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Evolution (and revolution) of the accounting profession

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THE EVOLUTION (AND REVOLUTION) OF THE ACCOUNTING PROFESSION.

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During this past year there have been numerous developments in accounting theory and financial reporting. Responding to a changing social environment, increasing pressure from the financial community and sometimes criticism from the press and from governmental authorities, our profession has recently taken giant steps to improve financial reporting in order to give investors more meaningful information on a more timely basis. Since mid-1973 there has been a proliferation of accounting pronouncements by both the private and the governmental sectors of the profession. The New York Stock Exchange has issued its "White Paper" report; the Securities and Exchange Commission has promulgated substantive new disclosure requirements for financial statements filed with the Commission; and the Financial Accounting Standards Board, replacing the Accounting Principles Board as the senior technical rule-making body of the accounting profession, has issued its first standards.

These pronouncements make it quite evident that the accounting profession is going through an unprecedented evolutionary process. In many ways the change might more aptly be characterized as revolutionary. The following discussion concentrates on the factors previously mentioned as being indicative of these rapid changes. The New York Stock Exchange, the Securities and Exchange Commission and the Financial Accounting Standards Board are three of the most powerful forces in the financial community, each with the ability to dictate changes in financial reporting, when such changes are considered to be in the best interests of the users of financial statements.

NEW YORK STOCK EXCHANGE

In December 1973 the Exchange published its White Paper "Recommendations and Comments on Financial Reporting to Shareholders and Related Matters." It recommended that corporate management develop new levels of excellence in financial reporting to stockholders and outlined certain other matters that the Exchange considers to be in the best interests of stockholders. These recommendations, while not official pronouncements and therefore not directly enforceable by the New York Stock Exchange, do carry a great deal of weight with companies whose stocks are listed on the Exchange. Few chief executives and financial officers of publicly held companies would like to be in the position of having to explain to the Exchange why their companies did not comply with certain recommendations, especially when many other companies were doing so. These recommendations might be compared to the present administration's policy of "jaw-boning;" that is, they carry a great deal of weight because of the position of the one making the recommendation, but they are not legally enforceable.

A company may well be anxious to comply with the New York Stock Exchange proposals, but hesitate to be among the first to do so. This fear of being a pioneer in, for example, a new standard of financial reporting is a real one. In each instance, stockholders' reactions must be considered as well as legal ramifications, reactions of the investment community and creditors, and coverage by the press.

Some of the Exchange's recommendations are considered briefly in the following sections.

■ **Audit Committees.** The White Paper strongly recommended that every listed company form an audit committee. This committee, preferably composed of from three to five outside directors of the company, should meet with the auditors whenever either party considers it necessary. Matters that might be discussed at these meetings include review of the adequacy of internal controls; the scope of the audit and, subsequently, its results; and the accounting principles and reporting practices followed by the company. In the author's experience, audit committees have generally consisted of two or three outside directors and have met with the auditors at least twice a year.

■ **Review of Quarterly Reports.** In suggesting that companies consult with their auditors periodically throughout the year, the Exchange particularly recommended consultation prior to publication of quarterly reports. Although the White Paper stopped short of proposing that auditors review quarterly reports, it seems clear that the Exchange would like to have auditors perform this function and equally clear that in the near future auditors will be doing so on a regular basis. This would seem to be a natural extension of the annual service presently provided to publicly held clients.

Investors can no longer wait a full year to be assured that financial reports are accurate; quarterly announcements and publications of operating results have just as much impact on investor decisions to buy or sell as do audited annual results. The time is coming when the public will demand some degree of auditors' assurance of the reliability of interim reports. In the writer's experience most companies have consulted with their auditors throughout the year; however, few have asked for a review of a quarterly report to stockholders before it was issued. This will be changing soon. Auditors will become more and more involved with their clients' interim reports and in assisting with interim reporting problems.

- **Lines-of-Business Reporting.** The Exchange also proposes that certain details of the different businesses engaged in by the company be disclosed in the annual report. Lines-of-business reporting is presently required in filings with the Securities and Exchange Commission, but the degree to which similar disclosures are being made in reports to stockholders varies. This recommendation urges disclosure of the different lines of business and of other pertinent matters such as competitive factors, key customers, markets, backlog, etc., in the annual report to stockholders. It is the writer's experience that many companies are reporting lines-of-business statistics in their annual reports but in lesser detail than in filings with the SEC. Also, the often conservative and typically legalistic presentation employed in filings with the Commission is generally replaced by an overly optimistic, public-relations-minded approach which is designed to enhance the company's appearance in the eyes of present and prospective stockholders.

- **Consistent Presentation.** The White Paper also recommends that all financial data included in the annual report be consistent with the audited financial data. For example, any financial statistics quoted in the president's letter, all graphs, the financial-highlights section, statistical tables, etc., should contain data in a format suitable for the auditors, even though the auditors will not be reporting on this material. The Exchange suggests that this information be furnished to the auditors prior to publication and that it should be read by them. Generally speaking, auditors do not have a legal responsibility for the accuracy of information contained in sections of the annual report not covered by the auditors' opinion. However, there is a gray area of legal responsibility where an auditor "associates" himself with information that is materially in error, even though it is not covered by his opinion. Courts have looked and are continuing to look in the direction of expanding an auditor's legal responsibility. Although the problem is obviously beyond the scope of this discussion, it would be fair to say that it would be embarrassing at least, and might be very costly at most, if the unaudited data were significantly in error. As a general rule, clients give the auditors drafts of the entire annual report before publication and may specifically request the auditors to check the financial material contained throughout the document. Any conscientious management is just as interested in protection against unintentional mistakes as are the auditors. They are also interested in listening to alternative viewpoints on matters of judgment where reasonably intelligent people can differ.

■ **Factors Affecting Operating Results.** Another proposal of the New York Stock Exchange White Paper relates to factors that affect the comparability of a company's results of operations for the current year with those of the prior year. Many companies discuss these factors in very general terms; the Exchange recommendation states that it is important to describe all significant factors affecting results of operations. These would include changes in products or customer mix, volume statistics, production costs, etc.

Few companies are providing this type of detail, and this is probably another area where fear of being among the first is slowing down the changeover. However, fear may soon take a back seat to governmental regulations, because the Securities and Exchange Commission recently issued amendments to certain of its existing publications that would, in essence, require a detailed evaluation by management of the factors causing changes in operating results reported in financial statements filed with the Commission. This is an appropriate time to discuss how the SEC has taken over the rule-making function in certain areas of financial reporting.

SECURITIES AND EXCHANGE COMMISSION

Until recently the SEC tended to stay in the background, to let the accounting profession come to grips with its own problems. However, in the last year or two the Commission has left this position and taken up a position squarely in the foreground. It has been insisting that it has the right to do so (and it unquestionably has the statutory authority), and it states that it will continue to do so when the accounting profession does not move quickly enough.

As previously mentioned, recently issued regulations require management to offer explanations of why certain financial-statement items have changed significantly between reporting dates. If this information is contained in any of the company's reports filed with the SEC, should not similar information be contained in the annual report to stockholders? Should not all stockholders have the benefit of this information? But how much information can be included in the annual report before it becomes a cluttered, useless document, containing too much information for the average unsophisticated investor to sift?

■ **Extent of Disclosure.** This leads to another subject of controversy. Should financial statements be prepared on two bases—one for the average reader and the other for the sophisticated investor? Recently it has seemed that the SEC may be suggesting this dual standard. For example, in its Accounting Series Release (ASR) No. 148 it stated that the information being requested (disclosure of compensating balances and short-term borrowing arrangements) was "of primary interest to those users of financial statements who wish to undertake detailed analysis of corporate activities. . . ." In ASR No. 149 the SEC further acknowledged that "the detailed disclosure provided herein [relating to improved disclosure of income-tax expense] will be primarily of interest to professional analysts. . . ." This concept is quite new—certain information need be reported only to certain people. It seems that this dual standard is taking hold, and it would not be surprising to see future SEC releases also making a distinction as to the extent of disclosure necessary to keep different classes of investors well informed.

■ **Business Combinations.** Another recent instance of SEC intervention has to do with what the Commission considers to be abuses of existing accounting standards. In its role as watchdog of the securities industry, the Commission released in 1973 a detailed interpretation of Accounting Principles Board Opinion No. 16, "Accounting for Business Combinations," and, more specifically, of the effect of treasury-stock acquisitions on accounting for a business combination. In this release, which carries the Commission's full weight and consequently enables it to use its statutory enforcement powers against any offenders, the SEC stated its opinion that treasury-stock acquisitions during the two years preceding a business combination are presumed to have been made in contemplation of that combination, and thus pooling-of-interests treatment is precluded. It then went on to interpret strictly several aspects of APB Opinion No. 16.

For example, the release stated that a formal board of directors' resolution stating the company's intent to be other than in contemplation of a pooling transaction was not necessarily persuasive evidence of such other intent. Also, by limiting the definition of "systematic pattern of reacquisitions" to selected instances, the release will have the effect of further limiting pooling treatment for companies that may have acquired treasury stock for good business or economic purposes other than business combinations. Then came the kicker: the SEC made the provisions retroactive to include stock acquired prior to the effective date of the release. In some instances, however, companies had already relied on the professional advice of their accountants to the effect that certain treasury-stock acquisitions would not jeopardize future poolings because they had been conducted in accordance with the then generally accepted accounting standards existing under APB Opinion No. 16. Now the SEC was saying that such treasury-stock acquisitions might jeopardize pooling treatment. As a result of the adverse public reaction to this release, the SEC informally withdrew it; however, in April 1974 it was reissued with substantially the same interpretations, but with the retroactive aspect deleted.

■ **Disclosure of Lease Transactions.** Another example of the Commission's ability to throw its weight around appears in the recently issued standards for required disclosure of lease transactions. In June 1973 the Accounting Principles Board issued an opinion covering this subject. In ASR No. 147 the SEC stated that it had carefully considered the contents of Opinion No. 31 to determine whether it provided for disclosure sufficient to meet the needs of investors, and had concluded that it did not. Specifically, the SEC determined that the disclosure of the present value of financing leases, and of the impact on net income of capitalizing these leases, was essential information to investors. Companies, and their auditors, were caught in the middle; the accounting profession's senior technical body had recently issued its opinion that this information was not essential. After thorough consideration of the problem, there was only one conclusion: the SEC's release had effectively superseded the APB's Opinion as the authoritative source to be followed. Companies began to gear up their internal reporting mechanisms to enable them to comply with the new generally accepted accounting principle dictated by the SEC.

■ **Other Areas of Disclosure.** Other areas where the Commission felt that financial-statement disclosure was inadequate include corporate liquidity and short-term borrowing arrangements, the components and other details of income-tax expense, and the amount of inventory profits reflected in income during periods of rising prices. The argument in this last area is essentially that in periods of inflation, inventory profits do not reflect an increase in the economic earning power of the company and consequently may not be repeated in subsequent years. Therefore, the SEC recommended that these amounts be disclosed to investors to enable them to make a better evaluation of an enterprise's earnings potential at the present and in the future. The SEC may be expected to make this recommendation a requirement in the near future. More and more companies will probably attempt to improve the quality of their reported earnings by disclosing similar nonrepetitive items.

FINANCIAL ACCOUNTING STANDARDS BOARD

In July 1973, responsibility for the establishment of financial accounting and reporting standards for the accounting profession was transferred from the Accounting Principles Board to the newly formed Financial Accounting Standards Board. The diversity of subjects that the FASB currently has under consideration may be illustrated by the following list:

Accounting for foreign currency translation

Accounting for future losses

Financial reporting by segments of a business

Accounting for leases

Criteria for determining materiality

Conceptual framework for accounting and reporting

Business combinations and related intangibles

General price-level reporting

The type of subject matter currently being researched and debated at the FASB is interesting. Some topics have never before been researched in such detail; others have been discussed at length, time and time again. Relatively new topics include, for example, the proper accounting for future losses and the criteria for determining materiality.

This latter study is desperately needed by auditors and the clients and public they serve. Some framework for determining when an item or economic event is material can help immeasurably in assisting the public to understand that much of an auditor's work involves judgment and estimation. If a reader of financial statements knows that errors of, say, 2 percent in financial statements are not considered material, whereas errors of 15 percent are, he should become aware that those statements do not purport to be precise statements of fact but rather fair presentations involving a substantial degree of judgment. By defining the criteria for determining the significance of an item, we will have gone a long way toward educating preparers and users of financial statements.

Other areas being researched by the FASB are old friends and have been dealt with before in the accounting literature. The most obvious examples are the proper accounting for leases and for business combinations. Differences in opinion as to establishment of accounting standards in these areas have long existed: to capitalize or not to capitalize a lease obligation; to account for a business combination as a pooling of interests or as a purchase by one company of another. These subjects have provided accountants with some of the more fascinating conceptual questions in accounting theory in recent years. Now the FASB will tackle the subjects all over again. After it completes its deliberations, it is the author's opinion that more and more lease transactions will be considered as qualified for capitalization treatment, while fewer and fewer business combinations will be accounted for on a pooling basis.

To date, two formal standards have been issued by the FASB. The first requires increased disclosure of foreign currency translation information, and the second establishes the standard for the appropriate method of accounting for research and development costs.

■ **Foreign Currency Translation.** In Statement of Financial Accounting Standards No. 1, the FASB has not as yet attempted to tackle the theoretical question of how to account properly for foreign currency translations. Rather, as a stopgap measure until the accounting concepts are clarified, it requires increased disclosure of the procedures companies are presently following. However, increased disclosure is never a substitute for better accounting. Until the FASB issues a pronouncement on what it considers to be the preferred accounting treatment, the problem of foreign currency translations will still be with us.

■ **Research and Development Costs.** There have been strong differences of opinion over the years as to the most appropriate method of accounting for research and development costs. In its deliberations, the Board discussed four possible methods. The existing diversity of opinion can be emphasized by listing them:

1. Charge all costs to expense as incurred.
2. Capitalize all costs when incurred.
3. Capitalize only certain costs if specific conditions are fulfilled and expense all others.
4. Accumulate all costs in a special category until the existence of future benefits can be determined.

In its second Statement, the Board concluded that research and development costs should be expensed as incurred. This is another step in reducing the number of variant accounting methods presently being used by different companies.

CONCLUSION

We have seen the accounting profession come a long way in just one year. The regulatory authorities and the private sector of the profession have brought about numerous changes to improve the quality of information disseminated to financial-statement users. The evolution of the accounting profession is going on; the revolution of the profession has hardly begun. ●