual group to which questionnaires were sent.

Most had a ready response to the query. Fifty-seven of the sixty-two auditors responding substantiated their method of presentation in a manner similar to the auditor quoted below.

> "I assume that your . . . question is directed at why our report dated February 27, 1971, does not cover . . . financial statements for 1969. I agree that paragraph 8 of <u>Accounting Research Bulletin Number 43</u> implies that an accountant's report should cover the comparative periods financial statements as well as those of the current year. However, paragraph 48, page 74 of <u>Statement on Auditing Procedure Number 33</u> states:
>
> 'Where financial statements for the prior year are presented for comparative purposes, the independent auditor need not extend his opinion to cover them; where he has not made an examination of the prior year's statements, there should be appropriate disclosure in the statement or in the auditor's report. Where the independent auditor presently has significant exceptions or reservations as to the prior-years statements he should make appropriate disclosure in his report . . . '
>
> Our firm has traditionally omitted reference to the comparative period when reporting on financial statements of companies for which we had also examined the preceding year's financial statements."

Of course, some of the respondents giving justifications similar in nature to the one above were not so charitable in their responses. One stated, "Your question is out of order!"; another simply "See SAP No. 33, Chapter 10, Paragraph 48, Opinions on Prior Year's Statements."[5] Several respondents simply stated that they could not understand what was not clear about the presentation made: the statements were named and the date was given in the scope paragraph.

A summary of the feelings of the respondents to the inquiry is reflected in the following statement by one of the auditors.

> "It must be borne in mind that Accounting Research Bulletins and pronouncement of the Accounting Principles Board relate to accounting matters and the presentation of financial statements, whereas standards of reporting by independent public accountants are comprehended by Statements on Auditing Procedure (SAP) of the AICPA. The ARB section referred to . . . merely advocates that comparative financial statements influence the usefulness of . . . reports. There is, however, no requirement therein that such comparative statement be covered by the accountants' opinion but only the statement that the accountant should make very clear what statements are included within the scope of his report."

Final Evaluation Results

As a result of replies received from auditors the following reclassifications were made.

In relation to Criteria 1, none of the auditors written

[5] *Ibid.*, p. 74.

provided justifications for failing to present complete comparative financial statements. As a result all five reports were given a final evaluation of Unsatisfactory Compliance.

On the basis of the responses of the auditors concerning the lack of clearness between opinion and statements presented, all reports that, because of Criteria 2, received an initial evaluation of Apparent Unsatisfactory Compliance were re-evaluated in terms of both ARB No. 43 and SAP 33. As a consequence of this re-evaluation 91 of the 96 reports were given a final evaluation of Satisfactory Compliance. The remaining five were given a final evaluation of Unsatisfactory Compliance. These reports were given this evaluation because, in each case the opinion was worded in such a manner that it was not possible to determine which statements were included within the scope of the report. The results of the final evaluations show 346 out of the 356 reports examined or 97.1 per cent (See Table III-3) were in Satisfactory Compliance, technically, with ARB 43, Chapter 2, Section A.

An interesting comparison of the final evaluation results of this study with those of the earlier studies is presented in Table III-4.

While the limitations of comparability of the results of these studies was discussed in Chapter II, it is interesting to note that during the interval between the time of publication of the annual reports used in the Ennis study and

TABLE III-3

FINAL EVALUATION

COMPARATIVE STATEMENTS

Results of final evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation related to the presentation of comparative balance sheets, income statements, and retained earnings statements. (Sub-classifications based on size of independent auditing firm and relative size of corporation.)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	156	98.1	17	94.4	173	97.7
Unsatisfactory Compliance	3	1.9	1	5.6	4	2.3
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	128	96.9	45	95.7	173	96.6
Unsatisfactory Compliance	4	3.1	2	4.3	6	3.4
	132	100.0	47	100.0	179	100.0
Totals						
Satisfavtory Compliance	284	97.6	62	95.4	346	97.1
Unsatisfactory Compliance	7	2.4	3	4.6	10	2.9
	291	100.0	65	100.0	356	100.0

TABLE III-4

COMPARISON FINAL EVALUATION RESULTS - COMPARATIVE STATEMENTS

Comparison of final evaluation results of current study with those of similar studies - designated by author and approximate date of annual reports used in such studies.

Evaluation Rating	Yager[1] 1954		Seawell[2] 1956		Ennis[3] 1966		Grigsby 1970	
	No.	Per Cent	No.	Per Cent	No.	Per Cent	No.	Per Cent
Satisfactory Compliance	145	55.6	133	52.1	69	84	346	97.1
Unsatisfactory Compliance	116	44.4	122	47.9	13	16	10	2.9
Totals	261	100.0	255	100.0	82	100	356	100.0

[1]Yager, "Evaluation of Annual Reports," p. 27.

[2]Seawell, "Evaluation of Selected Annual Reports," p. 37.

[3]Ennis, "Evaluative Study," p. 58. (Data for widely-owned companies only).

the time of publication of the annual reports used in this study, a Securities and Exchange Commission (SEC) requirement that published annual reports include financial statements for two years went into effect.[6] This release did not, however, require that both years' statements be certified, only the last year's statements were required to be covered by the auditor's opinion.

In summary, the presentation of comparative financial statements in a manner recommended by the American Institute of Certified Public Accountants was almost universally followed by the accountants in the annual reports examined. But over 70 per cent of the reports examined went further than required and included both years' statements in the scope paragraph and, therefore, in the auditor's opinion. This left a sizable minority publishing financial reports that to a non-professional would be at least slightly confusing because of the "different" relationship between the statements and the corresponding auditor's report. It appears that the Securities and Exchange Commission also felt that this was the case, because in its Release 9000, dated October 21, 1970, the Commission stipulated that for these companies required to file financial statements with the SEC under the Securities Act of 1934:

> "There shall be for the registrant, in comparative columnar form, certified balance sheets as of the close of the last two fiscal

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[6]SEC Release 8029, January 1, 1967.

> years and certified profit and loss and source and application of funds statements for such fiscal years."[7]

It seems probable that the percentage of independent auditors that include both years' statements in their opinions of published financial reports will go even higher.

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[7]SEC Release 9000, October 21, 1970, p. 25.

CHAPTER IV

REPORTING FOR LEASES BY LESSEES

Introduction

The leasing of land, of buildings, and of space in buildings has been a normal business activity for over 200 years. However, until the 1940's such lease obligations were of slight consequence to the financial position of most businesses, with two possible exceptions. These two exceptions were long-term leases, often for 99 years, on land on which buildings were erected by the lessee, and leases on retail store properties of substantial aggregate amount by several retail store chains which in some cases, went bankrupt during the depression of the 1930's. Up until this time, normally no disclosure of lease obligations appeared in the balance sheets or in the notes to the financial statement of lessee corporations.

Just before World War II, lease obligations began to grow in size and importance as a result of the great increase in demand for capital to finance expansion programs. At that time there was a corresponding expansion, on the part of many corporations, of the practice of selling real estate and then taking it back under long-term leases, normally for twenty to forty years, with renewal options, in many cases, at lower rates on the property. This practice evolved to the erection of structures to meet desired specifications and upon completion selling the property for immediate lease back to the seller. This practice expanded to such non-real property as merchant ships and airplanes. As a result of this "sale-and-lease back" practice, lease obligations of individual businesses have increased substantially over the years.

The evolution of the lease arrangement developed to the point whereby the lessee of land and buildings in many cases became obligated to pay all real estate taxes, insurance costs, and upkeep of the property over the life of the lease. Such arrangements have come to be known as "net leases".

The "net lease" can be very flexible in its terms. However, as one author has pointed out, there are at least four basic features common to every such lease.

> "1. It provides for a basic term during which the lease is cancelable only by the payment of a stipulated premium in excess of the amortized cost. The length of this basic lease period is determined primarily by the economic life of the asset and is usually somewhat shorter than its expected life. When the economic life of the asset is extremely long, the credit standing of the corporation may limit the length of the basic term.
>
> 2. The lease provides for periodic rental payments during the base period, which are calculated to return the original investment in the asset to the owner with a predetermined rate of interest. Occasionally, where the basic term is short in relation to the assets, economic life, or where land values represent a substantial portion of the investment, the amount repaid during the lease may be something less than the original investment.

3. The rental payment so determined may be increased to cover costs of maintenance, taxes, insurance, and other expenses directly related to the property. Usually, however, the arrangement is on a net lease basis with the corporation assuming the obligation for these expenses as well as continuing responsibility for the management of the property.

4. The lease customarily provides some means by which the corporation may continue to use the asset after the expiration of the basic lease term. This may take the form of renewal options for additional periods, usually at rentals substantially reduced from those paid during the initial term. The corporation may also be given the option to purchase the asset at the end of the basic lease period, or sometimes even during it."[1]

In a transaction such as this the lease creates an obligation on the part of the lessee to make a series of payments over a future period of time, which is as much a fixed obligation as a long-term mortgage loan. This technique provides a relatively easy means for corporate expansion. The alternative is a heavy direct investment in fixed assets financed by funded debt or by issuance of capital stock or some combination of the two. Under this alternative the increase in assets and the corresponding increase in liabilities and/or capital stock would appear on the financial statements. However, under normal circumstances lease transactions were not recorded in the balanced sheet.

In 1949, the Committee on Accounting Procedures of the American Institute of Certified Public Accountants (AICPA)

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[1]Donald R. Gant, "Illusion in Lease Financing," Harvard Business Review, March-April, 1959, pp. 123-142.

recognized the need for changes in accounting standards so that details of material lease obligations would be reported. The Committee recommended the following:

> [W]here the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:
> (a) disclosure should be made in financial statements or in notes thereto of:
> (1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and
> (2) any other important obligation assumed or guarantee made in connection therewith;
> (b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and
> (c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.
> . . . [W]here it is clearly evident that the transaction involved is in substance a purchase, then the leased property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related changes in the income statement.[2]

The intent of the Committee seemed quite clear, but the implementation of the recommendation left much to be desired. The spirit of the opinion was avoided and in many instances only minimal disclosure, if any, was made. The capitalization of leases which were, in substance, purchases continued to be extremely rare.

The Division of Accounting Research of the AICPA commissioned Professor John H. Myers of Northwestern University

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[2]Committee on Accounting Procedure, Committee on Terminology, Final Edition, p. 73.

to conduct a study on leases, the results of which were published in 1962 as Accounting Research Study No. 4 entitled Reporting of Leases in Financial Statements. Professor Myers concluded in this study that the current reporting practices were inadequate and that "To the extent then that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet."[3]

Two years later, in September, 1964, the Accounting Principles Board (APB) issued Opinion No. 5: Reporting of Leases in Financial Statements of Lessee. The Board did not accept the capitalization theory with respect to property rights presented by Professor Myers, and the introduction to Opinion No. 5 stated:

> "The Accounting Principles Board has considered the recommendations and the supporting argument presented in Accounting Research Study No. 4. The Board agrees that the nature of some lease agreements is such that an asset and a related liability should be shown on the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. The Board believes that the disclosure requirements regarding leases contained in Accounting Research Bulletin No. 43, Chapter 14, should be extended, and the criteria for identification of lease agreements which are in effect installment purchases of property should be clarified."[4]

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[3]John H. Myers, Reporting of Leases in Financial Statements, Accounting Research Study No. 4, (New York: American Institute of Certified Public Accountants, 1962), p. 5.

[4]Accounting Principles Board, Opinion No. 5: Reporting of Leases in Financial Statements of Lessee, (New York: American Institute of Certified Public Accountants, 1964), p. 32.

The specific disclosure requirements of Opinion No. 5 are stated as follows:

> The Board believes that financial statements should disclose sufficient information regarding material, noncancelable leases which are not recorded as assets and liabilities to enable the reader to assess the effect of lease commitments upon the financial position and results of operations, both present and prospective, of the lessee. Consequently, the financial statements or the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.
>
> In many cases, additional disclosure will be required. The Board believes that rentals for the current year on leases covered by this Opinion should be disclosed if they differ significantly from the minimum rentals under the leases. Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also usually be disclosed.[5]

Evaluation Criteria

The criteria for evaluation of financial statements in relation to disclosure of information regarding material, noncancelable leases are presented below. Because of the wording of the opinion, and the nature of the financial reporting problems arising from long-term leases, the normal two-group classifications of either Apparent Satisfactory Compliance or Apparent Unsatisfactory Compliance did not seem workable. A third classification, Apparent Non-Coverage, was added.

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[5] Ibid.

To receive an evaluation rating of Apparent Satisfactory Compliance, the presentation was required to meet all five of the following criteria:

1. <u>Disclosure must be made of the amount of the minimum annual rentals to be paid under long-term lease</u>. A statement that the amounts of annual or aggregate rentals were immaterial was considered acceptable.

2. <u>Disclosure must be made of the term of the lease or their expiration date</u>. A statement of the aggregate rentals to be paid, when combined with a disclosure of the term of the lease or expiration dates, appears to meet these two criteria.

3. <u>Disclosure must be made of type or types of property leased</u>.

4. <u>Disclosure must be made of obligation assumed or guarantees made in relation to the long-term leases</u>. In the absence of such disclosure or a statement to the effect that no such obligations were assumed or guarantees made, it was impossible to determine compliance with this criterion. In such instances a rating of Apparent Unsatisfactory Compliance was assigned.

5. <u>Disclosure must be made of significant provisions of lease agreements</u>. In the absence of such disclosure or a statement to the effect that no such provisions exist, it was impossible to determine compliance with this criterion. In such instances, a rating of Apparent Unsatisfactory Compliance

was assigned.

A rating of Apparent Non-Coverage was given to those annual reports which gave no indication of there being any long-term leases in the company's operations. It is probable that long-term leases existed in some instances but were not disclosed in the annual reports. It was deemed impracticable to determine the extent of such omissions.

However, a rating of Apparent Non-Compliance was given to those annual reports having one or more suggestions of leases, but no additional disclosure. Some suggestions of the existence of leases were, leasehold improvement appearing as an asset on the balance sheet; rent expense appearing on the income statement; prepaid rent appearing on the balance sheet; and accrued rents appearing on the balance sheet.

Tentative Evaluation Results

The initial evaluation of the annual reports indicate that 149 of 356, or 41.8 per cent of the reports examined gave no indication that long-term leases were used in the reporting companies' operations (See Table IV-1). The remaining 207 companies indicated in their financial statement presentation the existence of long-term leases. Of these 207 reports, 156 or 75.4 per cent, were given an evaluation of Apparent Satisfactory Compliance (Table IV-2). An examination of this table indicates that the apparent compliance rate ranged from an indicated high of 84.5 per cent for smaller corporations audited

TABLE IV-1

REPORTING FOR LEASES BY LESSEES

INDICATION OF LONG-TERM LEASES

Results of evaluation of 356 corporate annual reports for presentation of information related to reporting for leases by lessees. (Sub-classifications based on size of independent auditing firm and relative size of corporation.)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Covered in Report	96	60.4	10	55.6	106	59.9
Apparent Noncoverage	63	39.6	8	44.4	71	40.1
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Covered in Report	71	53.8	30	63.8	101	56.4
Apparent Noncoverage	61	46.2	17	36.2	78	43.6
	132	100.0	47	100.0	179	100.0
Totals						
Covered in Report	167	57.4	40	61.5	207	58.2
Apparent Noncoverage	124	42.6	25	38.5	149	41.8
	291	100.0	65	100.0	356	100.0

TABLE IV-2

INITIAL EVALUATION

REPORTING FOR LEASES BY LESSEES

Results of initial evaluation of 207 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to accounting for leases by lessees. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	76	79.2	7	70.0	83	78.3
Unsatisfactory Compliance	20	20.8	3	30.0	23	21.7
	96	100.0	10	100.0	106	100.0
Smaller Corporations						
Satisfactory Compliance	60	84.5	13	43.3	73	72.2
Unsatisfactory Compliance	11	15.5	17	56.7	28	27.8
	71	100.0	30	100.0	101	100.0
Totals						
Satisfactory Compliance	136	81.4	20	50.0	156	75.4
Unsatisfactory Compliance	31	18.6	20	50.0	51	24.6
	167	100.0	40	100.0	207	100.0

by "Big-Eight" firms to a low of 43.3 per cent for smaller corporations audited by other accounting firms.

The initial evaluation of each of the five recommended characteristics of leases to be disclosed is separately presented in Table IV-3. This was done because even though the recommendation can be viewed as a single compound statement, each of the characteristics can be disclosed without being accompanied by any of the others. A study of this table provides support for the following tentative observations relating to the AICPA recommendation to disclose the minimum annual lease rentals, the outlay period, the types of property leased, and obligations assumed or guarantees made.

The highest rate of compliance for any of the separate characteristics was for minimum annual rental. Of the 207 firms presenting lease information, 198, or 95.7 per cent, met this requirement. The lowest rate of apparent acceptance for any of the separate areas was the disclosure of the types of property leased. Only 84.0 per cent, or 174, of the 207 firms indicated the types of property leased.

Summary of Replies From Correspondents

Letters were written to forty-seven auditors giving opinions on the financial statements which were assigned a tentative rating of Apparent Unsatisfactory Compliance. (Addresses could not be located for the remaining four auditors.) Replies were received from twenty-three of these

TABLE IV-3

INITIAL EVALUATION

DISCLOSURE OF REQUIRED INFORMATION RELATED TO

LEASES BY LESSEES - INDIVIDUAL DISCLOSURE

Results of initial evaluation of 207 corporate annual reports for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to accounting for leases by lessees.

Disclosure Characteristic	Satisfactory Compliance		Unsatisfactory Compliance	
	Number	Per Cent	Number	Per Cent
Minimum Annual Rental	198	95.7	9	4.3
Outlay Period	185	89.3	22	10.7
Types of Property Leased	174	84.0	33	16.0
Obligations or Guarantees Made	183	88.4	24	11.6
Significant Provisions	183	88.4	24	11.6

auditors.

Six of the respondents refused to answer the questions. One refused on the basis that to do so would be a violation in general of the code of professional ethics. Two others refused for the similar reason that to do so would be a violation of the confidential relationship with their clients. Two other auditors declined to answer the questions on the basis that the corporations concerned had changed auditors. The sixth respondent who declined to answer the questions gave no reason. His letter dated a month and a half after the initial request for information and thirteen days after the second request and signed by a secretary; is quoted below, in its entirety.

"Due to the pressures of business I have not had the time to read your letter. This will be taken into consideration in the forthcoming audit."

The responses from the remaining eighteen auditors were classified as either (1) Acceptable Justification, or (2) Unacceptable or no Justification. Eight of the responses were considered as(1) Acceptable Justification. Three of the auditors answered that the long-term leases in their client's operations were immaterial. Two of the auditors based their judgment of immateriality on the relationship of rentals to total expenses. The other based his judgment on the comparison between the amount of property leased and the total amount of property owned by the client company. Three auditors indicated that additional disclosures were unnecessary due to the circumstances related to the lease. Typifying these responses is the following statement by one of these respondents.

"Inasmuch as there are no guarantees or other significant provisions such as restrictions on dividends, debt, or further leasing, or unusual options, we believe that it is not necessary to furnish any additional disclosures."

The remaining two auditors giving what was determined as (1) Acceptable Justification for the unsatisfactory compliance rating stated that the leases referred to in the questionnaire were short-term rather than long-term leases. Since the APB statements on lease disclosure are applicable to long-term leases, the auditor's justifications were acceptable.

The other ten responses were judged to be (2) Unacceptable Justification on the part of the auditors written. Three said the disclosures were not necessary, two said that the property leased was obvious. The other five respondents gave such answers as these: "Disclosures could be better," "We are following this procedure on all present and future financial statements," "Form 10-K gives required detail."

Final Evaluation Results

The results of the final evaluation of the 207 annual reports which contained some disclosure of long-term leases show an overall compliance rate of 79.2 per cent (Table IV-4) with the rate of acceptance of the four sub-classifications ranging from a high of 90.1 per cent, for smaller companies

TABLE IV-4

FINAL EVALUATION

REPORTING FOR LEASES BY LESSEES

Results of final evaluation of 207 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to accounting for leases by lessees. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	78	81.3	8	80.0	86	81.1
Unsatisfactory Compliance	18	18.7	2	20.0	20	18.9
	96	100.0	10	100.0	106	100.0
Smaller Corporations						
Satisfactory Compliance	64	90.1	14	46.7	78	77.2
Unsatisfactory Compliance	7	9.9	16	53.3	23	22.8
	71	100.0	30	100.0	101	100.0
Totals						
Satisfactory Compliance	142	85.0	22	55.0	164	79.2
Unsatisfactory Compliance	25	15.0	18	45.0	43	20.8
	167	100.0	40	100.0	207	100.0

audited by "Big-Eight" accounting firms, to a low of 53.3 per cent for smaller companies audited by "other" accounting firms.

It is interesting that the acceptance rate of the current recommendations regarding reporting of leases by lessees is only four percentage points higher than the indicated rate of acceptance of the then current recommendation indicated in Professor Seawell's study for annual reports in 1956. (Table IV-5.) However, what was then a relatively high rate of acceptance is now a relatively low rate of acceptance.

The indicated or reported rate of acceptance may well be lower than the true rate of acceptance. The method of evaluation probably introduced a Non-Acceptance bias into the results. Companies whose statements gave indication of leases and no further disclosure pertaining to leases, were automatically given an evaluation of Non-Acceptance. In addition those companies disclosing certain information regarding long-term leases and not making note of any lease obligations or guarantees or any other significant provisions of the lease agreement were also given an evaluation of Non-Acceptance. In many cases, as some replying auditors pointed out, the leases were not material, or they were short-term in nature. In addition, many lease agreements do not contain noteworthy provisions or guarantees. In contrast, however, there may have been long-term leases that did not appear in the financial statements or were not indicated anywhere in some of the annual reports examined.

TABLE IV-5

COMPARISON FINAL EVALUATION RESULTS

REPORTING FOR LEASES BY LESSEES

Comparison of final evaluation results of current study with the results of a similar study of the applicable AICPA recommendations related to accounting for leases by lessees. Studies designated by author and approximate dates of the annual reports used in the studies.

Evaluation Rating	Seawell* 1956		Grigsby 1970	
	No.	Per Cent	No.	Per Cent
Satisfactory Compliance	50	75.8	164	79.2
Unsatisfactory Compliance	16	24.2	43	20.8
Total	66	100.0	207	100.0

*Seawell, "Evaluation of Annual Reports," p. 175.

In such instances the report would have been assigned the rating of Apparent Non-Coverage rather than the Unsatisfactory Compliance rating that should have been assigned. In the absence of complete information, the evaluation ratings given were probably inaccurate in certain instances.

CHAPTER V

DEPRECIABLE ASSETS AND DEPRECIATION

Introduction

During the decade of the 1930's there were many methods and concepts of depreciation and many writers criticized the wide variation in depreciation policies. However, it was not until April, 1940 that the American Institute of Certified Public Accountants made its first official pronouncement concerning depreciation and depreciable assets. *Accounting Research Bulletin No. 5: Depreciation on Appreciation* was published. The conclusion of this bulletin was that depreciation should be computed on the appreciated value of assets when appreciation had been recorded in the accounting records.[1]

The second official statement of the AICPA regarding depreciation, *Accounting Research Bulletin No. 33: Depreciation and High Costs*, was published in December, 1947. In response to a suggestion that the problem of inflation and the replacement of assets be met by increasing depreciation charges, the Committee on Accounting Procedure stated, "that accounting

[1] Committee on Accounting Procedure, Committee on Terminology, *Final Edition*, p. 73.

and financial reporting for general use will best serve their uses by adhering to the generally accepted concept of depreciation on cost."[2]

In November, 1952, Accounting Research Bulletin No. 42: Emergency Facilities - Depreciation, Amortization and Income Taxes was published by the AICPA. Section 124A of the Internal Revenue Code, added by the Revenue Act of 1950, created certificates of necessity under which the cost of emergency facilities could be amortized over a period of sixty months for income tax purposes. In response to a suggestion that the same period be used for depreciation for accounting purposes, the Committee on Accounting Procedure responded that generally accepted accounting principles do not necessarily agree with tax accounting principles. Therefore, if the two periods (the useful life for financial accounting purposes and the emergency facility life) differed materially, the financial statements and the tax return must differ accordingly.

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences

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[2]Ibid., p. 68.

> during the year, it is not intended to be a measurement of the effect of all such occurrences."[3]

This appears to have been the first comprehensive view of depreciation and depreciable assets taken by the AICPA in an official statement.

One of the major provisions of the Revenue Act of 1954 was the recognition of double declining balance depreciation and sum of the year digits depreciation for tax purposes. As a result, the AICPA issued Accounting Research Bulletin No. 44: Declining Balance Depreciation in October, 1954. Three and one-half years later (July, 1958), Bulletin No. 44 was revised and re-issued under the same title. The revision was concerned with the presentation and approval of alternatives for treating the difference between income taxes for book purposes and income tax for tax purposes that resulted from a difference in depreciation methods for book and tax purposes. As far as depreciation and depreciable assets were concerned, the conclusion was the same: that the declining balance method and the sum of the years digits method both met the requirements of being "systematic and rational" and were therefore accepted for financial reporting purposes.[4]

November, 1962, brought the publication of Accounting

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[3] Ibid., pp. 76-77.

[4] Ibid., p. 1-A.

Principles Board (APB) Opinion No. 1: New Depreciation Guidelines and Rules. In this opinion, the Board concluded that: "a tax payer should carefully review the estimate of useful life of depreciable property adopted for financial accounting purposes, with the objective of conforming them with Guideline lives to the extent that the latter fall within a reasonable range of estimated useful lives applicable in his business."[5] Guideline lives referred to a Revenue Procedure published by the United States Treasury Department approving lives for depreciation purposes that were, in most cases, shorter than those in use at the time for tax purposes and, in many cases, for financial reporting purposes.

In 1965 Accounting Research Study No. 7: Inventory of Generally Accepted Accounting Principles for Business Enterprises was published. While not an official pronouncement or the official position of the Accounting Principles Board, this study was the most comprehensive statement made under the auspices of the AICPA in the area of depreciable assets and depreciation. Included were the following two principles of accounting:

PRINCIPLE C-2

> Fixed assets should be carried at cost of acquisition or construction in the historical accounts,

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[5]Accounting Principles Board, Opinion No. 1: New Depreciation Guidelines and Rules, (New York: American Institute of Certified Public Accountants, 1964), pp. 1-2.

> unless such cost is no longer meaningful. Cost of land should ordinarily be shown separately. Cost of construction includes direct costs and overhead cost incurred, such as engineering, supervision and administration, interest, and taxes. Items treated as fixed assets should have at least one year of expected useful life to the enterprise, and normally the life is considerably longer. Practicable yardsticks or criteria should be established in order that consistent distinctions may be made between fixed assets, operating expenses and maintenance. Ordinarily, this should be accomplished by creating a catalogue of property units to be included in fixed assets, any lesser items to be charged to current expense. Items no longer in service should be removed by charge to depreciation reserve or expense in order that fixed assets will represent the cost of properties in service.[6]
>
> PRINCIPLE C-3
>
> Appropriate provision or allowances should be made in order to charge operations with the investment in depreciable assets over the estimated life thereof. The accumulated allowances, less property retirements, should be shown as a deduction from fixed assets.[7]

There were several pages of discussion concerning these two principles. However, guidance for financial reporting purposes was rather sparse, and the principles were primarily a distillation of accounting experience and practice.

Accounting Principles Board _Opinion No. 6, Status of Accounting Research Bulletins_ was issued in October, 1965. There were two revisions of the previous accounting research made in this opinion. ARB 43, Chapter 9B, "Depreciation on Appreciation," was, in effect, deleted and a one paragraph

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[6]Paul Grady, _Inventory of Generally Accepted Accounting Principles for Business Enterprises_, Accounting Research Study No. 7 (New York: American Institute of Certified Public Accountants, 1965), pp. 252-53.

[7]_Ibid._, p. 259.

bulletin put in its place. The opinion stated that depreciable assets should not be written up above cost to the entity. Paragraph 17 of this opinion which made the change, in effect eliminated depreciation on appreciation except in connection with quasi-reorganizations or reorganizations. Paragraph 20 of Opinion No. 6 made a change in ARB 44 (Revised) Declining Balance Depreciation in relation to recognition of deferred income taxes, but made no changes related to accounting for depreciable assets or depreciation.[8]

Two years later Opinion No. 12, Omnibus Opinion - 1967 was published. The statement of the Board and the four requirements of that opinion concerning depreciation and depreciable assets are as follows:

> Disclosure of the total amount of depreciation expense entering into the determination of results of operations has become a general practice. The balances of major classes of depreciable assets are also generally disclosed. Practice varies, however, with respect to disclosure of the depreciation method or methods used.
>
> Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:
>
> a. Depreciation expense for the period,
>
> b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date,
>
> c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and

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[8]Accounting Principles Board. Opinion No. 6, pp. 41-3.

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.[9]

These four requirements are the most recent, comprehensive official statement by the AICPA on depreciation and depreciable assets.

Evaluation Criteria

The criteria established for the evaluation of financial statements in relation to the recommended disclosures related to depreciable assets and depreciation are given below. To receive an initial rating of Apparent Satisfactory Compliance, the financial statements or the notes thereto must have disclosed all of the following items:

1. Depreciation expense for the period.
2. Balances of major classes of depreciable assets by nature or function, at the balance-sheet date.
3. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date.
4. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

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[9]Accounting Principles Board, Opinion No. 12: Omnibus Opinion - 1967 (New York: American Institute of Certified Public Accountants, 1967), p. 188.

If all criteria were not met in the published financial statements then the report was given an initial evaluation of Apparent Unsatisfactory Compliance.

Tentative Evaluation Results

Application of the criteria given above to the 356 annual reports in the sample produced the tentative evaluation ratings summarized in Table V-1. The highest rate of apparent compliance by any of the four sub-classifications was by larger companies audited by "Big-Eight" accounting firms; 152 out of 159 or 95.6 per cent met all four criteria. The apparent lowest rate of compliance was by smaller companies audited by "other" accounting firms. Ten out of forty-seven reports or 21.3 per cent, failed to meet all four of the criteria listed above. There appeared to be quite a difference between those reports audited by "Big-Eight" accounting firms, with an indicated acceptance rate of 94.8 per cent, and those audited by "other" accounting firms which had an apparent acceptance rate of 78.5 per cent, a difference of sixteen percentage points.

Data related to the evaluation ratings of the financial statements for apparent compliance with each of the disclosure requirements related to depreciable assets and depreciation are presented in Tables V-2, V-3 and V-4. There is no presentation related to the requirement that disclosure be made of accumulated depreciation at the balance-sheet date; all

TABLE V-1

INITIAL EVALUATION

ACCOUNTING FOR DEPRECIABLE ASSETS AND DEPRECIATION

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation for disclosures related to accounting for depreciable assets and depreciation. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	152	95.6	14	77.8	166	93.8
Unsatisfactory Compliance	7	4.4	4	22.2	11	6.2
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	124	93.9	37	78.7	161	89.9
Unsatisfactory Compliance	8	6.1	10	21.3	18	10.1
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	276	94.8	51	78.5	327	91.9
Unsatisfactory Compliance	15	5.2	14	21.5	29	8.1
	291	100.0	65	100.0	356	100.0

TABLE V-2

INITIAL EVALUATION

ACCOUNTING FOR DEPRECIABLE ASSETS AND DEPRECIATION

EXPENSE FOR PERIOD

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation for disclosure of depreciation expense for the period related to accounting for depreciable assets and depreciation. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	159	100.0	18	100.0	177	100.0
Unsatisfactory Compliance	0	-	0	-	0	-
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	132	100.0	45	95.7	177	98.8
Unsatisfactory Compliance	0	-	2	4.3	2	1.2
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	291	100.0	63	96.9	354	99.4
Unsatisfactory Compliance	0	-	2	3.1	2	0.6
	291	100.0	65	100.0	356	100.0

TABLE V-3

INITIAL EVALUATION

ACCOUNTING FOR DEPRECIABLE ASSETS AND DEPRECIATION

BALANCES OF MAJOR CLASSES OF DEPRECIABLE ASSETS

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation for disclosure of balances of major classes of depreciable assets related to accounting for depreciable assets and depreciation. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	156	98.1	16	88.9	172	97.2
Unsatisfactory Compliance	3	1.9	2	11.1	5	2.8
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	129	97.7	42	89.4	171	95.5
Unsatisfactory Compliance	3	2.3	5	10.6	8	4.5
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	285	97.9	58	89.2	343	96.4
Unsatisfactory Compliance	6	2.1	7	10.8	13	3.6
	291	100.0	65	100.0	356	100.0

TABLE V-4

INITIAL EVALUATION

ACCOUNTING FOR DEPRECIABLE ASSETS AND DEPRECIATION

DESCRIPTION OF METHOD(S)

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation for disclosure of the method or methods used in accounting for depreciable assets and depreciation. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	156	98.1	14	77.8	170	96.0
Unsatisfactory Compliance	3	1.9	4	22.2	7	4.0
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	128	97.0	40	85.1	168	93.9
Unsatisfactory Compliance	4	3.0	7	14.9	11	6.1
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	284	97.6	54	83.1	338	94.9
Unsatisfactory Compliance	7	2.4	11	16.9	18	5.1
	291	100.0	65	100.0	356	100.0

statements examined disclosed this information either in the balance sheet or in the accompanying notes to the financial statements.

There did not appear to be any material difference in the rate of apparent compliance between any of the remaining three related recommendations. The apparent rate of acceptance ranges from a high of 99.4 per cent for disclosure of depreciation expense for the period to 94.9 per cent for noting the description of method or methods used in the calculation of depreciation. However, for each of the three recommendations, the group with the lowest rate of acceptance in each case was smaller corporations audited by "other" accounting firms, in one case, and by "Big-Eight" firms in two cases. Conversely, the group with the highest rate of acceptance in each case was the larger corporations audited by "Big-Eight" accounting firms.

Summary of Replies from Correspondents

Letters were written to the auditors of twenty-seven of the twenty-nine annual reports receiving an initial evaluation of Apparent Unsatisfactory Compliance. (Addresses could not be obtained for the other two.) Replies were received from fourteen or 51.8 per cent, of the auditors written. Four of the respondents refused to answer the questionnaire. One gave no reason, the other three refused generally on the basis of the confidential relationship that should exist between an auditor and his client.

Three of the remaining ten respondents justified their lack of disclosures for reasons that were Acceptable Justification. Two of the auditors stated that the respective reports did not contain the information related to depreciation because it was not considered material either in relation to the income statement or the balance sheet. The other auditor justified the absence of balances of the various classes of depreciable assets on the basis that "much of the equipment is an integrated part of the structures (sawmills) and as such, no separatation into the separate elements is practicable or reasonable . . . Opinions of the Accounting Principles Board need not be applied to immaterial items and it is implicit that they need not be followed when it is impracticable or impossible to do so."

The remaining seven replies were classified as Unacceptable Justification for not following the recommendations related to depreciable assets and depreciation. Four of these respondents stated that the required information was disclosed in the Form 10-K filed with the Securities and Exchange Commission. Three of the four admitted that this information should have been in the published annual report and that it would be disclosed in future financial statements.

Two of the replies contained no reason for the lack of disclosure. One of these, however, did say that, "We . . . are following this procedure on all present and future financial statements."

The remaining respondent made the following statement concerning the failure of the statements to disclose both the depreciation expense for the period and the method used to compute depreciation.

> At the outset let us assure you that we accept and support, in general, the pronouncements and work being done by the AICPA board. We try to reflect all pertinent recommendations to the extent that they relate to the presentation of our reports. However, circumstances arise in specific cases where we feel that an innovative disclosure would be of no value unless accompanied by further extensive explanation.
>
> In the case of . . . our annual audit report to the Board of Directors has included all the information and disclosures to which you have referred, but the published report of the company omits these items in accordance with the practice of prior years. By December, 1967, the date of Opinion No. 12, depreciation had accumulated to more than 60% of the original cost and had been computed by various methods including that allowed by virtue of a Certificate of Necessity, the latter having been disclosed in footnotes. It would have been a simple matter to make the suggested disclosures, such as those which purport to comply with paragraph 5d. of opinion No. 12, but the information would have been of a highly limited usefulness.
>
> We must add, however, that we would require the inclusion of such a footnote in circumstances where the company's fixed asset activity were less static than that of the subject corporation whose fixed assets have increased less than 1% from 1967 to 1970.
>
> The failure to disclose depreciation expense for the period has been corrected in the financial statements for April 30, 1971 in which there appears a statement of source and application of funds which includes the amount for depreciation and amortization.

The final evaluation results are displayed in Table V-5. The AICPA disclosure requirements related to depreciable assets and depreciation appear to be generally accepted. Almost

TABLE V-5

FINAL EVALUATION

ACCOUNTING FOR DEPRECIABLE ASSETS AND DEPRECIATION

Results of final evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to accounting for depreciable assets and depreciation. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	154	96.9	14	77.8	168	94.9
Unsatisfactory Compliance	5	3.1	4	22.2	9	5.1
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	125	94.7	38	80.9	163	91.1
Unsatisfactory Compliance	7	5.3	9	19.1	16	8.9
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	279	95.9	52	80.0	331	93.0
Unsatisfactory Compliance	12	4.1	13	20.0	25	7.0
	291	100.0	65	100.0	356	100.0

93 per cent of the annual reports examined were in compliance with the requirements. However, it should be noted that while 95.9 per cent of the statements audited by "Big-Eight" firms were in compliance with these recommendations, only 80.0 per cent of the statements audited by "other" accounting firms met the disclosure requirements.

CHAPTER VI

DISCLOSURE OF EARNINGS PER SHARE AND RELATED INFORMATION

Introduction

In recent years a technique of analysis has been developed which combines certain elements of the two basic financial statements, balance sheet and income statement, into a single statistic--the earnings per share. As a result of increasing widespread interest by investors in corporation common stocks, this statistic has become one of considerable importance not only to the investor, but also to the management of business corporations and to the independent accountants whose opinions accompany the corporations' published financial reports.

A review of professional literature relative to the value of the earnings per share statistic indicates a considerable difference of opinion among knowledgeable persons.

The quotations below are typical of various points of view encountered in professional journals during the decade of the 1950's when the controversy was at its peak.

The following comments were sent to the _Journal of Accountancy_ by Bertrand J. Belda:

> "U. S. Steel earns $2.49 Per Common Share in First Quarter!" This headline received top billing when it . . . appeared in financial publications, and rightly so, because this was important information. In this short sentence, the operating results of the world's largest steel producer were clearly and effectively transmitted to investors, the business world, and to the public generally.
>
> This practice of reporting operating results in terms of net earnings per share of equity stock has become quite popular. It is doubtful whether any other commonly used financial statistic is more significant, more useful, or easier to understand.[1]

In answer the editor stated:

> We do not join in Mr. Belda's enthusiasm for the earnings per share figure as a measure of a company's performance, since it is usually necessary to know the elements going into the make-up of the net income figure if the per share figure is to be meaningful. However, we agree that it is one of a number of useful financial statistics, and that a great deal of importance is attached to it by financial reporters, securities dealers, and investors. Accordingly, we subscribe to the view that more attention should be paid to the development of uniformity in the approach taken in calculating it.[2]

The Vice-President and Secretary of Southwestern Public Service Company once emphasized:

> Many stockholders have neither the time nor training to analyze financial statements thoroughly. And quite rightly, they think in

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[1]"The Calculation of Earnings Per Share," The Journal of Accountancy, September, 1955, p. 62.

[2]Ibid.

> terms of earnings per share. That is the basis on which they may have made the investment, and one of the bases which will exert an important influence on market prices.[3]

Opposing this optimistic point of view was a partner in the public accounting firm of Haskins and Sells, who contended:

> . . . Income for a relatively short period of time, such as a year, cannot be determined with exactness except in rare instances. Under these circumstances, a single figure purporting to express the results of operations is of little significance.
>
> Is it not undesirable, therefore, to encourage stockholders to rely upon earnings per share figures . . . ?
>
> The point is that earnings per share figures are not a fair summary of operating results. And it seems undesirable to emphasize earnings per share in view of the known tendency of many readers to consider such figures--and such figures standing alone--as indicative of how well or how poorly a company has fared.[4]

Fifteen years later, Herman W. Bevis, at the time a member of the Accounting Principles Board and a partner in the accounting firm of Price Waterhouse & Co., stated:

> The earnings-per-share statistic for the current year or quarter is probably the most widely used of all financial statistics.

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[3]W. F. Stanley, "Financial Statements Should Report Earnings and Dividends Per Share," The Journal of Accountancy, April, 1951, p. 66.

[4]J. E. Robertson, "Why Accountants De-emphasize Earnings Per Share," The Journal of Accountancy, April, 1951, p. 69.

> Millions of people appear to regard it as wrapping up--in one simple figure, mind you--the whole story of the corporation's financial progress during the period it covers. It is said that some make investment decisions after looking only at this single earnings per share statistic, or at the price-earnings ratio based upon it.
>
> This is frightening to those who take great pains to disclose important information about elements included and excluded in measuring the net income for the year (on which the earnings-per-share statistic is based). The alarm derives not from the development and use of per-share earnings figures, for if one must have a single statistic about a corporation's financial progress to put in a table, I can think of none better that could be divised. The concern rather, is the serious oversimplification of exalting it to the exclusion of the information as to how it was derived. It is this amplifying information which puts it in perspective and which we must contantly remember is an integral part of the story told by earnings per share.[5]

Earnings per share is the quotient of a fraction the denominator of which is common shares outstanding and the numerator of which is net income applicable to common shares. The possibility of oversimplification becomes apparent when the denominator and numerator are examined in more detail. The denominator for example, may include adjustments for such items as: subscribed shares; stock dividends or splits; treasury stock; or stock options. An adjustment for such items for comparative statement purposes could be quite complex.

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[5] Herman W. Bevis, "Earnings Per Share and the Need of Full Disclosure," The Journal of Accountancy, February, 1966, p. 52.

The composition of the numerator is no less complex. All of the limitations related to the whole field of income determination apply to earnings per share.

In 1948, the AICPA's Committee on Accounting Procedure recognized the difficulties related to the use of the earnings-per-share statistic and stated there was a tendency of even well-informed persons to place undue importance to these figures. The Committee urged that any such statistic should be related to the amount designated on the income statement as net income and that any material extraordinary items excluded from net income be presented in total or per share separately and simultaneously.[6]

Ten years later, the Committee on Accounting Procedure issued _Accounting Research Bulletin No. 49: Earnings Per Share_. The committee reaffirmed its conclusions made earlier, above, and made suggestions for guides related to the determination of the number of common stock shares to be used in the calculation of earnings per share. The bulletin discussed in some detail these guidelines in relation to: (1) single-year computations, and (2) comparative statistics. In addition the committee stated that where there were significant changes in outstanding stock during the related period or periods, an explanation of the method used in the earnings per share computation should accompany the presentation.

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[6]Committee on Accounting Procedure, Committee on Terminology, _Final Edition_, p. 65.

In closing, the committee made the following statement:

> It is impracticable to deal, in this bulletin, with all of the possible conditions and circumstances under which it may be necessary or desirable to compute data in terms of earnings per share--for example, acquisitions, mergers, reorganizations, convertible and participating securities, outstanding stock options, retirements, and various combinations of these circumstances. While such situations should be dealt with in harmony with the recommendations made in this bulletin, they call for especially careful consideration of facts and the exercise of judgment in the light of all the circumstances of the case and the purposes for which the data are prepared. In such complex situations as those mentioned in this paragraph, a clear disclosure of the basis on which the computations have been made is essential.[7]

The earlier statements, by the Committee on Accounting Procedure, while providing guides to the calculation of earnings per share and the related disclosure, generally discouraged using the statistic in such a manner that it was prominently displayed. There was no suggestion that the earnings-per-share statistics be a part of the financial statements. As a result this information was normally presented in corporate annual reports in unaudited summaries with such headings as, "Highlights," "Results in Brief," "Year in Review," and "Operations at a Glance." As a result earnings per share was not covered by the auditors' reports.

During the early 1960's there was an increased interest on the part of the American public for investments in

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[7]*Ibid.*, pp. 34-35.

corporate securities and a corresponding increase in the emphasis on, and interest in the financial reports of business entities. As a result the Accounting Principles Board issued Opinion No. 9: Reporting the Results of Operations in December 1966, in an effort to set " . . . the criteria for the determination of the amount to be reported as net income, insofar as it is affected by extraordinary items and prior period adjustments . . . "[8]

Part I of the Opinion sets forth the criteria for distinguishing between "extraordinary item" and "prior period adjustment" and recommends the appropriate treatment of these special items in financial statements. In Part II the APB offers its general recommendations for computing and reporting earnings per share. This part of the Opinion stated:

(1). The earnings per share statistics should be disclosed in the statement of income.

(2). The per share earnings should be reported for income before extraordinary items; for extraordinary items, net of tax; and for total net income.

(3). For the purposes of calculating earnings per share, the Board divided all equity securities into two categories; "residual securities" and "senior securities".

The weighted average of the residual securities outstanding was to be used in the calculation of earnings per share. The Board stated:

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[8]Accounting Principles Board, Opinion No. 9: Reporting the Results of Operations, (New York: American Institute of Certified Public Accountants, 1967), p. 112.

> When more than one class of common stock is outstanding, or when an outstanding security has participating dividend rights with the common stock, or when an outstanding security clearly derives a major portion of its value from the conversion rights or its common stock characteristics such securities should be considered "residual securities: and not "senior securities" for purposes of computing earnings per share.[9]

This Opinion did make progress toward developing uniformity. The Board had recommended a format for reporting earnings per share on the income statement and explained in detail how each earnings-per-share figure should be computed. However, the Opinion was criticized as being unclear as to what should be included under residual securities as opposed to senior securities. In addition, many critics felt that the phraseology used by the Opinion made it most difficult to interpret.

In May, 1969, APB Opinion No. 15: Earnings Per Share was issued. The introduction said, in part:

> In view of the widespread use of earnings per share data, it is important that such data be computed on a consistent basis and presented in the most meaningful manner. The Board and its predecessor committee have previously expressed their views on general standards designed to achieve these objectives, most recently in Part II of APB Opinion No. 9, Reporting the Results of Operations.
>
> In this Opinion the Board expresses its views on some of the more specific aspects of the subject, including the guidelines that should be applied uniformly in computation

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[9] Ibid., p. 120.

> and presentation of earnings per share data in financial statements.[10]

The Opinion is very specific in its requirements for the presentation and calculation of earnings per share data. It is sixty-two pages in length and contains many complex discussions and detailed descriptions. The Opinion was followed a year later by a publication of the Institute, Computing Earnings Per Share: Unofficial Accounting Interpretations of APB Opinion No. 15 by J. T. Ball, which contains, in addition to a reproduction of the Opinion, an additional 116 pages of supplemental information designed to clarify and interpret the provisions and recommendations of the Opinion.

In general, Opinion No. 15 replaced the concept of "residual securities" used in Opinion No. 9 with the new concept of "common stock equivalents".

> Under the Opinion, dilutive common stock equivalents are included with outstanding common stock in computing "primary" earnings per share. Common stock, dilutive common stock equivalents and other potentially dilutive securities are included in computing "fully diluted" earnings per share.
>
> The Opinion requires that earnings per share be presented on the face of corporate income statements or summaries of such statements with both the primary and fully diluted amounts presented when potential dilution of

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[10]Accounting Principles Board, Opinion No. 15: Earnings Per Share, (New York: American Institute of Certified Public Accountants, 1969), p. 112.

of earnings per share exists.[11]

Evaluation Criteria

The examination of the financial statements in relation to APB Opinion No. 15 was limited to the disclosure requirements quoted below:

> . . . earnings per share or net loss per share data should be shown on the face of the income statement.[12]
>
> Earnings per share data should be presented for all periods covered by the statement of income or summary of earnings.[13]
>
> . . . financial statements should include a description, in summary form, sufficient to explain the pertinent rights and privileges of the various securities outstanding.[14]
>
> A schedule or note relating to the earnings per share data should explain the basis upon which both primary and fully diluted earnings per share are calculated.[15]

To receive an initial evaluation of Apparent Satisfactory Compliance, the published financial report must have followed all four of the recommendations quoted above. If all

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[11] J. T. Ball, Computing Earnings Per Share: Unofficial Accounting Interpretations of Accounting Principles Board Opinion No. 15, (New York: American Institute of Certified Public Accountants, 1970), p. 1.

[12] Accounting Principles Board, Opinion No. 15, p. 220.

[13] Ibid., p. 222.

[14] Ibid., p. 223.

[15] Ibid.

the criteria appeared not to have been met, the report was given an initial evaluation of Apparent Unsatisfactory Compliance.

Tentative Evaluation Results

The initial evaluation of the 356 annual reports indicated that 329, or 92.4 per cent (Table VI-1), met the four criteria for Apparent Satisfactory Compliance. Each of the twenty-seven reports given an evaluation of Apparent Unsatisfactory Compliance was audited by one of the Big-Eight accounting firms. Nineteen of the twenty-seven were reports of relatively large corporations.

An examination of the reports in relation to each of the individual disclosure requirements indicates, that with one exception, all reports presented earnings per share or net loss per share data on the face of the income statement and they presented the earnings per share data for all periods covered by the statement of income. In addition, only six, or 1.7 per cent (Table IV-2), failed to explain the pertinent rights and privileges of various securities outstanding.

The highest rate of apparent non-compliance was related to the requirement that a schedule or note should be presented to explain the bases upon which both primary and fully diluted earnings per share were calculated. A total of twenty-four, or 6.7 per cent (Table VI-3), of the reports examined failed to present such an explanation. All these reports, as noted

TABLE VI-1

INITIAL EVALUATION

EARNINGS PER SHARE - PRESENTATION

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to earnings per share data. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	140	88.1	18	100.0	158	89.3
Unsatisfactory Compliance	19	11.9	0	-	19	10.7
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	124	93.9	47	100.0	171	95.5
Unsatisfactory Compliance	8	6.1	0	-	8	4.5
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	264	90.7	65	100.0	329	92.4
Unsatisfactory Compliance	27	9.3	0	-	27	7.6
	291	100.0	65	100.0	356	100.0

TABLE VI-2

INITIAL EVALUATION

EARNINGS PER SHARE

DISCLOSURE OF RIGHTS AND PRIVILEGES OF SECURITIES OUTSTANDING

Results of initial evaluation of 356 corporate financial statements for apparent sarisfactroy compliance or non-compliance with the AICPA recommendations related to the disclosure of rights and privileges of various securities outstanding. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	154	96.9	18	100.0	172	97.2
Unsatisfactory Compliance	5	3.1	0	-	5	2.8
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	131	99.2	47	100.0	178	99.4
Unsatisfactory Compliance	1	0.8	0	-	1	0.6
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	285	97.9	65	100.0	350	98.3
Unsatisfactory Compliance	6	2.1	0	-	6	1.7
	291	100.0	65	100.0	356	100.0

TABLE VI-3

INITIAL EVALUATION

EARNINGS PER SHARE

EXPLANANTION OF BASIS OF CALCULATION

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation related to the explanation of the basis upon which both primary and fully diluted earnings per were calculated. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	143	89.9	18	100.0	161	90.9
Unsatisfactory Compliance	16	10.1	0	-	16	9.1
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	124	93.9	47	100.0	171	95.5
Unsatisfactory Compliance	8	6.1	0	-	8	4.5
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	267	91.8	65	100.0	332	93.3
Unsatisfactory Compliance	24	8.2	0	-	24	6.7
	291	100.0	65	100.0	356	100.0

above, were audited by Big-Eight firms and sixteen of the twenty-four were published by the larger corporations represented in the sample.

Summary of Replies from Correspondents

Inquiries were sent to the auditors of twenty-five of the twenty-seven annual reports receiving an initial evaluation of Apparent Unsatisfactory Compliance. (Addresses could not be determined for the other two offices.) The auditors representing twelve, or 40 per cent, of the corporations written responded to the questionaire, and another two answered but declined to answer the questions.

The responses from eleven of the auditors related to financial statements given the unsatisfactory compliance rating for the apparent failure to meet one single same criterion--not presenting a note or schedule explaining the bases upon which both primary and fully diluted earnings per share are calculated.

Each of these respondents presented essentially the same reason for not presenting such a note or schedule. In each case the company had what qualified as a "simple capital structure" as defined in APB Opinion No. 15 and as a result only the single presentation expressed in terms such as "Earnings per common share" on the face of the income statement was the appropriate presentation of earnings per share data.

As these justifications did meet the criteria of the Opinion the related financial statements were given a final evaluation of Apparent Satisfactory Compliance.

The remaining respondent represented a corporation that presented no earnings per share information in the financial statements, or anywhere else in the report for that matter. The auditor stated that he did accept the AICPA's statement on disclosure of earnings per share as generally accepted principles. His justification for the contrary treatment was: "This is at variance with accepted treatment. Client believes simple capital structure permits anyone to calculate E.P.S." This response was classified as an unacceptable justification for failing to meet the recommendation.

Final Evaluation Results

The final evaluation of the financial reports examined shows sixteen, or 4.5 per cent, receiving an evaluation of Apparent Unsatisfactory Compliance. There was no significant difference between the "larger" and "smaller" corporations (Table VI-4), with an indicated rate of acceptance of 94.3 per cent for the "larger" corporations, and 96.7 per cent for the"smaller" corporations.

It seems worthy to note that the effective data for APB Opinion No. 15 was for fiscal periods beginning after December 31, 1968, and as a result the financial statements used in this sample were the first ones published subject to the Opinion requirements for most of the corporations. With a compliance rate of 95.5 per cent it appears the Opinion immediately became a "generally accepted accounting principle."

TABLE VI-4

FINAL EVALUATION

EARNINGS PER SHARE - PRESENTATION

Results of the final evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to earnings per share data. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	149	93.7	18	100.0	167	94.3
Unsatisfactory Compliance	10	6.3	0	-	10	5.7
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	126	95.5	47	100.0	173	96.7
Unsatisfactroy Compliance	6	4.5	0	-	6	3.3
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	275	94.5	65	100.0	340	95.5
Unsatisfactory Compliance	16	5.5	0	-	16	4.5
	291	100.0	65	100.0	356	100.0

CHAPTER VII

PRESENTATION OF FLOW OF FUNDS STATEMENT

Introduction

The practice of including a statement that accounted for changes in cash, changes in working capital, or changes in all balance sheet accounts in stockholders' reports is a relatively recent development. The historical term for such a statement has been a "funds" statement, or "cash-flow" statement. While such "funds" statements appeared occasionally in published annual reports in the late 1800's, external reporting of a statement of changes of financial position was uncommon prior to the mid 1930's and did not gain appreciable prominence until the mid 1940's.[1]

The first published statement made by the AICPA in relation to the "funds" statement was Accounting Research Study No. 2 "*Cash Flow*" *Analysis and the Funds Statement*, by Perry Mason published in 1961. The primary research for this study was an examination of the 1959 annual reports of the

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[1]Hector R. Anton, *Accounting for Flow of Funds*, (Boston: Houghton Mifflin Company, 1962), p. 82.

600 corporations included in Accounting Trends and Techniques.[2] Mason reported that 190 of the 600 companies, or 32 per cent, presented some form of a funds statement in their annual reports.[3] In these 190 statements, Mason found a great variety in the form, content, arrangement, and title of the funds statements.

As indicated by its title, Mason's study consisted of two broad parts. Included in the conclusions and recommendations of Part I, "Cash Flow Analysis," were the following:

> . . . 1. "Cash flow" in financial analysis means net income after adding back expense items which currently do not use funds, such as depreciation. (It may also involve deducting revenue items which do not currently provide funds, such as the current amortization of deferred income.) This concept of "cash flow" as the amount of assets or funds made available after meeting the current requirements of revenue-earnings operations is a valid and useful analytical tool . . .
>
> . . . 2. Depreciation and other similar "non-fund" charges to operations are not "sources" of funds . . .
>
> . . . 4. In no sense can the amount of cash flow or cash income be considered as a substitute for or an improvement upon the net income, properly determined, as an indication of the results of operations or the change in financial position.
>
> . . . 5. The presentation of cash-flow data in annual reports of corporations can be greatly

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[2] Prepared and Published annually by the American Institute of Certified Public Accountants.

[3] Perry Mason, "Cash Flow" Analysis and the Funds Statement, Accounting Research Study No. 2, (New York: American Institute of Certified Public Accountants, 1961), p. xvii.

improved. The inclusion of a well-designed comparative funds statement in the annual report should become a generally accepted practice. It should be accompanied by interpretive comments and charts which would provide the reader with useful information as to the conduct of financial affairs by the management during the period covered by this type of operating statement. Isolated comments or statistics concerning cash flow should be avoided since they are generally meaningless and often misleading.[4]

Included in conclusions and recommendations of Part II, "The Funds Statement," were the following:

1. The funds statement should be treated as a major financial statement. It should be presented in all annual reports of corporations and be covered by the auditor's short-form report.

2. The statement should be broad enough in scope and in its concept of "funds" to make it a report of all financial mangement operations. It should not be merely a reconciliation of cash or working capital. The definition of "funds" as "all financial resources," or as spending or purchasing power, comes closest to this conception of the function of the funds statement.

3. . . . comments and statistics of "cash flow" should not be presented apart from or without reference to the funds statement.

4. There should be no standard arrangement of the items within the funds statement. Instead, it should be designed to disclose and emphasize the more important financial events of the period covered by the statement. . . . The change in working capital should not be shown as a single item unless the changes in individual current assets and liabilities are immaterial.

5. The more popular form of the statement which begins with net income is recommended for general use, but great care should be taken to avoid giving the impression that depreciation and

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[4]*Ibid.*, pp. 42-43.

> other such adjustments are "sources" of funds. The best way to accomplish this is to begin the statement with the adjusted net income, the "funds provided from operations," and show the details of the calculation in a footnote.
>
> - - -
>
> 10. Comparative and cumulative funds statements should be encouraged. . . . a two-year comparative statement should be presented as one of the group of major financial statements.[5]

In summary, Mason found a great diversity in reporting related to the funds statement. Only one-third of the annual reports he examined contained a statement related to changes in financial position. In recommending that the funds statement be treated as a "major financial statement," Mason apparently felt that the usefulness of information in such a statement was equivalent to that of the income statement and balance sheet.

Two years later, in October 1963, the Accounting Principles Board (APB) issued Opinion No. 3: The Statement of Source and Application of Funds.

The Board recommended that a statement of source and application of funds "should" be presented in financial reports as "supplementary information". The inclusion of such a statement, however, was not made mandatory, and the independent accountant was given the option as to whether it should be covered in his report.

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[5] *Ibid.*, pp. 90-91.

The Board concluded that:

> 11. . . . Of the various forms of the statement, the preferred one follows the common practice of beginning with funds derived from operations (net income plus or minus "non-fund" adjustments), the calculation being shown either at the beginning of the statement or in a footnote.
>
> . . . .
>
> 13. The presentation of comparative and consolidated statements of source and application of funds should conform to the policies adopted for the basic financial statements. A statement of source and application of funds which is cumulative for a period of years . . . is often helpful in furnishing a broad review of the financial activities over a period of time.
>
> 14. . . . No generalization or conclusion can be drawn as to the significance of the "cash flow" without reference to the entire flow of funds as reflected in the complete statement of source and application of funds. . . .
>
> 15. . . . Misleading implications can result from isolated statistics in annual reports of "cash flow" which are not placed in proper perspective to net income figures and to a complete analysis of source and application of funds. "Cash flow" and related terms should not be used in annual reports in such a way that the significance of net income is impaired, and "cash earnings" or other terms with a similar connotation should be avoided. . . .[6]

Opinion No. 3 was the first formal recognition by the AICPA that the information presented in the funds statement was sufficiently useful to warrant its inclusion in annual reports. However, the inclusion of the statement was not

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[6]Accounting Principles Board, Opinion No. 3: The Statement of Source and Application of Funds, (New York: American Institute of Certified Public Accountants, 1963), pp. 17-18.

mandatory. Opinion No. 3 was the position of the Institute at the time of publication of the financial statements examined for this study and is the source of the criteria established for apparent compliance or non-compliance with recommendation of the American Institute of Certified Public Accountants.

The Accounting Principles Board has since that time issued _Opinion No. 19: Reporting Changes in Financial Position_ which requires that a "Statement of Changes in Financial Position" be presented as a basic financial statement whenever the balance sheet and income statement are issued.[7] Unlike the balance sheet and income statement, however, the precise form and content of the Statement are left to the discretion of management and may change from year to year. The APB specifically recognized the need for flexibility in form, content, and terminology. Except for broad guidelines, "the Statement may take whatever form gives the most useful portrayal of the financing and investing activities and the changes in financial position of the reporting entity."[8] From this opinion it appears that the external reporting of changes in financial position, while required, will not be uniform.

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[7]Accounting Principles Board, _Opinion No. 19: Reporting Changes in Financial Position_, (New York: American Institute of Certified Public Accountants, 1971), p. 373.

[8]_Ibid._, p. 375.

Evaluation Criterion

The criterion for evaluation of financial statements in relation to, what at the time was called, a Statement of Source and Application of Funds is given below. To receive an initial evaluation of Apparent Satisfactory Compliance:

1. A statement of source and application of funds must have been presented in the financial reports.

If such a statement was not presented then the report was given an initial evaluation of Apparent Unsatisfactory Compliance.

Tentative Evaluation Results

An examination of the annual reports in the sample disclosed that 338 of the 356 reports did present some form of a funds flow statement. This was a compliance rate of 94.9 per cent. An analysis of initial compliance by subclassification is presented in Table VII-1. The rate of apparent compliance for each of the four sub classes ranged from a high of 97.5 per cent for larger companies audited by one of the "Big-Eight" firms to a low of 89.4 per cent for smaller companies audited by "other" accounting firms.

A summary of titles used in disclosing funds flow information is presented in Table VII-2. It is interesting that the now recommended title, Statement of Changes in Financial Position, was used by only 7 of the 338 companies presenting statements showing funds flow information.

TABLE VII-1

INITIAL EVALUATION

PRESENTATION OF FLOW OF FUNDS STATEMENT

Results of initial evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation (1970) for the presentation of a statement of source and application of funds. (Sub-classification based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	155	97.5	17	94.4	172	97.2
Unsatisfactory Compliance	4	2.5	1	5.6	5	2.8
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	124	93.9	42	89.4	166	92.7
Unsatisfactory Compliance	8	6.1	5	10.6	13	7.3
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	279	95.9	59	90.8	338	94.9
Unsatisfactory Compliance	12	4.1	6	9.2	18	5.1
	291	100.0	65	100.0	356	100.0

TABLE VII-2

SUMMARY OF TITLES USED IN THE PRESENTATION OF FLOW OF FUNDS STATEMENT

The examination of 356 corporate annual reports disclosed that 338 included a statement showing the source and application of funds. The titles used in these statements are presented below.

Title	Number	Per Cent
Statement of Source and Application of Funds	196	58.0
Statement of Sources and Uses of Funds	41	12.1
Statement of Changes in Working Capital	29	8.6
Statement of Changes in Financial Position	7	2.1
Other Titles Denoting Working Capital	25	7.4
All Other Titles	40	11.8
Total	338	100.0

Summary of Replies from Correspondents

Letters were written to the auditors of the eighteen annual reports receiving an initial evaluation of Apparent Unsatisfactory Compliance. Replies were received from nine, or 50.0 per cent, of the auditors written. Three of the respondents refused to answer the questions posed. One gave no reason for his refusal, the other two refused on the basis of the confidential relationship that should exist between an auditor and his client.

All six of the remaining respondents justified the lack of "funds statement" on the basis that the inclusion of such a statement was not mandatory under Opinion No. 3. Only one auditor gave further justification for the omission of such a statement. In this case the client corporation's balance sheet had not been classified into current and non-current items, and there were " . . . questions as to the efficacy of such a report for companies not presenting a classified balance sheet." This reply was the only one classified as an acceptable justification for not meeting the recommendation related to the presentation of a statement of source and application of funds.

Final Evaluation Results

The results of the final evaluation are shown in Table VII-3. Over 95 per cent of the reports examined appeared in the final evaluation, to be in compliance with the

TABLE VII-3

FINAL EVALUATION

PRESENTATION OF FLOW OF FUNDS STATEMENT

Results of final evaluation of 356 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendation (1970) for the presentation of a statement of source and application of funds. (Sub-classification based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	156	98.1	17	94.4	173	97.7
Unsatisfactory Compliance	3	1.9	1	5.6	4	2.3
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Satisfactory Compliance	124	93.9	42	89.4	166	92.7
Unsatisfactory Compliance	8	6.1	5	10.6	13	7.3
	132	100.0	47	100.0	179	100.0
Totals						
Satisfactory Compliance	280	96.2	59	90.8	339	95.2
Unsatisfactory Compliance	11	3.8	6	9.2	17	4.8
	291	100.0	65	100.0	356	100.0

spirit of the recommendation to present a statement of source and application of funds.

A comparison of the results of this examination with those of two earlier studies indicated that there has been a steady increase in the number of firms presenting "funds statements" in their annual reports since the publication of Opinion No. 3 in October 1963. In an examination of a random sample of 115 domestic corporations listed on the New York Stock Exchange in 1965, Felt found that 92, or 80 per cent, included a funds statement in their annual reports in 1965.[9]

Professors Fess and Weygandt also researched the extent of compliance with Opinion No. 3. The authors randomly selected the reports of 100 firms from the 2,000 annual reports in the University of Illinois Library. Of the 100 firms, 89 presented a funds statement in their reports for 1966.[10]

While the studies involved samples from slightly different populations, there does seem to have been a steady increase in the percentage of corporations that included a "funds statement" of some form in their annual reports.

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[9] Howard Felt, "Standards for Disclosure of 'Cash Flow' Data in Corporate Annual Reports," (unpublished Ph.D. dissertation, University of Southern California, 1969), p. 74.

[10] Phillip E. Fess and Jerry Weygandt, "The Funds Statement: Trends and Recommendations," The New York CPA. February, 1969, p. 122.

CHAPTER VIII

DISCLOSURE OF INFORMATION RELATED TO PENSION PLANS

Introduction

Substantial growth of private pension plans, both in number of employees covered and in amounts of retirement benefits, since World War II made pension costs a significant factor in determining the financial position and results of operations of American business.

The principal accounting problem was related to the timing of charging the pension expenses against revenue--should the charges to income have been related to the active service of the employees covered, or should the amount paid, either directly or indirectly, have been pension expense for the period. The first approach attempted to conform to the accrual basis of accounting, while the second resulted in accounting for pensions on a cash basis.

If the accrual basis was accepted as the desirable method of accounting for pension expenses, another problem was immediately presented at the time a pension plan was first established. If past services of employees were to be recognized in their participation in the plan, the method of accounting for this prior service cost presented very real problems. When U.S. Steel Corp. launched a pension plan in 1950, the company's unamortized past-service liability was estimated at $574 million--approximately one-half the market value of all its common and preferred stock at the time. The alternatives available to a company at the time of adoption of a pension plan were to ignore past service cost, charge it directly to retained earnings, treat it in its entirety as an extraordinary item for the year of inception, or amortize it against revenues of the present and future periods.

The AICPA's first statement related to accounting for pension plans was Bulletin No. 36: Pension Plans--Accounting for Annuity Costs Based on Past Services issued in November, 1948. After describing the varying practices in existence, the Committee on Accounting Procedure stated its position as follows:

> The committee believes that, even though the calculation is based on past service, costs of annuities based on such service are incurred in contemplation of present and future services, not necessarily ot the individual affected but of the organization as a whole, and therefore should be charged to the present and future periods benefited. . . . The element of past service is one of the important considerations in establishing pension plans, and annuity costs measured by such past service contribute to the benefits gained by the adoption of a plan. It is usually expected that such benefits will include better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel, all of which should result in improved operations.

4. The committee, accordingly, is of the opinion that:

(a) Costs of annuities based on past service should be allocated to current and future periods; however, if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year;

(b) Costs of annuities based on past service should not be charged to surplus.[1]

In September 1956, Bulletin No. 47, Accounting for Costs of Pension Plans was issued by the Committee of Accounting Procedure to provide guides which were acceptable for dealing with costs of pension plans in the accounts and financial statements of companies having such plans.

The Committee felt the method quoted below was the method most likely to effectively match costs and revenues and therefore considered it the preferable method:

> . . . costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations. Such calculations may be made as to each employee, or as to categories of employees (by age, length of service, or rate of pay, for example), or they may be based upon an average of the expected service lives of all covered employees. . . .[2]

However, the committee recognized that at the time of

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[1]Committee on Accounting Procedure, Committee on Terminology, Final Edition, pp. 117-118.

[2]Committee on Accounting Procedure, Accounting Research Bulletin No. 47: Accounting for Costs of Pension Plans, (New York: American Institute of Certified Public Accountants, 1956), p. 15.

issuance of Bulletin No. 47 there was not enough agreement in the accounting profession to support a full accrual program, and for this reason provided for a transition period. During this period as a minimum:

> . . . the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees. . . .[3]

With respect to disclosure requirements the committee made the following statement:

> The committee believes that the costs of many pension plans are so material that the fact of adoption of a plan or an important amendment to it constitutes significant information in financial statements. When a plan involving material costs is adopted, there should be a footnote to the financial statements for the year in which this occurs, stating the important features of the plan, the proposed method of funding or paying, the estimated annual charge to operations, and the basis on which such annual charge is determined. When an existing plan is amended to a material extent, there should be a similar disclosure of the pertinent features of the amendment. When there is a change in the accounting procedure which materially affects the results of operations, there should be appropriate indication thereof. If there are costs of material amount based on past or current services for which reasonable provision has not been, or is not being, made in the accounts, appropriate disclosure should be made in a footnote to the financial statements as long as this situation exists.[4]

Despite the issuance of the Bulletin, there continued to be considerable variation in reporting pension costs. It

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[3] *Ibid.*, p. 17.

[4] *Ibid.*

appeared that many companies viewed the minimum transitory requirement as an acceptable alternative and reported pension costs accordingly.

To clarify the accounting principles and to narrow the practices in accounting for pension costs, the Accounting Principles Board issued *Opinion No. 8*, *Accounting for the Cost of Pension Plans* in November 1966. An editorial in *The Journal of Accountancy* called it "A Milestone in APB Opinions."[5]

The Opinion is more comprehensive than the preceding Bulletins. Specifically it, among other things:

a.) provides that the annual provision for pension cost should be based on an acceptable actuarial cost method that will result in a provision that falls between a minimum and maximum amount; (The method of determination of these two amounts is specified in detail in the Opinion.)[6]

b.) describes the acceptable actuarial cost methods;[7]

c.) provides for the treatment to be given actuarial gains and losses including realized investment gains and losses;[8]

d.) states which employees should be included in the

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[5]"A Milestone in APB Opinions," *The Journal of Accountancy*, January, 1967, p. 25.

[6]Accounting Principles Board, *Opinion No. 8*: *Accounting for the Cost of Pension Plans*, (New York: American Institute of Certified Public Accountants, 1966), p. 73.

[7]*Ibid.*, p. 77.

[8]*Ibid.*, p. 81.

cost calculations;[9]

e.) provides for the treatment of insured plans and both funded and unfunded plans;[10]

f.) provides in addition for the treatment of income taxes, changes in accounting method, and transition to the recommended practices;[11]

g.) states also the disclosures that should be made in the financial statement related to pension plans. The specific disclosure requirements of Opinion No. 8 are stated as follows:

> The Board believes that pension plans are of sufficient importance to an understanding of financial position and results of operations that the following disclosures should be made in financial statements or their notes:
>
> 1. A statement that such plans exist, identifying or describing the employee groups covered.
>
> 2. A statement of the company's accounting and funding policies.
>
> 3. The provision for pension cost for the period.
>
> 4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges.
>
> 5. Nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods (actuarial

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[9] *Ibid.*, pp. 82-83.

[10] *Ibid.*, pp. 84-85.

[11] *Ibid.*

> cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or adoption or amendment of a plan.[12]

Evaluation Criteria

The criteria for the evaluation of financial statements in relation to the disclosure requirements of Opinion No. 8 are presented below. As in the case of the evaluation of financial statements concerning the disclosure of information related to long-term leases, a third classification, Apparent Non-coverage, was added to the normal classifications of either Apparent Satisfactory Compliance or Apparent Unsatisfactory Compliance.

To receive an evaluation rating of Apparent Satisfactory Compliance, the disclosure related to pensions was required to meet all five of the following criteria:

1. _Disclosure must be made of the existence of a pension plan and the employees covered._

2. _Disclosure must be made of the company's accounting and funding policies._

3. _Disclosure must be made of the provision of pension cost for the period._

4. _Disclosure must be made of excess of the value of vested benefits over the total net pension fund and accruals._ If no disclosures were made related to the relationship between

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[12] _Ibid._, p. 84.

vested benefits and fund assets, the financial statement was assigned a rating of Apparent Unsatisfactory Compliance. The rating was assigned on this basis because the vast majority of the statements examined disclosed the relationship of the vested benefits to the fund regardless of which was the larger.

5. Disclosure must be made of any significant matters affecting comparability for all periods presented. In the absence of such disclosure, if there were no indications in the report to the contrary, this requirement was assumed to have been met.

A rating of Apparent Non-Coverage was given to those financial statements which gave no indication of extant pension plans.

Tentative Evaluation Results

The initial evaluation of the financial statement in the sample indicated that 93 of 356, or 26.1 per cent, of the annual reports examined gave no indication of the existence of a pension plan. (See Table VIII-1.)

The other 263 companies each gave indication of a pension plan in force in its financial statement. Of these 263 reports, 215, or 81.7 per cent were assigned a tentative evaluation of Apparent Satisfactory Compliance. An examination of Table VIII-2 indicates that the rate of apparent compliance ranged from an indicated high of 84.4 per cent, for both larger companies audited by "Big-Eight" firms and smaller

TABLE VIII-1

DISCLOSURE OF REQUIRED INFORMATION RELATED TO

PENSION PLANS

INDICATION OF PENSION PLANS

Result of evaluation of 356 corporate financial statements for presentation of information related to disclosure of the existence of pension plans. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Covered in Report	147	92.5	8	44.5	155	87.6
Apparent Noncoverage	12	7.5	10	55.5	22	12.4
	159	100.0	18	100.0	177	100.0
Smaller Corporations						
Covered in Report	76	57.6	32	68.1	108	60.3
Apparent Noncoverage	56	42.4	15	31.9	71	39.7
	132	100.0	47	100.0	179	100.0
Totals						
Covered in Report	223	76.6	40	61.5	263	73.9
Apparent Noncoverage	68	23.4	25	38.5	93	26.1
	291	100.0	65	100.0	356	100.0

TABLE VIII-2

INITIAL EVALUATION

DISCLOSURE OF REQUIRED INFORMATION RELATED TO

PENSION PLANS

Results of initial evaluation of 263 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to accounting for pension plans. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditing		Non Big-Eight Auditing		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	124	84.4	5	62.5	129	83.2
Unsatisfactory Compliance	23	15.6	3	37.5	26	16.8
	147	100.0	8	100.0	155	100.0
Smaller Corporations						
Satisfactory Compliance	59	77.6	27	84.4	86	79.6
Unsatisfactory Compliance	17	22.4	5	15.6	22	20.4
	76	100.0	32	100.0	108	100.0
Totals						
Satisfactory Compliance	183	82.1	32	80.0	215	81.7
Unsatisfactory Compliance	40	17.9	8	20.0	48	18.3
	223	100.0	40	100.0	263	100.0

companies audited by "other" accounting firms, to a low of 62.5 per cent for larger companies audited by "other" accounting firms.

The tentative evaluation of each of the five individual disclosures is presented in Table VIII-3. An examination of the table gives an indication that there appeared to be no significant non-compliance except as related to disclosure of the excess of the value of vested benefits over the total net pension fund and accruals. This disclosure characteristic had an Apparent Unsatisfactory Compliance rate of 17.9 per cent (47 of 263). This may have been, in part, due to the assumption related to Criterion 4 above. The other four disclosure requirements each had an Unsatisfactory Compliance rate of 1.1 per cent or less.

Summary of Replies from Correspondents

Letters were written to forty-seven of the independent accountants who gave opinions on the financial statements assigned a tentative rating of Apparent Unsatisfactory Compliance. Replies were received from twenty of these auditors.

Three of the respondents refused to answer the questions. One refused on the basis that the statements were the client's and "not those of the auditors." Another refused on the basis that "our firm no longer represents ________, Inc." The third refused because " . . . due to the confidential nature of our relationships with clients, it would be inappropriate for us to respond to your letter."

TABLE VIII-3

INITIAL EVALUATION

DISCLOSURE OF REQUIRED INFORMATION RELATED TO

PENSION PLANS - INDIVIDUAL DISCLOSURES

Results of initial evaluation of 263 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA individual recommendations related to accounting for pension plans.

Disclosure Characteristic	Satisfactory Compliance		Unsatisfactory Compliance	
	Number	Per Cent	Number	Per Cent
That plan exists and the employees covered	261	99.2	2	0.8
Company accounting and funding policies	260	98.9	3	1.1
Provision of pension cost for the period	262	99.6	1	0.4
Excess of the value of vested benefits over total net pension fund and accruals	216	82.1	47	17.9
Any significant matters affecting comparability for all periods presented	263	100.0	0	-

Seventeen of the auditors written, or 36.2 per cent, responded to the questions posed concerning disclosures related to pension plans.

The responses from these seventeen auditors were classified as either (1) acceptable justification; or (2) unacceptable justification. Sixteen of the responses were considered as (1) acceptable justification. Fourteen of these auditors stated essentially the same thing--there was no excess of vested benefits over the total net pension fund and accruals or that it was immaterial. One auditor said that the company's plan was a profit sharing plan and therefore not subject to Opinion No. 8. The other auditor giving what was classified as (1) acceptable justification pointed out that this researcher had in fact overlooked the disclosure of pension cost for the period presented in the statements.

The one response that was classified as (2) unacceptable justification stated that the disclosures related to the pension plan were in the President's letter located in the front of the annual report.

The results of the final evaluation of the 263 annual reports which contained some disclosure of a pension plan show an overall indicated compliance rate of 87.8 per cent. (See Table VIII-4.)

However, of the thirty-two reports given a final evaluation of Apparent Unsatisfactory Compliance, twenty-six failed only to disclose an excess of value of vested benefits over

TABLE VIII-4

FINAL EVALUATION

DISCLOSURE OF REQUIRED INFORMATION RELATED TO

PENSION PLANS

Results of final evaluation of 263 corporate financial statements for apparent satisfactory compliance or non-compliance with the AICPA recommendations for disclosures related to accounting for pension plans. (Sub-classifications based on size of independent auditing firm and relative size of corporation)

	Big-Eight Auditors		Non Big-Eight Auditors		Totals	
	No.	Per Cent	No.	Per Cent	No.	Per Cent
Larger Corporations						
Satisfactory Compliance	131	89.1	7	87.5	138	89.0
Unsatisfactory Compliance	16	10.9	1	12.5	17	11.0
	147	100.0	8	100.0	155	100.0
Smaller Corporations						
Satisfactory Compliance	66	86.8	27	84.4	93	86.1
Unsatisfactory Compliance	10	13.2	5	15.6	15	13.9
	76	100.0	32	100.0	108	100.0
Totals						
Satisfactory Compliance	197	88.3	34	85.0	231	87.8
Unsatisfactory Compliance	26	11.7	6	15.0	32	12.2
	223	100.0	40	100.0	263	100.0

net pension funds and accruals; and, in addition, the auditors written did not respond to the questions directed to them. Based on the answers from those auditors who did answer the question related to this particular disclosure requirement, there is a very high probability that most, if not all of these companies reported no excess value of vested benefits because there was none. If this was the case (all twenty-six), only 6 of the 263 reports would have been classified as Unsatisfactory Compliance.

In contrast, there may have been some companies that had extant pension plans that were not disclosed any place in any way in the annual report which would have caused a bias in favor of Satisfactory Compliance.

All factors considered, the final evaluation Satisfactory Compliance rate of 87.8 per cent appears to be a conservative one.

CHAPTER IX

SUMMARY AND CONCLUSIONS

Background

This study was undertaken to provide some insight into the accounting profession's acceptance of the recommendations of the American Institute of Certified Public Accountants (AICPA) related to the preparation of published financial statements.

The AICPA first assigned the responsibility for the determination and development of accounting principles to the Committee on Accounting Procedure in 1938. In 1959 the Committee was replaced by the Accounting Principles Board. (The APB is being replaced by the Financial Accounting Standards Board in 1973.)

As a consequence of this historical development, the auditor is assumed to be referring to the pronouncements of the Committee and the Board when he states that, in his opinion, the financial statements of a given corporation present fairly the financial position and operating results "in conformity with generally accepted accounting principles." However, there is no procedure or system designed to monitor published financial statements in an attempt to determine the extent of compliance with the recommendations of the AICPA. In fact, an examination of accounting literature disclosed no extant study and evaluation of the acceptance and non-acceptance of the pronouncement of the AICPA as indicated by published financial statements since 1957.

The purpose of this study was to determine the degree of acceptance of some of the opinions of the Accounting Principles Board.

Results of the Evaluation of the Six Study Areas

Six areas of financial reporting were selected for examination from the bulletins of the Committee on Accounting Procedure and the opinions of the Accounting Principles Board. A random sample of annual financial reports of American industrial corporations was selected and the reports secured. Criteria for the evaluation of each of the areas were established and applied in the examination and evaluation of the financial statement presentations in the annual reports. In instances of Apparent Unsatisfactory Compliance, the auditor of the company was asked to explain the apparent divergency. The auditor's response was evaluated to obtain a final determination of satisfactory or unsatisfactory compliance with respect to specific recommendations in question. From the information obtained in this manner, it was possible to draw conclusions concerning the degree of apparent acceptance of the recommendation and areas of difficulty related to application and interpretation.

The combined final evaluation results of the study are shown in Table IX-1 by number of companies and in Table IX-2 by percentage of evaluations. As shown in these summaries the overall rate of acceptance of the selected areas of study was 92.5 per cent, and each of the individual areas had a rate of acceptance ranging from a low of 79.2 per cent for reporting for leases by lessees to a high of 97.1 per cent for presentation of comparative statements.

A similar analysis by Professor Seawell in his study, discussed in Chapter I, completed in 1958, produced a lower overall level of satisfactory compliance. His findings with respect to 1,423 presentations show 1,113 (78.2 per cent) indicated satisfactory compliance. The same study indicated a rate of acceptance, for the eight areas he evaluated, ranging from a low of 49.1 per cent to a high of 97.2 per cent.[1]

If the criterion of 90 per cent acceptance is considered as constituting "general acceptance," five of the areas examined were sufficiently followed to qualify them as "generally accepted." Only the disclosure requirements related to accounting for leases by lessees failed to meet this criterion. This particular Opinion (No. 5) has been criticized by many members of the profession from the time it was issued and the Accounting Principles Board issued an exposure draft, _Proposed APB Opinion Disclosure of Lease Commitments by Lessees_,

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[1]Seawell, "Evaluation of Selected Annual Reports," pp. 179-182.

TABLE IX-1

SUMMARY

FINAL EVALUATIONS

BY NUMBER OF COMPANIES

Final evaluation of 356 corporate financial statements for compliance with the AICPA recommendations in six selected areas of financial reporting.

Area	Compliance		Apparent Non Coverage
	Satis- factory	Un- satis factory	
Comparative Statements	346	10	-
Reporting for leases by lessees	164	43	149
Depreciable assets and depreciation	331	25	-
Disclosure of Earnings per Share and related information	340	16	-
Presentation of a flow of funds statement	339	17	-
Disclosure of information related to pension plans	231	32	93
	1,751	143	242
Per cent of 2,136 presentations by 356 companies	82.0%	6.7%	11.3%
Per cent of 1,894 applicable ratings	92.5	7.5	-

TABLE IX-2

SUMMARY

FINAL EVALUATIONS

BY PERCENTAGE OF APPLICABLE EVALUATIONS

Final evaluation of 356 corporate financial statements for compliance with the AICPA recommendations in six selected areas of financial reporting.

Area	Number of Applicable Evaluations	Per Cent	
		Satisfactory Compliance	Unsatisfactory Compliance
Comparative Statements	356	97.1	2.9
Reporting for leases by lessees	207	79.2	20.8
Depreciable assets and depreciation	356	93.0	7.0
Disclosure of Earnings per Share and related information	356	95.5	4.5
Presentation of a flow of funds statement	356	95.2	4.8
Disclosure of information related to pension plans	263	87.8	12.2

on January 9, 1973, with any comments due by March 23, 1973.

The financial statements examined were classified by relative size and auditing firm--"Big-Eight" or "other" in an attempt to determine if these factors had influence upon the degree of compliance with the recommendation being evaluated.

An examination of Table IX-3, indicates that within the confines of the sample studied, the annual reports of the smaller corporations were responsible for a slight majority of the total unsatisfactory compliance ratings (55.2 per cent). In addition, the smaller corporations were responsible for the majority of the unsatisfactory compliance evaluations in four of six study areas. The smaller corporations had a minority of the unsatisfactory compliance ratings related to Disclosures Related to Earnings per Share and disclosures related to accounting and funding for pension plans.

A comparison of the rates of apparent compliance for financial statements audited by "Big-Eight" accounting firms vis-à-vis "Other" accounting firms (Table IX-4) shows that with the exception of Disclosures Related to Earnings per Share the statements audited by "Big-Eight" firms indicated a higher rate of satisfactory compliance in the other five study areas.

Respondents and the Accounting Principles Board

Forty-two auditors written concerning financial statements on which they had given an opinion responded to the

TABLE IX-3

SUMMARY

FINAL EVALUATION

ANALYSIS OF UNSATISFACTORY COMPLIANCE BY SIZE OF CORPORATION

Final evaluation of 356 corporate financial statements for complaince with the AICPA recommendations in six selected areas of financial reporting

	Number of Annual Reports Unsatisfactory	Per Cent Represented by	
		Larger[1] Corporations	Smaller Corporations
Comparative Statements	10	40.0	60.0
Reporting for leases by lessees	43	46.5	53.5
Depreciable assets and depreciation	25	36.0	64.0
Disclosure of Earnings per Share and related information	16	62.5	37.5
Presentation of a flow of funds statement	17	23.5	76.5
Disclosure of information related to pension plans	32	53.1	46.9

[1]"Larger Corporations" - larger 50 per cent of the sample studied in terms of total assets.

TABLE IX-4

SUMMARY

FINAL EVALUATIONS

ANALYSIS OF SATISFACTORY COMPLIANCE BY SIZE OF CPA FIRM

Final evaluation of 356 corporate financial statements for compliance with the AICPA recommendations in six selected areas of financial reporting.

Area	Per Cent Apparent Satisfactory Compliance of Financial Statements Audited by	
	Big-Eight Accounting Firms	Other Accounting Firms
Comparative Statements	97.6	95.4
Reporting for leases by lessees	85.0	55.0
Depreciable assets and depreciation	95.9	80.0
Disclosure of Earnings per Share and related information	94.5	100.0
Presentation of a flow of funds statement	96.2	90.8
Disclosure of information related to pension plans	88.3	85.0

open-ended question related to their opinion of the Accounting Principles Board and the Board Chairman's statement on specifics and the concept of flexibility (reproduced in Appendix A, Exhibit 10). The length of the answers ranged from one word--"agree"; to a two-page letter; to, in eight separate cases, a copy of the testimony or presentation by the firm in question before the AICPA Study Group on the Establishment of Accounting Principles.

A consensus of opinion indicated the following:

1. In general, the APB was doing an adequate job.

2. Where possible and reasonable, flexibility in accounting principles and reporting practices should be eliminated.

3. There will always be a need for professional judgment and in that sense flexibility as a basic concept is not, and will never, be dead.

Those respondents willing to take the time to be more expansive in their responses seemed to feel that the Accounting Principles Board had done a good job considering the size and the fact that the members were considered only to be devoting part of their time to the Board's activities. In addition, with a few exceptions, most approved and supported the recommendations of the Study on Establishment of Accounting Standards.[2]

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[2]Establishing Financial Accounting Standards, Report of the Study on Establishment of Accounting Principles (New York: American Institute of Certified Public Accountants, 1972).

Conclusions

The research indicated a high degree of compliance in published financial statements with the recommendations of the AICPA issued through the Accounting Principles Board and its predecessor, the Committee on Accounting Procedure. However, the responses to the questionnaires did indicate a problem area not known to exist before the study began.

There has been a feeling on the part of many members of the profession that the APB has gradually deteriorated over the years into an organization which issues more and more arbitrary and inconsistent rules rather than broadly based and logical standards or principles that are consistent with a set of guiding objectives. Each Opinion appears to have been approached in an independent manner, seeking to accommodate conflicting views rather than as an expression of goals to be achieved. In addition, to many, the APB has become overly concerned with a self appointed role of plugging up "loopholes" and stopping alleged abuses. But as more rules are written, more "loopholes" are created, because the more precise a rule, the more questions related to its scope and applicability.

These criticisms, of course, are not new and, along with others, were discussed in the Report of the Study on Establishment of Accounting Principles mentioned above. However, the responses to the inquiries made as a part of this study indicate that this attitude may well have been adopted by many members of the profession. Every explanation given by a responding auditor was in terms of the precise and exact interpretation of the recommendation in question. No mention was made of adequacy of reporting, better or clearer communication to the reader of the statements, or more meaningful presentation.

The auditors appeared, in their responses, to be less concerned with the usefulness or clearness of the presentation and in the fulfillment of a professional responsibility to the reader of their statements, than in meeting each of the detailed rules of the APB.

Another area of concern is the relationship between management, financial statements, and the auditor of the financial statement. Bulletin 43 states:

> Underlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management. The responsibility of the auditor is to express his opinion concerning the financial statement and to state clearly such explanations, disagreement, or disapproval as he deems appropriate.[3]

Several of the auditors written during the course of this study refused to answer the questions posed because the respondents stated that the questions should be addressed to the companies, since the financial statements are theirs and not those of the auditor.

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[3]Committee on Accounting Procedure, Committee on Accounting Terminology, Final Edition, p. 10.

However, the Council of the AICPA has stated that any material departures from APB Opinions must be disclosed in the report of the independent auditor or disclosed in the notes of the financial statements and that members of the Institute must assume the burden of justifying any such departures.

The pronouncements of the AICPA are directed primarily to the independent public accountants, and apparently only indirectly to management. But these pronouncements deal almost in their entirety with the preparation of published financial statements. The appearance given from the various statements of the Institute is that, in general, the group responsible for the preparation of financial statements is not responsible to or held accountable to the AICPA and that those held accountable to the AICPA are not responsible for the financial statements upon which they have given a written Report.

Subsequent Events

No recommendations or solutions have been proposed as a result of the conclusions primarily because of the Report of the Study on Establishment of Accounting Principles issued in March 1972 and the continuing efforts to implement the recommendations of the Report by the accounting profession.

There is a general consensus that the root of the problem in arriving at a general set of principles or standards in the preparation of financial statements is the lack of a statement of the goals or objectives of financial reporting. The establishment of such a set of objectives was one of the primary charges to the Accounting Principles Board when it was established fifteen years ago. The goal has not been achieved, and in March 1971 the responsibility was transferred to the Accounting Objectives Study Group, which at this writing is still working on what has proved to be a very difficult and elusive task. Despite the great reorganization and reconstruction of the body charged with the responsibility for the establishment of accounting principles, it is doomed to the same fate as the Accounting Principles Board if these basic objectives are not reached. For not until this is done can accounting principles be developed on the basis of logic, reason, and in relation to the stated objectives of financial presentation, instead of being approached ". . . in an *ad hoc* manner, seeking to accommodate conflicting views with no clear expression of the goals to be achieved."[4]

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[4]Harvey Kapnick, "Changes Needed to Meet Challenges of the Future," *Subject File AD 7910, Item 37*, (Chicago: Arthur Anderson & Co., October 18, 1971), p. 4.

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APPENDIX A

COPIES OF LETTERS AND FORMS DIRECTED TO CORRESPONDENTS

Exhibit 1

September , 1971

Gentlemen:

I am currently engaged in a study of published financial statements of selected industrial corporations. I would appreciate being furnished a copy of the financial statements of your corporation, as presented in the latest annual report to your stockholders.

Your granting of this request is necessary for the successful completion of my study. If you are unable to provide me with a copy of your annual report, please share your reasons with me.

I will appreciate your assistance with my study.

Sincerely yours,

William W. Grigsby, Jr., C.P.A.
Assistant Professor of Accounting

WWG:njm

Exhibit 2

October 12, 1971

Gentlemen:

On approximately September 20, I wrote you in connection with my study of published financial statements of selected industrial corporations. In that letter I requested a copy of the latest annual report to your stockholders.

Since I have not heard from you, I am again requesting a copy of your latest annual report. I am trying to bring this study to a timely conclusion and your granting of this request is necessary for a successful completion.

If you are unable to provide me with a copy of your annual report, please share your reasons with me.

Sincerely yours,

William W. Grigsby, Jr., C.P.A.
Assistant Professor of Accounting

WG/nm

Exhibit 3

Gentlemen:

During the past few months I have made a careful examination of 370 annual financial reports of American industrial corporations. One of your clients, selected on a random basis, was included in my examination.

In this research effort, I am trying to gather specific answers to certain important questions in relation to accounting principles and disclosures followed in financial presentation. This study should contribute to the development of the Accounting Principles Board's procedures and policies and should enable the Board to be more responsive to the needs of the profession as well as to the needs of other concerned parties.

Will you help me in this study by answering the questions presented on the attachments? The successful completion of this study is dependent upon your candid answers to these questions. The basis for my request is given on page 9, paragraph 8 of Accounting Research Bulletin Number 43: ". . . the burden of justifying departure from accepted procedures, to the extent that they are evidenced in committee opinions, must be assumed by those who adopt another treatment." However, these questions are not intended to be a criticism in any way of these statements and notes. I am merely trying to determine why the AICPA's recommendations apparently were not followed.

Any information which you are able to give me will be held in strict confidence. Neither the names of auditors nor corporations will be presented in the results of the study as they relate to specific answers to questions or financial statements. If you would like a copy of the summarized results, I will be glad to send one to you.

Please use the enclosed self-addressed envelope to return your answers.

Sincerely yours,

William W. Grigsby, Jr., C.P.A.
Assistant Professor of Accounting

Exhibit 4

Q-1

Auditor:

Corporation:

Financial Statement Date:

The annual report noted above reveals an instance of a treatment that appears contrary to the recommendations of the AICPA as expressed in Chapter 2, Section A, Accounting Research Bulletin Number 43, page 15, quoted below, with the statement(s) most relevant underlined:

> "In any one year it is ordinarily desirable that the balance sheet, the income statement, and the surplus statement be given for one or more preceding years as well as for the current year. Footnotes, explanations, and accountants' qualifications which appeared on the statements for the preceding years should be repeated, or at least referred to, in the comparative statements . . . "
>
> "The independent accountant should, . . . , make very clear what statements are included within the scope of his report."

1. Do you accept the AICPA's statements on comparative Financial Statements as generally accepted accounting principles? If not, why not?

2. I will appreciate any explanation you can offer relating to this treatment that appears to be contrary with the recommendations of the AICPA.

William W. Grigsby, Jr., C.P.A.

Exhibit 5

Q-2

Auditor:

Corporation:

Financial Statement Date:

The annual report noted above reveals an instance of a treatment that appears contrary to the recommendations of the AICPA as expressed in Opinion Number 5 of the Accounting Principles Board, page 32, quoted below, with the statement(s) most relevant underlined:

> " . . . the financial statements or the accompanying notes should disclose the minimum annual rentals under such [material and noncancelable] leases and the period over which the outlays will be made."
>
> "Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also usually be disclosed."

1. Do you accept the AICPA's statements on disclosure of information relating to leases by lessees as generally accepted accounting principles? If not, why not?

2. I will appreciate any explanation you can offer relating to this treatment that appears to be contrary with the recommendations of the AICPA.

William W. Grigsby, Jr., C.P.A.

Exhibit 6

Q-3

Auditor:

Corporation:

Financial Statement Date:

The annual report noted above reveals an instance of a treatment that appears contrary to the recommendations of the AICPA as expressed in Opinion Number 12 of the Accounting Principles Board, page 188, quoted below, with the statement(s) most relevant underlined:

> " . . . the following disclosures should be made in the financial statements or in notes thereto:
>
> a. Depreciation expense for the period,
> b. Balances of major classes of depreciable assets, by nature or function, and the balance-sheet date,
> c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date, and
> d. A general description of the method or methods used in computing depreciation with respect to major class of depreciable assets."

1. Do you accept the AICPA's statement on disclosure of depreciable assets and depreciation as generally accepted accounting principles? If not, why not?

2. I will appreciate any explanation you can offer relating to this treatment that appears to be contrary with the recommendations of the AICPA.

William W. Grigsby, Jr., C.P.A.

Exhibit 7

Q-4

Auditor:

Corporation:

Financial Statement Date:

The annual report noted above reveals an instance of a treatment that appears contrary to the recommendations of the AICPA as expressed in Opinion Number 15 of the Accounting Principles Board, pages 220-223, quoted below with the statements most relevant underlined:

> ". . . earnings per share or net loss per share data should be shown on the face of the income statement."
>
> ". . . financial statements should explain the pertinent rights and privileges of the various securities outstanding. Examples of information which should be disclosed are dividend and liquidation preferences, participation rights, call prices or rates and pertinent dates, sinking fund requirements, unusual voting rights, etc."
>
> "A schedule or note relating to the earnings per share data should explain the bases upon which both primary and fully diluted earnings per share are calculated."

1. Do you accept the AICPA's statement on disclosure of earnings per share data as generally accepted accounting principles? If not, why not?

2. I will appreciate any explanation you can offer relating to this treatment that appears to be contrary with the recommendations of the AICPA.

William W. Grigsby, Jr., C.P.A.

Exhibit 8

Q-5

Auditor:

Corporation:

Financial Statement Date:

The annual report noted above reveals an instance of a treatment that appears contrary to the recommendations of the AICPA as expressed in Opinion Number 3 of the Accounting Principles Board, page 16, quoted below.

> " . . . a statement of source and application of funds should be presented as supplementary information in financial reports."

1. Do you accept the AICPA's statement on source and application of funds as generally accepted accounting principles (at that date)? If not, why not?

2. I will appreciate any explanation you can offer relating to this treatment that appears to be contrary with the recommendations of the AICPA.

William W. Grigsby, Jr., C.P.A.

Exhibit 9

Q-6

Auditor:

Corporation:

Financial Statement Date:

The annual report noted above reveals an instance of a treatment that appears contrary to the recommendations of the AICPA as expressed in Opinion Number 8 of the Accounting Principles Board, page 84, quoted below, with the statement(s) most relevant underlined:

> ". . . pension plans are of sufficient importance to an understanding of financial position and results of operations that the following disclosures should be made in financial statements or their notes:
>
> 1. A statement that such plans exist, identifying or describing the employee groups covered.
> 2. A statement of the company's accounting and funding policies.
> 3. The provision for pension cost for the period.
> 4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges."

1. Do you accept the AICPA's statement on disclosure of pension plans as generally accepted accounting principles? If not, why not?

2. I will appreciate any explanation you can offer relating to this treatment that appears to be contrary with the recommendations of the AICPA.

William W. Grigsby, Jr., C.P.A.

Exhibit 10

Please state your personal feelings toward the opinions of the Accounting Principles Board in general and in relation to the following statement made by Mr. Philip L. Defliese, Chairman of the APB in an address given November 19, 1970.

> "The profession is now agreed on the need for specifics in defining accounting principles and reporting practices and is rapidly moving in that direction. The alternatives are being reduced and abuses eliminated. Flexibility, as a basic concept, is dead."

William W. Grigsby, Jr., C.P.A.

Exhibit 11

Gentlemen:

On approximately April 5, I wrote you requesting your assistance in my efforts to obtain answers to certain questions in relation to accounting principles and disclosures followed in financial statement presentation. In that correspondence I posed certain questions in relation to the annual report noted above.

Your answers are urgently needed for me to complete this study. I sincerely request that you reply to the questions.

If you are unable to provide answers to these questions, please share your reasons with me.

Thank you for your time.

Sincerely yours,

William W. Grigsby, Jr., C.P.A.
Assistant Professor of Accounting

WWG:js

APPENDIX B

ALPHABETICAL LISTING OF THE 356 CORPORATIONS WHOSE FINANCIAL STATEMENTS WERE IN THE RANDOM SAMPLE

1. The Acadia Company, Inc.
2. The Acme Shear Company
3. Acushnet Company
4. Adams-Russel Co., Inc.
5. Addison-Wesley Publishing Company, Inc.
6. Addressograph Multigraph Corporation
7. Air Products and Chemicals Inc.
8. Albersons's Inc.
9. Alco Standard Corporation
10. Alcon Laboratories, Inc.
11. Allen Electric and Equipment Company
12. Allied Chemical Corporation
13. Allied Supermarkets, Inc.
14. Allied Technology, Inc.
15. Amalgamated Sugar Company
16. American Beef Packers, Inc.
17. American Brands, Inc.
18. American Cement Corporation
19. American Motors Corporation
20. American Precision Industries, Inc.
21. American Seating Company
22. Ampco-Pittsburgh Corporation
23. Ampex Corporation
24. Anadite Inc.
25. Apache Corporation

26. Aquirre Company
27. Arrow-Hart, Inc.
28. Associated Spring Corporation
29. Automatic Merchandising, Inc.
30. The Auto-Soler Company
31. AVM Corporation
32. L.S. Ayers and Company
33. Bally Manufacturing Corporation
34. Bangor Punta Corporation
35. The Barden Corporation
36. E.T. Barwick Industries, Inc.
37. Bassett Furniture Industries Inc.
38. Bath Industries, Inc.
39. Bausch & Lomb Incorporated
40. A.J. Bayless Markets, Inc.
41. Belco Petroleum Corporation
42. The Bendix Corporation
43. Bertea Corporation
44. Boston Herald-Traveler Corporation
45. Bibb Manufacturing Corporation
46. Big Drum, Inc.
47. Bogue Electric Manufacturing Company
48. The Bohack Corporation
49. Boise Cascade Corporation
50. Borden, Inc.
51. Borg-Warner Corporation
52. Borman's, Inc.

53. Brinkman Instruments, Inc.
54. Brown-Foreman Distillers Corporation
55. BTU Engineering Corporation
56. The Budd Company
57. The Buehler Corporation
58. Burnham Corporation
59. Burroughs Corporation
60. Butler Aviation International, Inc.
61. Buttes Gas & Oil Co.
62. Campbell Machine, Inc.
63. Capitol Food Industries, Inc.
64. Carlisle Corporation
65. Cascade Corporation
66. Cavitron Corporation
67. Central Coal & Coke Corporation
68. Central Soya Company, Inc.
69. Certron Corporation
70. Champion Parts Rebuilders, Inc.
71. Chemical Products Corporation
72. Cherry-Burrell Corporation
73. Churchill Downs Incorporated
74. Citadel Industries, Inc.
75. Clarkson Industries, Inc.
76. Clopay Corporation
77. Cohn Electronics, Inc.
78. Colt Industries Inc.
79. Conrac Corporation

80. Consolidated Papers, Inc.
81. Continental Conveyor & Equipment Company
82. Cook Chemical Company
83. Copperweld Steel Company
84. Corduroy Rubber Company
85. Corning Glass Works
86. Craig Corporation
87. The Cross Company
88. Crutcher Resources Corporation
89. CTS Corporation
90. Cutler-Hammer, Inc.
91. Daitch Crystal Dairies, Inc.
92. Dayton Hudson Corporation
93. Diamond Crystal Salt Company
94. Dillon Companies, Inc.
95. Diodes Incorporated
96. Doyles Dane Bernbach, Inc.
97. Drever Company
98. Driver-Harris Company
99. Duquesne Brewing Company of Pittsburg
100. The Duriron Company Inc.
101. Duro-Test Corporation
102. Eason Oil Company
103. Electric Hose & Rubber Company
104. Electronic Assistance Corporation
105. Evans-Aristocrat Industries, Inc.

106. Emenee Corporation

107. Ex-cell-o Corporation

108. The Exolon Company

109. Fabien Corporation

110. Fabri-Tex Incorporated

111. The Fairbanks Company

112. Fairchild Camera and Instrument Corporation

113. Fanny Farmer Candy Shops, Inc.

114. Federal Paper Board Company, Inc.

115. Federated Publications, Inc.

116. Fieldcrest Mills, Inc.

117. Fields Plastics and Chemicals, Inc.

118. Filigree Foods, Inc.

119. Filmways, Inc.

120. Fisher Scientific Company

121. M. H. Fishman Co., Inc.

122. S. M. Flickinger Co., Inc.

123. The Flintkote Company

124. Fluor Corporation

125. Forest Laboratories, Inc.

126. Foster Grant Co, Inc.

127. Franklin Electric Co., Inc.

128. Franklin Stores Corporation

129. Frisch's Restaurants, Inc.

130. H. B. Fuller Company

131. GAF Corporation

132. GCA Corporation
133. General Cinema Corporation
134. General Medical Corporation
135. Getty Oil Company
136. The Gilbert Companies, Inc.
137. The Henry B. Gilpin Company
138. Global Marine Inc.
139. Globe-Union Inc.
140. Golden Flake, Inc.
141. Grain Belt Breweries, Inc.
142. The Great Atlantic & Pacific Tea Company, Inc.
143. Great Northern Nekoosa Corporation
144. Grief Bros. Corporation
145. Gulf Oil Corporation
146. Gyrodyne Company of America, Inc.
147. Halliburton Company
148. Hampton Shirt Co. Inc.
149. Handy & Harman
150. The Hawaii Corporation
151. Hecla Mining Company
152. Helena Rubinstein, Inc.
153. Helene Curtis Industries, Inc.
154. Heublein, Inc.
155. Hexcel Corporation
156. The Higbee Company
157. Edward Hines Lumber Co.

158. The Hobart Manufacturing Company

159. Hofmann Industries, Incorporated

160. Homasote Company

161. The Horn & Hardart Company

162. Hudson Leasing Corporation

163. The Huffman Manufacturing Company

164. Huyck Corporation

165. Ideal Basic Industries, Inc.

166. Inland Steel Company

167. Interlake, Inc.

168. International Flavors & Fragrances, Inc.

169. International Harvester Company

170. International Paper Company

171. I-T-E Imperial Corporation

172. Charles Jacquin et Cie, Inc.

173. The Jeannette Glass Company

174. Jefferson Stores, Inc.

175. Jetronic Industries Inc.

176. The Stratton Group, Ltd.

177. Jonathan Logan, Inc.

178. Kalvex, Inc.

179. Kawecki Berylco Industries, Inc.

180. Kearney & Trecker Corporation

181. Keebler Company

182. Keene Corporation

183. Keystone Consolidated Industries, Inc.

184. Keller Industries Inc.

185. Kelly Services, Inc.

186. Kelsey-Hayes Company

187. Kennecott Copper Corporation

188. Keuffel & Esser Company

189. Kewaunee Scientific Equipment Corporation

190. The Kirk Corporation

191. Kysor Industrial Corporation

192. The Larsen Company

193. Leasco Data Processing Equipment Corporation

194. Lea-Ronal, Inc.

195. Lewis Business Forms, Inc.

196. Liberty Fabrics of New York, Inc.

197. Ling-Tempco-Vought, Inc.

198. Lone Star Brewing Company

199. Loral Corporation

200. Lowe's Companies, Inc.

201. LSB Industries, Inc.

202. Lum's Inc.

203. Lynch Communication Systems Inc.

204. Macandrews and Forbes Company

205. Major League Bowling & Recreation, Inc.

206. Mallinckrodt Chemical Works

207. P. R. Mallory & Co. Inc.

208. Marriott Corporation

209. Martha White Foods, Inc.

210. Maryland Shipbuilding & Dry Dock Company

211. C. H. Masland & Sons

212. Masonite Corporation

213. Oscar Mayer & Co. Inc.

214. McCormick & Company, Inc.

215. McGraw-Edison Company

216. McQuay Inc.

217. Medicenters of America, Inc.

218. Meister Brau, Inc.

219. Melville Shoe Corporation

220. Meredith Corporation

221. Methode Electronics, Inc.

222. Midland-Ross Corporation

223. Millmaster Onyx Corporation

224. Milton Bradley Company

225. Missouri Beef Packers, Inc.

226. Miss Pat

227. Modern Maid Food Products, Inc.

228. Monolith Portland Midwest Company

229. Movielab, Inc.

230. MWA Company

231. Nashua Corporation

232. National Alfalfa Dehydrating and Milling Company

233. National Bellas Hess, Inc.

234. National Steel Corporation

235. National Systems Corporation

236. National Tape Distributors, Inc.

237. Natomas Company
238. J. J. Newberry Co.
239. Newmont Mining Corporation
240. The New Yorker Magazine, Inc.
241. A. C. Nielsen Company
242. Norton Company
243. Nytronics, Inc.
244. Oak Electro/Netics Corp.
245. Official Industries, Inc.
246. The Offshore Company
247. Opelika Manufacturing Corporation
248. Optical Coating Laboratory, Inc.
249. Originala Incorporated
250. Pacific Plantronics, Inc.
251. Pacific Tin Consolidated Corporation
252. Pacific Vegetable Oil Corporation
253. Panoil Company
254. Parklane Hosiery Company, Inc.
255. PepsiCo, Inc.
256. Peter Paul, Inc.
257. Petrie Stores Corporation
258. Phoenix Steel Corporation
259. Pioneer Plastics Corporation
260. Polaroid Corporation
261. P P & C Companies, Inc.
262. Prentice-Hall, Inc.

263. Publishers Company, Inc.
264. Puritan Fashions Corporation
265. Quaker State Oil Refining Corporation
266. Ralston Purina Company
267. Ranco Incorporated
268. Reading & Bates Offshore Drilling Company
269. Recor Corporation
270. Rollins, Inc.
271. ResistoFlex Corporation
272. Resorts International, Inc.
273. Riblet Products Corporation
274. Roanwell Corporation
275. Robertshaw Controls Company
276. A. H. Robins Company
277. Robo-Wash, Inc.
278. Rocket Research Corporation
279. Rogers Corporation
280. Rohm and Hass Company
281. Rotron Incorporated
282. Royal Industries, Inc.
283. Sabine Royalty Corporation
284. Safeguard Industries, Inc.
285. Safran Printing Company
286. St. Joe Minerals Corporation
287. St. Regis Paper Company
288. San Fernando Electric Manufacturing Company

289. San Gamo Electric Company

290. Savin Business Machines Corporation

291. Schiller Industries, Inc.

292. Schultz Sav-o Stores Inc.

293. The Scott & Fetzer Company

294. Scrivener Boogaart, Inc.

295. Seaboard Plywood and Lumber Corporation

296. Seligman & Latz, Inc.

297. Servo Corporation of America

298. Shatterproof Glass Corporation

299. Sheller-Globe Corporation

300. Henry I. Siegel Co., Inc.

301. Simmonds Precision Products, Inc.

302. Simon & Schuster, Inc.

303. Simplex Wire and Cable Company

304. Skaggs Drug Centers, Inc.

305. SMD Industries, Inc.

306. Sonoco Products Company

307. Southern Bakeries Company

308. Southland Royalty Company

309. Sparton Corporation

310. Spectra-Physics, Inc.

311. Sperti Drug Products, Inc.

312. Staco Inc.

313. Standard Oil Company (New Jersey)

314. Statham Instruments, Inc.

315. Steak n Shake, Inc.

316. Tab Products Co.

317. Taft Broadcasting Company

318. Tensor Corporation

319. Thiokol Chemical Company

320. Thomas & Betts Corporation

321. Tokheim Corporation

322. Thomas Industries, Inc.

323. Torin Corporation

324. Transitron Electronic Corporation

325. Trans-sonics, Inc.

326. Tridair Industries

327. TRW Inc.

328. Twentieth Century Fox Film Corporation

329. Tyson's Foods, Inc.

330. Varco Incorporated

331. VMC Industries, Inc.

332. Union Camp Corporation

333. Union Stock Yards of Omaha (Ltd.)

334. Unitec Industries, Inc.

335. United Foods, Inc.

336. USM Corporation

337. Utah Construction & Mining Co.

338. VCA Corporation

339. Vesley Company

340. Virco Mfg. Corporation

341. VSI Corporation

342. Vulcan Corporation
343. E. R. Wagner Manufacturing Company
344. Warner Electric Brake & Clutch Company
345. H. Warshow & Sons, Inc.
346. Washington Steel Corporation
347. Watkins-Johnson Company
348. Weis Markets Inc.
349. Wentworth Manufacturing Company
350. West Chemical Products, Inc.
351. Western Publishing Company, Inc.
352. Whitaker Cable Corporation
353. Whittaker Corporation
354. Will Ross, Inc.
355. Whitco Chemical Corporation
356. Woods Corporation

APPENDIX C

ALPHABETICAL LISTING OF INDEPENDENT ACCOUNTING FIRMS WHO SERVED AS AUDITORS OF THE ANNUAL REPORTS IN THE RANDOM SAMPLE. THE NUMBER OF ANNUAL REPORTS OF WHICH AN INDIVIDUAL FIRM GAVE AN OPINION IS GIVEN IN PARENTHESES.

Alexander Grant & Company (5)

A. M. Pullen & Company (3)

Aronson & Oresman (2)

Arthur Andersen & Co. (45)

Arthur Young & Company (29)

Brout, Isaacs & Company (1)

Byrnes & Baker (1)

Chirlian, Parker & Co. (1)

Clarence Rainess & Co. (2)

Cornick, Garber & Sandler (1)

David Berdon & Co. (1)

Eisner & Lubin (1)

Elmer Fox & Company (1)

E. M. Schwartz & Co. (1)

Ernst & Ernst (40)

Fred Landau & Co. (1)

Grisette & Beach (1)

Harris, Kerr, Forster, & Company (1)

Haskins & Sells (26)

Humphrey Robinson and Company (1)

Hurdman and Cranstoun, Penny & Co. (4)

Hutchinson and Bloodgood (1)

I. J. Skilnick & Co. (1)

Irwin Small Company (1)

J. D. Cloud & Co. (1)

J. K. Lasser & Company (2)

John F. Forbes & Company (1)

Joseph Froggatt & Co. (1)

Joseph S. Herbert & Company (1)

Laventhol, Krekstein, Honarth & Horwath (4)

Lybrand, Ross Bros. & Montgomery (44)

Main LaFrentz & Co. (3)

M. D. Oppenheim & Company (1)

Meahl, McNamara & Co. (1)

Miller, Wachman & Co. (1)

Milton Lanz & Company (1)

Moore, Smith, & Dale (1)

Ostroff and Fair (1)

Peat, Marwick, Mitchell & Co. (41)

Price Waterhouse & Co. (40)

Rashba & Pokart (1)

Reischer, Voynow and Company (1)

Russell Brown & Company (1)

Samuel E. Bloom & Co. (1)

S. D. Leidesdorf & Co. (6)

Seidman & Seidman (4)

Stebbins & Stebbins (1)

Touche Ross & Co. (23)

Westheimer, Fine, Berger & Co. (1)

Wolf and Company (1)

Zauber, Bugni & La Banca (1)