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Trueblood Professors' Seminar : accounting and auditing case studies : student case book

Touche Ross Foundation

American Accounting Association

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The Trueblood Professors' Seminar

Accounting and Auditing Case Studies

STUDENT CASE BOOK

*The Touche Ross Foundation
and
The American Accounting Association*

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Preface

Touche Ross & Co. began the professors' seminar program in 1966. The first session addressed the subject of computer auditing, and interestingly, computer auditing continues to be a profession-wide critical topic seventeen years later. The star performers of the first program were Touche partner Greg Boni (now deceased), who gave a nearly spell-binding lecture on "A Conceptual Analysis of Auditing"; Boni was a genius of a man who had also been the thesis advisor to Tom Porter, the second instructor, who was then a Ph.D. candidate at Columbia University, and is now a partner in the Seattle office. The third member of the faculty was Dennis Mulvihill, who had received his Ph.D. from the University of Pittsburgh and is now a partner in the Melville, Long Island office. Three computer auditing seminars for professors were held. All subsequent seminars, with one or two exceptions, have dealt with current accounting and auditing topics. Since the initial programs, nearly a thousand professors from more than 300 schools have participated in these programs.

We may have never held a seminar for professors were it not for the support of Robert Beyer, who was then Managing Partner of the firm. It was he who agreed to experiment with the program and approved the budgets necessary to cover all the expenses. (Robert Beyer is also responsible for the CMA Gold Medal given for the highest grades on the Certified Management Accountant examination.)

From the beginning, the program has received high praise and the professors who have participated urged us to put together the case material used in the program and make it available for classroom work. The reason for this publication is to honor that request.

The programs have had two important ingredients: the case material and the discussion leaders. The cases are prepared by a gifted group of partners working on our National Accounting and Auditing staff. Their objective is to capture the essence of a client problem, usually in a few paragraphs, design the description to stimulate group discussion, and disguise the situation enough so as to protect client confidentiality. Even with good case material, programs might fall short if it were not for the skills of the discussion leaders.

The first seminar cases were designed by Hans J. Shield, an Austrian-educated member of our National Accounting and Auditing staff who worked for Robert M. Trueblood. Donald J. Bevis, who served as Managing Partner of Touche Ross, Bailey & Smart and was subsequently appointed a member of the Accounting Principles Board for a number of years, also designed cases and led discussions. Those professors who attended these initial programs still remind me of the favorable impression they retain of our sharing with them the most challenging and interesting professional issues facing our firm and our clients. The Seminar format has always required two discussion leaders, a National Accounting and Auditing staff partner and a line partner from the field, who on a daily basis works with implementation issues in the client environment. Robert J. Sack, who is now a partner in the Cleveland office, deserves special mention. Sack is undoubtedly the most

outstanding discussion leader in the accounting profession. Those who have attended the program give testimony to this through the hundreds of complimentary letters we have received concerning Bob's great skill.

Upon the death of Robert M. Trueblood, Chairman of the Board of Touche Ross & Co., Managing Partner Russell E. Palmer suggested that we recognize the contributions Trueblood made to the firm and to the profession in some appropriate way. After considering several alternatives, I proposed that we share the professors' seminars with the American Accounting Association and name them the Trueblood Professors' Seminar. The trustees of the Touche Ross Foundation concurred and the President of the Touche Ross Foundation, Gerald Polansky — a member of the Board of Directors of Touche Ross & Co. — and Robert M. Anthony — the President of the American Accounting Association — and I prepared an agreement in which we made a three-year commitment to the American Accounting Association to have the professors' program as a part of the professional development activities of AAA. The original three-year commitment has been extended twice. Polansky headed up a pledge campaign to honor Trueblood, and the funds contributed by individual partners were used to finance the first eighteen seminars. Subsequently, Touche Ross & Co. has contributed to the Foundation the necessary funds for the seminars. Without the help of Russell E. Palmer, our Managing Partner at the time, the program could not have been continued.

In more recent years, the National Accounting and Auditing staff, under the direction of Donald Georgen and Robert Kay and with support from Robert Sack, Michael Bohan and Raymond Perry, prepared much of the case material which was used both in our own partner and manager training programs and subsequently shared with professors attending the seminar programs.

As a result of "sharing" the program with the AAA, Touche Ross & Co. also transferred to AAA the responsibility for determining the selection procedures to be used in inviting participants to the program. Lists of schools have been compiled and selection is made on a random basis. Individual professor participants are chosen by accounting department chairpersons. Previously the Foundation had selected and invited professors to attend based upon recommendations from our local offices.

The cases contained in this publication represent the work of a number of Touche partners, but recognition must go to Mike Bohan, Bob Sack, Bob Kay, and especially to Tom Wall, a Touche partner in the San Francisco office, who worked hard writing, editing, redrafting, and doing all those things necessary to put the discussion leader's material together.

The seminar program continues with support from our present Managing Partner, David Moxley, and the National Director of Accounting and Auditing, Stanley Russell.

It is Touche's goal to have our professor friends and students use the cases in the college classroom in a way which will enhance the development of future professional accountants. The material has been designed so that one volume of cases, instructor guidelines and reference material, will be available for professors of accounting, and a separate volume, containing the cases and selected reference material, will be available to students of accounting. While the material is copyrighted, professors are free to duplicate the ma-

terial for classroom usage. The case material may not be used in books, manuals, articles or other publications.

In recognition of the many professors who have supported the program through their AAA committee work and the partners of Touche who have made the programs so successful, we have included their names in the appendices.

Special mention should also be made of AAA President Yuji Ijiri of Carnegie-Mellon University, President-elect Harold Q. Langenderfer of the University of North Carolina, and Professor Samuel Frumer of Indiana University, who offered encouragement to publish the cases in cooperation with the American Accounting Association. Special thanks are also extended to Paul L. Gerhardt, Executive Director of the AAA, Janet G. Nuñez, Publications Director, and to Carol Galante, the Assistant Secretary/Treasurer of the Touche Ross Foundation.

Henry C. Korff
Secretary/Treasurer
The Touche Ross Foundation

Foreword

The American Accounting Association, in cooperation with The Touche Ross Foundation, is most happy to make available to its members and other accounting educators a compilation of the outstanding cases presented at the Trueblood Seminars.

Since 1975 the Trueblood Seminars have been held three times annually in honor of Robert M. Trueblood, former Chairman of the Board of Touche Ross. Nearly a thousand professors from among more than 300 institutions have attended these seminars. Each seminar, administered by an Association committee and Touche Ross partners, has focused on 16 to 25 cases dealing with accounting and auditing issues, which have been developed from Touche Ross practice offices and which are presented by Touche Ross discussion leaders at an annual out-of-pocket cost to Touche Ross now approaching \$100,000. The high quality of these cases has been judged as being of exceptional merit, even by professors such as myself who have not participated in a seminar but who have been provided with copies of some of these cases by attending colleagues or former students.

Now all of us are given the opportunity to have access to this unique source of educational material with the publication of these two volumes.

Thomas J. Burns
Professor and
Director of Education

Note to Students

This Student Case Book is designed to present students of accounting and auditing with some of the complex and subtle problems faced by practitioners in the field. In some of the Cases, the description of the problem is considered sufficient to start students toward the solution, perhaps with additional input from classroom discussion. In other Cases, a Study Guide is provided to help students sort through the more complex problems. The Study Guide may consist of a statement of the objectives of the Case and applicable professional pronouncements to refer to; business assumptions and other data; in-depth discussion; and, in a few instances, the solution to the Case.

The Trueblood Professors' Seminars

Accounting and Auditing Case Studies

Student Case Book

Whose Audit Report Is It Anyway?

You and your audit team examined the financial statements of Peoples County Farm Cooperative for the year ended December 31, 1980. Your audit report, dated February 18, 1981, was qualified significantly. Your middle paragraph explained that the cooperative had suffered significant losses in the past two years, had invested in certain ventures that were not working out, had not collected substantial past-due advances to members, and had not allocated significant cumulative losses to individual members.

In September, 1981, the cooperative issued a proxy in connection with a proposed merger with another cooperative. You were not aware of the proposed merger — it came to your attention when the client sent you a courtesy copy of the proxy. The proxy was prepared by the client's administrative officer with the help of client's legal counsel.

Most of the 1980 financial statements were included in the offering circular. A number of the more important footnotes were omitted — and so was your report. The proxy explains that the statements were audited by a major firm but does not mention your firm's name. It summarizes your qualified opinion and states that a full, audited annual report is available for inspection upon request.

A little piqued, you called the administrative officer and asked him why he omitted your report and the other financial data and disclosures. He explained that your report and the omitted disclosures were cumbersome and technical and would be difficult for the readers to understand as they were not educated in financial matters. "Besides," he went on, "neither your report nor those footnotes were necessary for the proxy. Our attorneys told us what we had to include to be legal and we included only those things they told us to include. Also, if I had included your report, you'd have been very upset that we didn't give you permission to redo the audit as of today. And we've already paid for one audit this year!"

**WHAT SHOULD YOU DO NOW THAT YOU ARE AWARE
OF THE MERGER PROXY?**

STUDY GUIDE

Whose Audit Report Is It Anyway?

Objectives of the Case

This case focuses on the question of the right of clients to use, and control the use of, auditors' reports. In particular, the case deals with the unauthorized alteration or summarization of the report, and with the general reference to the fact that the statements were audited (without identification of the auditor) and to the implication that the statements presented are the ones that were audited when in fact that is not so. Upon completion of this case study the students should have an understanding of the obligation of auditors to deal with possible unauthorized use of their reports. In addition, the case study could lead to discussion of the question of the need for "auditors of record" or continuous auditor contact with client affairs.

Applicable Professional Pronouncements

Statement on Auditing Standards No. 1, Section 530 — Dating of the Independent Auditor's Report

Statement on Auditing Standards No. 37 — Filings Under Federal Securities Statutes

Business Assumptions and Other Data

Auditors and others are responsible under the 1933 Securities Act (Section 11) for untrue statements of material facts in registration statements. Their liability under that section could be viewed as more onerous than liability under the 1934 Act or under civil litigation or other similar proceedings. In recognition of this sterner provision in the 1933 Act, registration statements are required to have currently dated auditors' consents (by Section 7) before they are allowed to become effective. And, until recently, that was about the only control auditors had over their opinions that might be used in documents furnished shareholders.

A few years ago, amid the flurry of mergers and acquisitions, auditors and the Securities and Exchange Commission became painfully aware that a number of proxies contained auditors' reports included without knowledge of such auditors (to the end that the auditors had no opportunity to extend their procedures to consider "subsequent events," i.e., those between the date of the report and the date of the proxy). This shortfall was corrected by requiring a currently dated type of consent from the auditors, in substance similar to the requirements of the 1933 Act.

That is about where legally required control by auditors over subsequent use of their reports ends. Some other Securities and Exchange Commission filings can, and do, still contain auditors' reports without their knowledge, and thus without any possibility of their review of subsequent events. Two of the more common filings with such deficiencies

are Form 8-K (usually in situations containing reproduced or photocopied financial statements and auditors' reports of companies being purchased by the filing company) and amendments to tax shelter offerings (usually in situations where additional units of the same shelter are being made available for public purchases).

While some measure of control, as noted above, is afforded auditors of publicly held companies, corresponding controls in other than SEC-reporting companies is severely limited — at times, nonexistent, as in the case at hand. The situation is changing, but gradually. For example, public offerings of municipal bonds in years past were typically made without audited financial statements. Then some offerings started to contain information about as shown in this case, and some began to contain full financials and complete auditors' reports. As the latter stage approached, underwriters began to insist on a comfort letter, currently dated, from the auditors, thus giving the auditors a chance to review subsequent events. Another force adding impetus is the bond rating house, which typically will now rate only bonds of those municipalities whose financial statements are audited. Still, neither the law nor professional auditing literature requires a currently dated consent, comfort letter, or the like for use of an auditor's report in a municipal offering document.

Except for Section 561 of SAS 1, and SAS 37, current auditing literature sets forth no requirement that auditors control the use of their reports after the dates of issuance. SAS 1 gives procedures to be followed by auditors who, subsequent to the date of their reports on audited financial statements, become aware that facts have existed as of that date which might have affected their reports. Statement 37 deals with procedures to be followed by auditors who consent to the inclusion of their report in a registration statement filed under the '33 Act.

The requirement for review of subsequent events under the 1933 Act is, in substance, an exception — the only exception — to Section 530 of Statement on Auditing Standards No. 1, which provides that "the auditor has no responsibility to make any inquiry or carry out any auditing procedures for the period after the date of his report, unless the auditor becomes aware that facts may have existed at the date of his report which might have affected his report had he then been aware of such facts." The language is clear that an auditor has no responsibility to make further investigation or inquiries as to events which have occurred during the period between the original report date and the date of release of a reissued report.

The profession skirted the issue at hand when it issued Statement on Auditing Standards No. 8, "Other Information in Documents Containing Audited Financial Statements," but it essentially limited the applicability of that statement to annual reports, which the proxy is not. Further, it limited the required procedures essentially to a reading of the other information to identify inconsistencies between that information and the financials, which is somewhat different from the auditor's concern here, which is the possibility of subsequent events requiring further handling. The students could discuss the advantages and disadvantages of extending Statement on Auditing Standards No. 8 from annual reports to cover all documents and, further, to require something more than identification of inconsistencies.

Limited as legal and professional requirements may be regarding reproduced financial statements and auditors' reports, they are prolific compared to the rules regarding summarization — or emasculation, in the Peoples case.

Discussion

The students may gain perspective from an early-on discussion of the purpose of a subsequent review by auditors. For filings under the 1933 Act, the purpose is clear: "To sustain the burden of proof that he has made a 'reasonable investigation' . . . , the auditor should extend his procedures with respect to subsequent events from the date of his report up to the effective date or as close thereto as is reasonable and practicable in the circumstances." But, can the legal requirement for a "reasonable investigation" be said to be equally applicable to security offerings outside the 1933 Act, to proxy solicitations, and other documents submitted to shareholders and prospective shareholders to influence their action, one way or the other, regarding issuance of additional securities? Points of view will differ, obviously, and certainly no easy answer exists. As noted previously, without benefit of any law or professional requirement, some progress toward the affirmative is being made, as in the municipal bond market. A strong possibility exists that review of subsequent events will either remain status quo or be expanded in relation to future court findings for or against auditors in situations such as this one.

It is hard to see how auditors could have much responsibility for subsequent review if they have no control over subsequent use of their reports or, as in this case, reference to their reports. When auditors release their reports they have no further control over their use. Professional literature is clear on that, except for 1933 Act filings. Yet, the public and the courts may not necessarily agree with that stated position.

The students ought to discuss the reasonableness of public assertion or court findings of auditor responsibility in cases outside the 1933 Act. They should understand how difficult it is for auditors to stay continuously involved in their clients' activities and to be continually updating their audits. But, on the other hand, it should be clear to the students that the public is ill-served by a situation where auditors audit financial statements and then effectively "wash their hands" of further responsibility; some would advocate the profession must look for ways to change the traditional role so that auditors examine the business rather than the financial statements. One means, as suggested by many, is the "auditor of record" approach which would have auditors involved more or less continuously in all public communications to shareholders, prospective shareholders, and others.

The students could have fun discussing the possibility that important footnotes were left out or that the client may have erred in its summarization of the auditor's opinion, but ultimately the class discussion must come back to focus on the auditor's responsibility for subsequent events.

The crux of concern undoubtedly arises from two principal issues: (1) from the extended delay of seven months between the audit report date and the re-use of the report in the proxy, and (2) from the modifications made to the financial statements and to the auditor's report. Presumably, had the proxy been issued concurrently, or within a short period, the students would consider that the auditor would have less concern; had the proxy faithfully reproduced the financials and the auditor's report, the students would again see less concern for the auditor. A discussion of these two possible variations and their effects should bring the case into sharp focus.

Similarly, the students might discuss their position had the fact, instead, been that of including the same modified statements and footnotes but with absolutely no reference either to the fact that they had been audited or to the fact that the audit report was avail-

able for inspection upon request. The omission of certain statements and important footnotes is still as grievous and, presumably, could lead to claims against auditors should the financials presented be construed as misleading.

The students might also discuss whether their solution would be affected by the belief that, in good faith, the auditors were not informed on a timely basis. Perhaps, management and its counsel lacked business sophistication that would say, "This is something we had better involve our auditors in." In this case, there is a hint that good faith may have been lacking. The client seemed more concerned with cost than with doing the "right thing" — that is, notifying the auditors on a timely basis and getting their view of what they considered was necessary in the circumstances.

No matter how indignant auditors may be over being bypassed, given the circumstances of this case, they probably have no legal action against the client.

Big GAAP/Little GAAP

During the audit of the Country Bank, one of your associates noticed another client's financial statements in the loan files. That client, Forthwright Co., is a small local manufacturer whose financial statements have never been audited. Your associate seemed to recall your having mentioned some financial difficulties at Forthwright, but her reading of the statements leaves no impression of financial difficulties.

The statements in the bank's files were compiled statements that contained no footnote disclosures but did contain your firm's report. Your associate casually mentions to you that she saw your compilation report on Forthwright in the bank's loan files and says further, "They sure didn't suggest to me that Forthwright was in trouble — of course, there wasn't much in the way of disclosures because you left out all the footnotes." Not liking her inference, you counter that it was Forthwright and not you that omitted the footnotes and, further, that they had every right to do so according to Statement on Standards for Accounting and Review Services No. 1.

While you may have straightened out your associate as to what is what, you feel far from elated. You seem to recall Mr. Forthwright was adamant that he wanted all disclosures omitted even though you were suggesting that you put together statements with all of the generally accepted accounting principles-type disclosures you were aware of. Mr. Forthwright had said, "Most of those disclosures are silly. I sure don't need them to run my business, nor does my banker need them; he knows everything about my business. Besides I doubt if I'll even give them out, I just want a record for my files." So, you left off the disclosures.

Yet, you wonder. Mr. Forthwright may have changed his mind and given those statements to the bank (which he had every right to do), or the bank may have asked for them. You wonder, for example, if the banker is aware that if the Environmental Protection Agency has its way, expensive equipment to clean up chemical wastes will need to be installed over the next two years, and that would really strain Forthwright financially unless suitable financing could be arranged. Worse yet, the statements you compiled do not show a strained financial position now, but that is only because Forthwright sold a lot of its equipment at December 31 and leased it back in order to bolster its cash so as not to be in default on its working capital requirements under the bank loan agreement.

And you wonder now if you should have stuck to your guns and told Mr. Forthwright that if he did not use the disclosures appropriate to generally accepted accounting principles on his financial statements, he could find himself another boy. On the other hand, he could be right — the banker may know all of this.

You keep thinking, "Maybe I ought to do something; but, what?"

WHAT SHOULD YOU DO?

STUDY GUIDE

Big GAAP/Little GAAP

Objectives of the Case

The broad issue is whether two standards of disclosure are appropriate for annual financial statements given to users outside a company, whether such difference in disclosure is based on size, public ownership, users' needs, or other criteria. Closely akin is whether standards should be required beyond those that appear to be necessary for specific users. Also at issue is whether accountants/auditors should associate their name with financial statements devoid of all disclosures, including some that might be relevant to the users. Further, who is in a position to decide what is and what is not relevant? And, at issue is the question of whether, and if so how, accountants/auditors can satisfy themselves that, to their knowledge, the omission of disclosures was not undertaken by clients with the intention of misleading those who might reasonably be expected to use such financial statements. The students should also explore the imponderables in trying to appropriately say what should be Big GAAP and what should be Little GAAP. At issue also is the responsibility of the accountant for compiled financial statements devoid of all disclosures both when the accountant is comfortable and, as here, uneasy about their absence. And on the question of responsibilities, the case should develop the student's perceptions of the credit grantor's responsibility in accepting a report that clearly states that omitted disclosures might influence the lender's (user's) conclusion.

The students may want to discuss the ethics involved where an auditor learns through a client's audit certain matters affecting another client of the same firm. Though such is not the objective of the case, it certainly introduces the possibility of interesting actions or constraints.

Applicable Professional Pronouncements

Statement on Standards for Accounting and Review Services No. 1, "Compilation and Review of Financial Statements"

Statement of Financial Accounting Standards No. 21, "Suspension of the Reporting of Earnings Per Share and Segment Information by Nonpublic Enterprises"

Handbook of Accounting and Auditing, Burton, Palmer, and Kay, pages 4-2 to 4 and 4-9 and 10 (nonauthoritative)

Business Assumptions and Other Data

The FASB and the AICPA unfortunately did not agree on the definition of nonpublic enterprise (or nonpublic entity). However, the disparity is of no consequence here — Forthwright meets both definitions.

The students can be told that this is the present accountant's first engagement for Forthwright, and it is not exclusively a compilation engagement. The principal activity for the client was perceived to be assistance in preparation of tax returns and participation in tax planning and advice. The previous accountant had prepared unaudited financial statements without disclosures, but marked for management use only as was permitted professionally before the advent of Statement on Standards for Accounting and Review Service No. 1, which became effective around mid-1979. The problems discussed in this case were not present in the June 20, 1979, year-end statements reported on by the previous accountant.

Discussion

There are so many issues involved in this case that to try to cover them all would be just too much. Some of the issues are discussed briefly below; however, all of those issues may not be developed by the students. They will recognize at the outset that no such thing as a professionally correct answer exists. One auditor might do this; another, that; and a third, nothing. Yet they could all be right, or all be wrong, dependent on the person making the judgments as to right or wrong.

The students should discuss the dual standards of disclosure and accounting that might be appropriate professionally. Here we have a set of annual financial statements with no disclosures. Since mid-1979 that is all right — thus establishing a standard for nonpublic entities that differs from standards for public entities. Statement on Financial Accounting Standards No. 21 permits nonpublic enterprises to omit disclosure of earnings per share and segment data. Both of these variable standards hinge on public or nonpublic ownership, and, of course, are quite narrow in application. Other disclosure or accounting differences could hinge on size of company, industry, or something else. The differentiation need not be limited to ownership criteria. For example, the Securities and Exchange Commission makes a number of disclosure distinctions based on size alone, such as those requiring disclosure of interim earnings, and current value or changing price data when certain size tests are met. Similarly, distinctions in both disclosure and accounting requirements can be found.

On a broad scale people often lump these distinctions together under a catch-all phrase, "Big GAAP/Little GAAP." The issue has facets other than Big-Little, but that is a good discussion topic for the students. As early as the mid-1970s the American Institute of Certified Public Accountants was attempting to deal with Big GAAP/Little GAAP. The Financial Accounting Standards Board has since mounted its effort, but no authoritative guidance has come from either. Who is to say what is "Big" and what is "Little"? Who can set the standards and how can a sort be made between "Big" and "Little" for each of the hundreds of disclosure requirements?

One student may say "little" companies should be able to omit pension plan data, operating lease disclosures, most foreign translation disclosures, and research and development disclosures. Another student will have a different laundry list of disclosures and omissions appropriate for "little" companies.

The *Handbook of Accounting and Auditing*, Chapter 4, could be used by the students to further their understanding of the disclosure issue for "big" and "little" companies which "have come under pressure to expend considerable amounts in producing informa-

tion that they feel is not relevant to users.” The Handbook quotes from the 1979 Annual Report of Dan River, Inc., thusly:

Some material in the Notes to the Consolidated Financial Statements . . . is complex and, in the opinion of management, unnecessary to an understanding of the company. Such material is included only because it is mandatory, primarily due to government regulations and, to a lesser extent, the requirements of the public accounting profession.

And the Handbook goes on to say, “There are no signs the expanding disclosure movement will halt.”

The “big” SEC-reporting companies continue to be battered with disclosure requirements; some relief may come for “little” companies. Though such relief may develop, and most likely very slowly, apparently few if any companies in good conscience are advocating deletion of all disclosures — the Forthwright case.

The students should discuss what happened to suddenly produce a seal of approval for what had previously been banned — association of an accountant/auditor’s name with financial statements distributed outside the client company without GAAP-type disclosures.

The old rule seemed to work — that is, unless a client “cheated” and, ignoring the legend saying “for internal use only,” distributed the financials. The new rule produces precisely the problem faced by the accountant/auditor for Forthwright. Can the new rule be better than the old? At least students should discuss whether they would want their names associated with Forthwright’s statements, sans all disclosures, with foreknowledge that they would be used for credit purposes. Some accountants would refuse, and do refuse, such an association, notwithstanding the admonition in their report that

Management has elected to omit substantially all of the disclosures (and the statement of changes in financial position) required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s financial position, results of operations, and changes in financial position. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Presumably, Forthwright’s accountant/auditor also would have refused association with his name had he not been under the impression that the statements were to be used “for internal use only.” Can statements that omit all (or substantially all) disclosures ever convey the financial data of a company with sufficient clarity to be meaningful, and not misleading, for use by creditors, investors, and the like? Perhaps in a few isolated cases they clearly can. But in most of the cases, as with Forthwright, the answer is not so clear.

And, that point could lead the students to a discussion of what is the responsibility — if, indeed, any — of Forthwright’s bankers to do something on their own after having read the accountant’s caveat, above, that if they knew what might be missing from the statements their lending judgment might be influenced. The banker is more likely to be a plaintiff than a defendant should the statements be grossly “underdisclosed” and should losses to the bank result. The courts are yet to weigh what responsibility resides with the bank to do something further; so, as a minimum, accountants could be faced with sizable legal fees before that question is answered. The companion question is whether accountants/auditors can hide behind a caveat such as the above if they are aware of information

that, were it known to outsiders, would most likely influence their lending or investment decision. To our knowledge, no case has been adjudicated under the Statement on Standards for Accounting and Review Services No. 1 omitted-disclosure caveat — and may never be. Students should consider carefully, however, if that is the kind of case in which they would want to be a defendant.

Along this line, the students also should discuss the meaning of the language of Statement on Standards of Accounting and Review Services No. 1 to the effect that the omission of substantially all disclosures was not, to the accountant's knowledge, undertaken by management "with the intention of misleading those who might reasonably be expected use to such financial statements"; and, more particularly, they should discuss how an accountant/auditor can reasonably make any judgment except that the omissions were made with the express intention of misleading the users. That intention may not be present in a given case, but, by definition, financials that omit significant disclosures are "misleading." So how can the accountant/auditor say the client did not intend to mislead when what the client is handing out is misleading on its face?

The Solution

As noted earlier, the solution is what is perceived by the individual. There is no "right" answer. The case is a composite of more than one case and thus the solution given is a representation of suitable action where such case is encountered. The accountant should not breach the confidentiality of the information his associate obtained while plowing through the bank's loan files and thus should not tell Mr. Forthwright that he is aware that the bank has a copy of the statements that the accountant understood would likely remain with the company. The accountant could say to his client that his firm is concerned about issuing these kinds of reports where all disclosures have been omitted, unless the omission pertains to mundane subjects such as the method of depreciation used because such reports could be obtained and used by lenders or investors to influence their investment decisions. Further, he could say his firm has decided that in the future where matters of substance should be disclosed the firm will require GAAP-type disclosures. And, still further, he could say that where lenders or investors have been furnished statements in which disclosures of substance were omitted, the firm is advising its clients to consider, along with their attorneys, the desirability of furnishing such information to the users.

The accountant/auditor should be concerned as to whether Mr. Forthwright's indication that he would probably not give out the statements was in fact an attempt to deceive. While the answer probably can never be determined, where the accountant/auditor has a nagging feeling that he has been tricked, the suggested advice above should be confirmed in writing. And, further, in this situation, the accountant may want to contemplate the advisability of continuing to service the client.

Special Reports

You have received a call from the president of Farm Land Investment Corporation (FLIC) asking you to undertake a special engagement. FLIC is a subsidiary of Farm Agri-Management Company, which specializes in the management of irrigated farm land for many diverse ownership interests. FLIC deals with outside investors, selling shares in Farm Agri-Management's projects.

The farm land in the current project is in 170 circular parcels of 130 acres, each of which is planted with grain and each of which is irrigated by a circular irrigator. Each parcel has been clearly segregated and has been sold to outside investors. Ownership, parcel by parcel, differs; the grain from all parcels is intermixed in common grain silos. The management company supervises the property and directly oversees the planting, irrigating, and harvesting, the latter of which is done by independent contractors. When the property is harvested, the tenant farmer recovers his cost and is paid a profit based on production. The management company obtains a commission for its supervisory services, and any remaining cash flow is returned to the investors. Generally, there is no remaining cash flow. The investors are relying on appreciation in the value of the farm land for return on their investment.

The president does not want you to audit the financial statements of the management company or the investment company. He would like you to examine the reasonableness (in quantitative terms) of the harvest allocated to each investor so that he can provide an annual accounting to the investors.

You expect that reporting on the reasonableness of the harvest would entail, among other things: reviewing grain harvest procedures, observing the harvest on a test basis, tracing observed truckloads of harvested grain to harvest records, confirming acreage with independent surveyors, agreeing quantities to records received from grain elevators, testing mathematical accuracy of grain harvest records, confirming quantities and qualities harvested with grain elevators, and confirming yields per acre with tenant farmers.

You are aware of the scope of Statement on Auditing Standards 14 and Statement on Auditing Standards 35 concerning special reports but you are not sure that they apply to reports of the nature described above.

**HOW WILL YOU DECIDE WHETHER OR NOT TO TAKE
THIS ENGAGEMENT? IF YOU TAKE THE ENGAGEMENT,
WHAT MIGHT YOUR REPORT SAY?**

STUDY GUIDE

Special Reports

Objectives of the Case

The lifeblood of any auditing firm is its ability to obtain quality new work that is profitable. This case study should focus on the auditor's ability to accept this new work and, assuming acceptance, the auditor's responsibility for amounts reported. Assuming acceptance, a further objective is to focus on the type of work to perform and the type of report to be used.

Applicable Professional Pronouncements

Statement on Auditing Standards, Special Reports, AU 621(SAS 14)

Statement on Auditing Standards, Special Reports — Applying Agreed Upon Procedures to Specified Elements, Accounts or Items of a Financial Statement, AU 622 (SAS 35)

Off-Balance-Sheet Financing

Glass Bottle Company has perfected a new process for manufacturing small plastic bottles at half the cost of any comparable product. Glass has been actively promoting its new process and the response has been enthusiastic.

One of Glass's potential customers, International Drugs, could use so many plastic bottles that Glass would need to build a plant specifically to fill its orders. Glass does not have much capital and wants International to finance the construction. International refuses to put up cash, but wants the bottles and is agreeable to almost any financing plan.

Initially, Glass offered to create a new subsidiary, Plastics, to build the plant, finance it with a 100 percent bank loan, and lease it to International for 30 years. Lease payments would be substantially equal to the payments on the bank loan, which would be collateralized by the plant and by the lease agreement. Glass would have a 30-year management contract to operate the plant, for a fee. The plan looked good, and it certainly was convenient. The bottle plant was to be built next to International's main manufacturing facility and a conveyor belt was to carry the bottles into International's packing room.

But a snag soon appeared. International's auditors said that under Financial Accounting Standards Board Statement No. 13 on leases, the Plastics lease would require capitalization and the related additional "debt" would put International into default on its debt/equity requirement. Their conclusion was based on the fact that the proposed lease provided for minimum lease payments with a present value in excess of 90 percent of the fair value of the leased property. And so, International asked Glass to try again.

Now Glass has a new plan. Once again a new subsidiary (Plastics) would construct and finance the plant. This time, however, International would not be required to sign a lease but would simply be required to sign a purchase agreement. Under the purchase agreement, International would express its intention to buy all of its bottles from Plastics, paying a unit price which at normal capacity would cover labor, material and overhead, the Glass operating fee, and the debt service requirement on the plant. That expected unit price is substantially lower than current market. Also, under the agreement, if International takes less than the normal production in any one year, and if the excess bottles are not sold at a high enough price on the open market, International is to make up any cash shortfall so that Plastics can make the payments on its debt and retain a profit to the extent of the management fee. The bank will be willing to loan the money for the plant, taking the plant and the purchase agreement as collateral.

Glass is pleased with the new plan. It will have the management fee from operating the plant and a guaranteed source of funds sufficient to service the obligation for the plant. International has an assured source of supply, without incurring any obligation. The bank has its loan and feels secure. Glass's only concern is that International's auditor might object at the last minute. Glass's controller explains, "They were going to make International capitalize that lease but surely they can't make International capitalize a purchase agreement. But just to be on the safe side, I'd like *you* to study this deal and tell me what you think. I'd like to be able to tell International that our auditors agree that this contract need not be recognized as an asset, or as a debt."

**WHAT DO YOU THINK OF GLASS'S NEW PLAN?
DOES INTERNATIONAL HAVE AN ASSET AND A DEBT TO RECORD?**

STUDY GUIDE

Off-Balance-Sheet Financing

Objectives of the Case

This case illustrates the difficulties that can arise in accounting for the economic substance of a transaction within the current accounting framework. The economic substance appears to be the financing of the construction of a new plant. However, a broader view of the economic substance of the proposed transactions might be the financing of a source of supply of small plastic bottles. One's view of the substance of the transactions could in fact affect the ultimate answer; yet, it should be clear to the students that whatever is being financed, the applicable financing is wholly dependent upon International's financial support, in one form or another.

The case further should develop an understanding of the inability of accounting standards to cope with fluid arrangements such as are demonstrated here. Neither the specific Statement on "Accounting for Leases" nor the more general Statements on "Accounting for Contingencies," "Product Financing Arrangements," and "Disclosure of Long-Term Obligations" are sufficiently comprehensive to furnish all the answers needed to account for the ever-increasing off-balance-sheet financing schemes.

Also, the case should encourage the student to focus on the business aspects of each of the propositions to visualize whether in substance they are the same or different. The principal consideration seems to revolve around property rights — at inception, during, and at the end of the 30-year contracts. Some other considerations would be the proprietary rights to formulae, technical know-how, and processes, particularly at the end of the contracts; the status of the management arrangement at the end of each contract; and the ultimate economics of the operating contract (under the lease) compared to the comprehensive unit price of product (under the supply contract). Accounting solutions are evolving more and more toward economic substance rather than legal form, though "rule book" requirements of certain accounting standards continue to stifle the recognition of such substance.

And, as is so often true when alternative business arrangements are available, the accounting consequences at times have forced the selection of one business decision over another. The students perhaps should talk about this very real fact of life and its application here.

Applicable Professional Pronouncements

Statement of Financial Accounting Standards No. 13, "Accounting for Leases," paragraphs 1, 5, 6, 7, 10, 64

Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," paragraphs 8, 10

Statement of Financial Accounting Standards No. 47, "Disclosure of Long-Term Obligations," paragraphs 6, 7

Business Assumptions and Other Data

In general, there has been a trend, since the mid-1960s, to debt financing for many major business enterprises. This has resulted from weak equity markets and the relative tax benefits of debt as opposed to equity financing. However, there are limits; companies are generally constrained by indenture covenants that specify maximum debt to equity ratios. Creative financial officers and investment bankers try to avoid covenant constraints by financing "off balance sheet." Initially, leasing was the way, but the Accounting Principles Board, through Opinions 5, 7, 27, and 31, and the Financial Accounting Standards Board, through Statement No. 13, largely reduced the off-balance-sheet financing possibilities inherent in leasing.

Therefore, companies and investment bankers are developing new means to finance off balance sheet. Some of the methods are: nonconsolidated captive finance companies, leveraged joint ventures, and take-or-pay contracts (which seem to fit the proposed supply contract). Naturally, the Accounting Standards Executive Committee is addressing problems raised by known methods of off-balance-sheet financing. And the FASB has recently issued two Statements aimed at off-balance-sheet financing: No. 47, "Disclosure of Long-Term Financing," and No. 49, "Accounting for Product Financing Arrangements." However, as with SFAS No. 13, it seems likely that as soon as a precise set of rules is established, a new financing method will be developed that will avoid the precision of the rules.

In this case, the use of the subsidiary, *Plastics*, in both instances would be for business reasons and would not affect the answer to the accounting question.

It should be assumed that in both alternatives the plant and facilities would remain the sole property of *Plastics* with *International* having no property rights at the end of the 30-year terms specified. Were the property to revert to *International* at the end of the lease, the accounting would not have been altered from that required by SFAS No. 13. However, if it reverts to *International* under the supply contract, some change in accounting may be appropriate.

Also, it should be assumed that the proprietary rights to the new manufacturing process remain with *Glass* or *Plastics* at the end of 30 years under either arrangement. Whether receiving a fee for operating someone else's plant (under the lease) might result in the same ultimate economic benefits to *Plastics* (or costs to *International*) as running one's own plant (under the supply contract) would have a bearing on whether the contracts are substantively the same. For this case, assume that some differences naturally would result but the effect would be immaterial.

Debt vs. Equity

Hopeful, Inc., a privately held company, has been struggling for several years to bring a new product to fruition. They have spent a great deal of money on product development and on market research. The original stockholders' equity is gone and their resources for borrowed funds are exhausted as well. Management is confident that with another year's work their product will be ready to go, but they need operating funds for that one more year.

To find those funds, management has desperately been exploring all options. The banks have all said that the company is too highly leveraged now and they have refused to extend additional credit. The market for common stock of development companies is very depressed. And, the present stockholders will not agree to the sale of additional common stock because of the dilution that would entail.

The company's investment banker, however, has suggested a new scheme — that the company sell an issue of preferred stock in a private offering. With the additional equity provided, the company ought to be able to increase its bank borrowings. He has put together a preferred stock package which he thinks he can sell and which has been tailored to the company's expected cash flows. He proposes to sell a thousand shares of preferred stock at \$50, with a \$5 cumulative dividend, payable if earned. To be marketable, the stock must be redeemable in five years at the option of the holder at \$65 a share.

Clearly, the company does not intend to pay any dividends in the immediate future. However, if the product development goes as they expect, they should be able to pay the accumulated dividends within three or four years and to pay dividends from that point on. If things do not turn out well, the holders of the preferred stock will have a call on assets of the company equal to their original investment plus a reasonable return. The preferred stockholders would be junior to the outstanding bank debt, but senior to the common stockholders.

When the treasurer discusses this plan with you, you can tell that he is delighted. He points out that it will be difficult to account for the dividends and/or the increase in the redemption value. He suggests that you and he plan to discuss those questions later on, after the offering has been sold. He asks you to study the proposed preferred stock program and tell him if there are any other questions that need to be resolved now. After some hesitation, you ask him whether the preferred stock is really equity. You ask whether the \$50,000 should be classified as additional debt, rather than as additional equity. The treasurer's smile fades. He asks, "Why would you call preferred stock debt? I can get you all kinds of legal opinions saying that preferred stock is legal equity. I'll admit it has some strange terms, but debt is debt and equity is equity. What basis could you have to override the legal definition?"

**HOW SHOULD HOPEFUL, INC., ACCOUNT FOR
THE PREFERRED STOCK ISSUE?**

Shareholder Accounting

Fresh Wind had been owned equally by three individual shareholders. But, the three had some personal and business disagreements, and finally Mr. Three decided to get out. You and the company's attorney met with the three stockholders and worked out an arrangement whereby the company bought Three's stock, paying \$200,000 in cash and giving an eight percent, \$800,000, eight-year note, payable in equal annual installments.

One and Two then set out to find a new shareholder. After several months, they succeeded in interesting a prominent local citizen, Mr. Four. He is known in the community as an aggressive business leader and is reputed to have extensive real estate holdings. One and Two are happy to have him. He has agreed to become an equal shareholder, to sit on the board, and to lend his management skills when they are needed. He will not be a full-time participant in the business, but that may be just as well considering the previous conflicts between the three owner-operators.

Mr. Four appears to be a very wealthy man, but apparently he is "cash poor." In exchange for his stock, he has paid \$50,000 in cash and has given a \$950,000 balloon note (with eight percent interest) payable at the end of two years. Anticipating your concerns, One and Two asked Four for financial statements. He has given them a personal financial statement audited by another respectable firm. A few discreet inquiries among your business acquaintances verify that Mr. Four is indeed an intelligent businessman of considerable wealth.

You explain to One and Two that traditionally a stockholder receivable arising from sale of stock is shown as a reduction in equity and not as an asset. Mr. One, who is the financial man and responsible for relations with banks, is stunned. He says, "The purchase from Mr. Three was a credit transaction and we booked it as a reduction of equity and an addition to liabilities. Why can't the sale to Mr. Four be shown as an addition to our assets and our equity?" The company's attorney assures you that the transaction is totally legal under the state's corporation laws. The shares can be considered fully paid and nonassessable and the note is legally enforceable against Mr. Four by the corporation or its creditors. Mr. One argues, "It is a legal transaction and Mr. Four is certainly good for the money. We have a good asset and a good stockholder — I want the statements to reflect those facts."

HOW SHOULD THE STATEMENTS REFLECT MR. FOUR'S INVESTMENT?

Employee-Stockholder Transactions

As a partner in the Indianapolis office, you have responsibility for a wide variety of clients. Today you are scheduled to visit the two extremes — Gigantic Corp., a world-wide conglomerate headquartered in Indianapolis, and later in the day, Local Stores, Inc., a family-owned retailer that is a long-time tax and audit client. Gigantic's treasurer has asked you to review a new stock option plan they are considering for top management. The Local family asked you to stop by and meet a new man they have just hired as a store manager. They want this new man eventually to become a key part of the business.

At Gigantic, the treasurer explains that the condition of the stock market has negated the value of their traditional stock option plan which had met most objectives: employees were pleased with their compensation, and the company avoided any charge to income. But now, the employees have asked for a direct participation in the company's growth, apart from the vicissitudes of the stock market.

The treasurer has designed a new plan: The company would create a pseudo stock which would receive dividends but would not vote. Each employee would be given an opportunity to buy a certain number of shares of the pseudo stock at a price equal to the company's net book value per common share at the date of grant, such price being considerably less than market price (based on history to date). It is understood that the pseudo shares would not be tradeable and would have to be sold back to the company when the employee retires or otherwise leaves the firm. The purchase price would be based on the company's net book value per common share at the time the employee turns in the pseudo shares.

The treasurer argues that this is a normal stock transaction because the employees have actually put their own money at risk. Therefore, he is satisfied that there is no compensation expense connected with the program. After some further discussion, you disagree. You tell him that the program is in essence a profit-sharing plan and, in your judgment, that portion of the company's earnings which increases the book value of the pseudo shares must be considered to be compensation and charged against earnings. After some further argument, you convince the treasurer of your position and he decides to abandon the idea.

Moving on, you stop to visit the folks at Local Stores, Inc. You meet the new store manager and greet the members of the family.

They explain that to get the new manager, they had to give him a piece of the action. The company sold him a newly issued block of shares so that he has about a 25 percent interest in the company. The shares have been restricted, however — the certificates are stamped with the legend, “These shares may only be sold directly to the company.” There is no market for the stock and so it was agreed that the new manager would buy in at current book value. It has also been agreed that the company would buy the shares back at book value if for any reason he decided to leave. You congratulate them all and wish them well. As you get ready to leave, the bookkeeper stops you to say that she has never encountered a stock sale, but that she simply debited cash and credited common stock. “That was the right entry, wasn’t it?” You agree; that is the right entry, at least for the moment.

**SHOULD LOCAL STORES, INC., RECOGNIZE COMPENSATION EXPENSE
IF THE BOOK VALUE OF THE NEW MANAGER’S SHARES GOES UP?**

STUDY GUIDE

Employee-Stockholder Transactions

Objectives of the Case

What is compensation to employees has never really been defined in authoritative literature and, in a narrower vein, compensation paid through stock also remains undefined, though a number of authoritative pronouncements cope with various types of arrangements. The students should explore the nature of compensation, in general terms if they want, but surely in connection with stock transactions or involvement. Such a discussion could lead to a consideration that discounts on sale of stock and other stock sale arrangements can readily result in an income charge, whereas income credits will almost never result from premiums on sale of stock or other stock sale arrangements.

A specific issue for discussion centers around the appropriateness of using significantly different methods of accounting for what may be fundamentally identical fact situations. Are the two arrangements substantially the same? The case illustrates the difficulty in knowing how to differentiate between apparently substantially identical stock transactions and the fact that often accounting decisions are influenced by circumstantial evidence. The case may suggest that auditors are not always evenhanded in their dealings with large, SEC-reporting clients and smaller, privately held clients. The case should also direct attention (1) to the potentially wide variety of employee stock plans that do not fit the guidelines of Accounting Principles Board Opinion No. 25 or Financial Accounting Standards Board Interpretation No. 28 and (2) to the possibility that, because of this, their solutions will lack uniformity in spite of basically uniform conditions. The students may also want to discuss the merit or the logic of having a stock's change in book value or in market price serve as a measure of the economic benefit of services rendered.

Applicable Professional Pronouncements

No authoritative literature directly addresses the accounting for either Gigantic or Local, much less the anomalous answers given by the auditor to his client. Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," may be considered applicable; yet, fitting either the Gigantic or Local situations into its guidelines is difficult.

The Opinion does refer, however, to phantom stock or shadow stock plans. Financial Accounting Standards Board Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans," says it does not cover "book value stock option, purchase, or award plans."

Troubled Debt Restructuring

Your client, Unsuccessful Inc., a calendar year company, was not generating sufficient cash to meet its loan commitments. After a considerable amount of acrimony, creditors and the principal stockholder agreed that pressing for payment would only cause the company to flounder and seek protection under Chapter XI of the bankruptcy law. All of Unsuccessful's \$20 million long-term debt is at a ten percent annual interest rate due in equal installments over the next five years. The long-term creditors and the principal stockholder reasoned that a restructuring of that debt, of which \$4 million is the principal stockholder's, would increase their probability of recovery. Further, the principal stockholder believed that this would help to protect his and other stockholders' equity in the company.

In September, the company completed a refinancing that involved a partial conversion of debt into equity. The debt of the principal stockholder was converted into nonvoting common stock B, all of which participates in dividends and liquidating rights to the same extent as the initial issue of common stock. It has a current fair value of \$2 million, and is all owned by the principal stockholder.

The other long-term creditors each agreed to the following restructuring of the remaining \$16 million of debt:

- Forty percent was converted into preferred stock with a fair value of \$5 million and an annual dividend rate of ten percent.
- Ten percent of debt was paid on September 30.
- Fifty percent of the debt remained intact and was collateralized with long-term receivables (net of allowance for uncollectibles) having a fair value of \$7 million. The debt was extended from five years to eight years to parallel the long-term receivables. The annual interest rate was reduced from ten percent to five percent.

The current market interest rate is 11 percent. Although contingent interest was not specified, debt repayment will be accelerated if specified future earnings levels are achieved.

**WHAT ACCOUNTING RECOGNITION IS REQUIRED
FOR THE CURRENT YEAR?**

Purchase Accounting — Reporting Results

Diddle Stores, a national chain of discount stores, began negotiations to purchase D. Press & Sons, a smaller retail chain, in January, 1978. At January 31, 1978, D. Press's net worth, based on fair value, was \$5 million and, by terms of an agreement dated February 3, 1978, Diddle agreed to pay \$6 million cash for all of D. Press's outstanding stock. On November 1, 1978, the acquisition was finally consummated. Diddle paid the \$6 million even though D. Press's net worth had dropped to \$4 million by then. Consistent with its past pattern, D. Press lost \$1 million during the nine months between February 1 and October 31, 1978; as in the past, it was profitable in the last two months of the year, earning \$1.5 million. Both the seller and the buyer were aware of the seasonal earnings pattern of the past and both presumably expected a similar pattern to be repeated in 1978.

The February, 1978 agreement of purchase provided that control of D. Press would pass to Diddle upon payment of the \$6 million purchase price and transfer of the stock purchased. It did not, however, specify an "acquisition date" as that term is used in accounting for business combinations. For many reasons — some major, some minor — delay followed delay, and it was not until November 1, 1978, that the cash and the D. Press stock changed hands. Nonetheless, there were signs, suggestions, and hints that Diddle had some control, though surely less than full control, soon after the February agreement was signed.

At November 1, 1978, D. Press & Sons had cash, receivables, and inventory of \$4 million; the fair values of property, plant, and equipment approximately equaled the liabilities. Therefore, when Diddle recorded the purchase, it recorded \$2 million of goodwill to balance the purchase price with the net assets received.

Diddle naturally included D. Press's \$1.5 million earnings from November and December in the consolidated results for the year ended December 31, 1978. Of course, the Diddle footnotes describe the acquisition and report pro forma results as if the transaction had taken place at the beginning of the year.

CRITIQUE DIDDLE'S ACCOUNTING AND REPORTING REGARDING THE ACQUISITION OF D. PRESS & SONS.

Purchase Accounting — A Bargain Purchase

Matrix Mfg. Co. has purchased, in a stock for stock transaction, 100 percent of West Taxicab Company, which owns operating permits issued by three major cities for fleets of taxicabs. Matrix exchanged nonvoting, cumulative preferred stock for all of the West common. The market price of Matrix shares issued in the purchase is \$5 million. Vital statistics for West, formerly a subsidiary of a large corporation, and the accounting Matrix proposes for the purchase are as follows:

(\$000s omitted)

Balance Sheet Accounts	West's Net Book Value	Fair Value of West's Identifiable Assets	Proposed Accounting Application	
			Allocation of Excess	Matrix's New "Cost" For West
Taxicabs	\$ 3,000	\$ 1,500	\$ (600)	\$ 900
Garages and Equipment	1,000	2,500	(1,000)	1,500
Permits	—	6,000	(2,400)	3,600
Goodwill	1,000	—	—	—
Liabilities	(1,000)	(1,000)	—	(1,000)
Total	\$ 4,000	_____	_____	\$ 5,000
Fair Value of "Purchased Assets"	_____	9,000	_____	_____
Cost of Purchase	_____	5,000	_____	_____
Excess of Fair Value Over Cost	_____	\$ 4,000	\$(4,000)	_____

The valuation of the permits is based on bona fide offers made by three other taxicab operators within the last two months. The permits probably can be said to have an indefinite life, but they will be amortized over 40 years. The fair values of the other assets are based on sound appraisals. The average useful remaining life of the taxicabs is three years and of the garages and equipment, 15 years.

West's operations have suffered recently due to fuel difficulties and related economic dislocations. As a result current profits are depressed.

**CRITIQUE THE ACCOUNTING WHICH MATRIX
HAS PROPOSED FOR THIS PURCHASE.**

Pooling of Interests Accounting — Intent

Your client, Conglom, Inc., a New York Stock Exchange favorite, has acquired over a period of years several businesses that have worked out quite well. It has profitable subsidiaries in lines such as home computers, seismographic operations, agricultural chemicals, and solar energy. Its earnings have shown steady growth, and the stock market shows its appreciation and expectation by way of a high price-earnings ratio.

A month or so ago you and Conglom's treasurer discussed the proposed acquisition of Byum, Inc., a nationwide real estate brokerage operation with a number of subsidiaries, some of which own and operate apartment houses in various cities. What with the depressed real estate market, high interest costs, inflation, and flat earnings, the stock of the real estate company was trading at less than book value. The acquisition was to be made by a simple, straight-forward exchange of common stock for common stock using market prices. After reviewing the criteria for business combinations, the treasurer and you readily agreed that, if the deal went through, the accounting would follow the pooling-of-interests method.

But now the treasurer is on the line — with other ideas. He says, "It looks like the deal for Byum will go through. As I see it, if we intend to sell off some of those apartment house subsidiaries, or any of our other assets, we have to use the purchase method of accounting; and, no matter how I figure it, we'll have a minimum of \$20,000,000 negative goodwill to take into income over the next three years. We can discuss whether three is the right number of years later, but I just wanted to check and be sure that purchase accounting is OK before we close the deal." With considerable lack of enthusiasm, you say, "Yeah, that's what the 'book' says, provided it's a significant part of the assets and not a disposal in the ordinary course of business." He quickly responds, "That's great; you can tell us later what is significant and that's the amount we intend to sell. And, thanks."

Your lack of enthusiasm centers around the thought that here is a company that may be able to "manipulate" \$20,000,000 or more into its future earnings stream by expressing an intention to sell off some properties. Your uneasiness is fortified by your recollection of a situation that confronted you some six months earlier. Another client had acquired a ladies' apparel manufacturing complex in a pooling-of-interests transaction with no intention (represented in writing) of selling off any assets. But, notwithstanding such intention, it had in fact sold off a significant, unprofitable girdle and corset manufacturing subsidiary 16 months after acquisition. So much for intentions then and now.

DID YOU GIVE THE RIGHT ANSWER TO CONGLOM?

**WHAT WILL YOU TELL THE TREASURER IS A
"SIGNIFICANT PART OF THE ASSETS"?**

**IF THE PURCHASE METHOD OF ACCOUNTING IS FOLLOWED,
WHAT WILL YOU DO IF CONGLOM DOES NOT SELL OFF
A SIGNIFICANT AMOUNT OF ASSETS?**

STUDY GUIDE

Pooling of Interests Accounting — Intent

Objectives of the Case

A broad objective is to have the students debate the validity of the pooling-of-interests method of accounting. Many accountants and others have long questioned the concept, except perhaps in limited situations such as a business combination of affiliates or companies under common control. Related considerations include (a) the appropriateness of an accounting policy that produces significant accounting swings based on intention alone, (b) the accounting consequences of a subsequent deliberate violation of that intention or an existing intention to violate conditions negotiated at the time of acquisition. Further, the students should focus on the form-versus-substance issue — that is, whether one can identify the economic substance of a pooling as contrasted to the economic substance of a purchase. Part and parcel of the form-versus-substance issue is the need to focus on the practice of “structuring” transactions to achieve different accounting results without necessarily changing the economic effects of the transactions.

In a narrower sense the objective is to have the students deliberate on the meaning of “significant part of the assets” and “in the ordinary course of business.”

Applicable Professional Pronouncements

Accounting Principles Board Opinion No. 16, Accounting for Business Combinations

Business Assumptions and Other Data

By way of background the students should be aware that a time-honored practice has been to try to structure business combinations as purchases (rather than pooling of interests) where the purchase price results in substantial “negative goodwill” (a “deferred credit” according to APB Opinion No. 16). The attraction of purchase accounting can be even stronger if material, noncurrent assets do not exist that have to be reduced to zero before determination of negative goodwill. While not all companies have pressed to qualify for purchase method accounting when acquired net assets exceed cost, the temptation sways many companies because of the boost in future earnings resulting from amortization of negative goodwill.

The stock-for-stock exchange ratio was based on market prices, as stated. Though not necessary for the solution, that fact, with others, tends to make the acquisition generate substantial negative goodwill. Some of the other factors are:

- Market price of the brokerage company stock is already below book value.
- Apartments had been held for a number of years, and depreciated cost is less than net realizable value, which has been influenced by inflation.

- If apartments are to be sold they are required to be valued at net realizable value (which is not reduced to zero by an excess of acquired net assets over cost).
- Because it is a service organization, the brokerage company has relatively little in noncurrent assets which also would need to be reduced to zero.

Though not necessary to the solution as stated, the students should be aware of the circumstances which attracted the treasurer to do a flip-flop in roughly a month's time. (Some students may be quick to suggest that the auditor should have pointed out this attractive possibility a month or so ago and not waited for the treasurer to come up with it. Others may disagree.)

Though not stated in the case, Byum has never sold a subsidiary. Further, the apartment house subsidiaries, which have been in existence for varying periods from three to nine years, have never sold any of their owned properties. They are jealously trying to guard a tax position that they believe will allow a more favorable tax rate if and when any properties are sold. (The parent, Byum, buys and sells properties from time to time for its own account, but never carries an inventory held for sale, as such.) As to Conglom, it has on occasion sold unprofitable subsidiaries and operations and is expected to continue to do so.

Discussion

The students may recall that a number of years ago, perhaps in 1968 or 1969, when the world was sick and tired of "pooling abuses," the Accounting Principles Board circulated a draft opinion that would have effectively dispatched the pooling-of-interests method — it would no longer have been acceptable. But the draft failed to gain sufficient support and APB Opinion No. 16 followed in 1970. The "Background" section in that Opinion does a good job in summarizing the pros and cons of pooling-of-interests accounting. Those arguments are not repeated here, but the students may want to discuss some that are of interest to them.

Roughly three years later, in 1973, the Accounting Principles Board issued its Opinion No. 29 on Accounting for Nonmonetary Transactions, wherein it stated, "The Board concludes that, in general, accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as used in monetary transactions." But, that principle is stated not to apply to business combinations accounted for as a pooling of interests. Also, the students may want to discuss, as part of the conceptual support for poolings, the anomaly that is provided in APB Opinion No. 20 (1971) whereby a business combination reported by the pooling-of-interests method results in a different reporting entity but remains the same entity if the purchase method is followed. We all know the entity is the same in either case. Saying it is different does not make it different.

One of the principal positions stated in opposition to the purchase method (thus supporting the concept of pooling) was the inability to determine fair value in many cases. If inability to determine is a valid argument, the students may want to discuss why it loses its validity when the uncertainty of such things as intent and contemplation (keystones of the pooling concept) are understood. Some students may want to discuss the soundness of an

accounting principle that requires one to wait two or more years before knowing if, when all facts are known, the right accounting decision was made. Estimates of future events are made all the time; they are a part of accounting. But, when estimates are later discovered to be in error, the result is typically a change in dollar amount, not a change in accounting principle or a belated recognition that the wrong accounting principle was used.

The intention of management plays a part in accounting in situations other than pooling-of-interests accounting. (It is fair to say auditors like to hold intention-based accounting to a minimum.) In many cases, the intention bears solely on classification of assets or liabilities, for example, intention to hold marketable securities as an investment. In perhaps fewer cases intention bears directly on net earnings, for example, intention not to repatriate foreign earnings or intention of a savings and loan association not to pay dividends from tax-restricted reserves. In still other cases, intention alone is insufficient, for example, not only must management have an intention of refinancing short-term debt as long-term debt after the balance sheet date, it must also have an irrevocable contract so that the intent can become reality.

Authoritative literature offers little guidance toward concepts that would establish when intention alone is enough to affect the accounting. The students may perceive the unwritten guidelines to be that when management has the ability to unilaterally carry out its intention then the accounting can follow that intention. But, when action of an outside interest is necessary to carry out management's intention, the accounting must await the outside action. The theory is sound; unfortunately many of the situations are not clear-cut as to management's ability to perform in what appear to be unilateral actions. For example, management may not recognize a loss from market declines in a bond portfolio on the basis it intends to hold the bonds to maturity; yet adverse future developments could make it imperative that the bonds be sold before maturity to provide needed working capital. Such is the situation here; Byum intends to sell apartments, or failing that, some other assets not in the ordinary course of business, within two years to "break" the requirement for pooling-of-interests accounting. While management's intention may be good, market conditions or other factors may operate in such a way that the intention cannot be carried out.

Professional literature gives some guidance here and there as to what to do if accounting recognition is given an intention and that intention fails. For example, in the foreign earnings and savings and loan reserve cases, literature says accrue the taxes previously not accrued. In the case of an intention not to sell assets (the opposite of this case) in order to qualify for pooling treatment, it says disclose the failed intention and show any gain or loss on the sale as extraordinary. But nothing is said about a failed intention in the fact situation applicable to this case.

In discussing failed intentions, the students may see a need to differentiate between deliberate violation of an intention (such as Conglom now likes all its assets too much to sell any of them off) and a preconceived plan at the time of combination not to carry out the stated intention that threw the accounting from one method to the other. Professional literature offers no specific guidance as to the sort between the two types of failure. Were the latter situation known at the time of initial accounting, the intention would be disregarded in the selection of an accounting method. (And, some serious question would result as to whether to continue a professional relationship with a client who attempted to

deceive.) Were the latter situation to come to light after the initial accounting, some students would opt to reverse the purchase accounting retroactively and restate under pooling concepts. The students should understand that proving, in an audit sense, an earlier design to deceive would be most difficult. Even an admission of deceit would be viewed with skepticism — it may be a false, self-serving admission simply to switch to what now is a greener pasture. (Again, continued client relationship would become a question.)

In most situations involving the form versus substance issue, the answer speaks for itself; for example, a sale of property for a note receivable bearing one percent interest. Such a clear distinction is missing in the case of purchase/pooling as to legal form and economic substance. Instead the distinction between the two is devoid of any form/substance comparison but rather rests on a number of man-made criteria, which as noted can be subject to rather easy manipulation — particularly going in the direction of “making” a pooling a purchase; it is considerably more difficult in the opposite direction. What the students might discuss is whether a so-called pooling has economic substance, as such, or whether it is an accounting form only (surely not a legal form). If such be the thinking then what follows logically would seem to be that poolings are devoid of economic substance but rather are manufactured by following prescribed form. Stated differently, companies combining by stock-for-stock exchange possess the same economic substance regardless of whether called purchase, pooling, merger, amalgamation, consolidation, acquisition, or some other name - only the accounting differs. So, rather than the accounting following substance, it may be following form.

The students should discuss the pros and cons of “structuring deals.” It would be a poor businessman who did not “structure” a deal to the extent possible to obtain the best economic advantage. But, when transactions are structured solely to give a different accounting answer, they tend to be more suspect. In the case of Conglom the students should recognize that the \$20,000,000 additional income it is proposing to structure into the deal is not hard, quality earnings such as can be used to liquidate debt, pay out in dividends, invest in inventories, and the like. Though the income is illusory, some companies continue to strive to create it.

Opinion No. 16 does not define what is meant by a “significant part of the assets.” The natural inclination of the students may lean toward ten percent of total combined assets because some of the other criteria in the Opinion use ten percent as a break point. Others may consider a higher percentage — say 15 or 20 percent — because the test is applied to total assets of both companies rather than the assets of the company being “acquired.”

“Ordinary course of business” seems not to be defined explicitly in professional literature. Everyone seems to know what it means. But in Conglom’s situation, slight interpretation one way or the other triggers a monumental swing in future income. Presumably Conglom, as a service company, would be limited in the type of assets it would have for sale. Byum has plenty of assets it can sell but the question is whether any can be sold other than in the ordinary course of business of the formerly separate company. Conglom has sold subsidiaries before — presumably in the ordinary course — and is unlikely to be able to sustain further sales of subsidiaries as not in the ordinary course of business. Sale of a subsidiary by Byum may be said to be “in substance” a sale by Conglom. Byum has not sold subsidiaries but Byum has sold apartment houses and a sale of apartment subsidiaries

may be in substance the sale of apartment buildings. As stated earlier, Byum has sold apartment buildings before but never any that it had designated as held for operations. Yet it seems probable that in the world of real estate, even apartments held for operations will be sold from time to time. The character of the property, alone, in the hands of a real estate company may be enough to say that any sales qualify as "in the ordinary course." Arguments can be made both ways; the answer is not clear as to what sales, if any, will meet the test.

Interim Accounting — Deferral of Costs

The Kool-Komfort Ice Cream Company is a publicly held manufacturer and retailer of ice cream products. Their products are sold by vendors from mobile units which cover residential areas during the summer months. The product line includes the standard ice cream bars and Popsicles and also features several novelty ice cream treats as promotional items. These novelty items have usually been big sellers. The 1978 summer novelty hit was the Jaws Breaker, a grape Popsicle shaped like a shark.

The company's fiscal year ends October 31, which historically has been the end of the summer season. The selling season begins again in April. Between October 31 and April 1, the company expends a great deal of its effort to develop novelty treats for sale during the next selling season. The company does not start product research and development prior to October 31 because the theme is usually topical, as evidenced by their 1978 hit, the Jaws Breaker. The product research and development effort includes the following stages:

1. Identification of products for sale,
2. Market research as to consumer acceptance and enthusiasm,
3. Product design,
4. Production planning, and
5. Advertising.

The company's controller has asked how he should account for product development costs in the statements for the first quarter ending January 31, 1979. The company has settled on its main novelty product for the 1979 selling season, the Star Licker, a double Fudgsicle with the figure of a space ship on top. They have completed the first three steps described above and have incurred some costs for steps 4 and 5. By January 31, they have incurred a significant amount of development cost, but they are satisfied that the product will be a hot item. The controller believes that all the costs of developing the Star Licker should be deferred to the selling season and then amortized to cost of sales by October 31. But, he knows he must have them written off by October 31 because Financial Accounting Standards Board Statement No. 2 prohibits the deferral of research and development costs at year-end. He is not sure how the theory of Statement of Financial Accounting Standards No. 2 should be applied in interim reports, however, and he would like your advice.

HOW SHOULD KOOL-KOMFORT ACCOUNT FOR ITS DEVELOPMENT COSTS IN ITS INTERIM FINANCIAL STATEMENTS?

Uncertainties — Accounting and/or Reporting

You are partner in charge of the audit of Shangri-La, Inc. The company is a real estate developer, specializing in luxury vacation areas. The company's operations have been profitable, although not spectacular. Most of the development property is pledged as collateral for bank loans; there is a reasonable stockholders' equity of about \$10 million.

Shangri-La has a substantial investment in a large parcel of land in Key Biscayne, Florida. The company originally paid \$25 million for the property two years ago and has since capitalized an additional \$5 million in taxes and other carrying costs.

The property is zoned for single-family homes, but Shangri-La has been working diligently to have it rezoned for condominiums. As a site for condominiums, the property would be very valuable and the company has an appraisal to that effect. However, if sold as single-family home sites, it probably would be worth no more than \$15 million.

Shangri-La management concedes that their efforts at rezoning have met stiff local resistance, but they refuse to admit defeat. They are planning subtle social pressures on local political groups. Your audit inquiries confirm that the company has carried its rezoning campaign through the necessary legal steps and has been turned down each time. It will clearly be difficult to obtain rezoning for multifamily use but it is not clear that the job is impossible.

Your staff people on the engagement report real frustration on this matter. They have concluded that the client cannot be successful in its rezoning efforts, and, therefore, they have suggested that the land be written down to \$15 million. The client has obviously objected, arguing that any such adjustment prejudices their ability to do their job.

The treasurer takes the position that the uncertainty regarding the carrying amount of the Key Biscayne land is just that — an uncertainty — and for your people to insist, or really even suggest, that a write-down in value is necessary is merely showing your strong bias. He then launches into a voluble exhortation of why your people are off base, and he quotes generously from the so-called Trueblood Objectives Report (page 58), on which he has obviously been priming himself. In essence, the applicable portion of that report cautions against bias which benefits one group at the expense of another and further cautions that conservatism for its own sake may actually introduce bias.

While the treasurer graciously acknowledges the existence of an uncertainty, he goes on to say: "It seems to me that any big write-down on that land would reflect a bias, benefiting only you. Your benefit would be the reader's loss. I believe that a frank disclosure of the uncertainty results in a fairer presentation."

**WILL DISCLOSURE RESULT IN A FAIR PRESENTATION
OR MUST YOU INSIST ON A WRITE-DOWN?**

Liquidity Problems

You are in the final stages of completion of the December, 1981, audit of Revolutionary, Inc., which has been your client since it was formed in 1978. The company was organized to develop a new method of residential construction. The original impetus (and the original capital) came from American Home Builders Co., a very large construction company audited by another CPA firm. American originally put up \$2,500,000 but Revolutionary went through that in no time at all. American put in another \$2,500,000 and, simultaneously, Revolutionary had a public offering of stock, raising an additional \$5,000,000. Revolutionary's experimentation looks promising and, in fact, several of the pilot projects have been very successful. However, the company has been eating up cash at a startling rate. Cash drain has been \$1,500,000 a month. Up until now, American has been willing to loan funds to Revolutionary for operating purposes. The loans were always five-year notes and so are due in 1984 and 1985.

Most of Revolutionary's expenditures have been for salaries and supplies, and expensed as incurred. However, the company has also invested substantially in an assembly line plant and has capitalized a significant amount of legal and similar expenses related to patent rights.

This has been a difficult year for home construction, and American is having troubles of its own. In fact, one morning you read in the *Wall Street Journal* that American has announced its intention to sell its 50 percent interest in Revolutionary. When you stop by the office of the treasurer to discuss this development, you find that he has already anticipated your question. He has been in contact with American's chief financial officer, and Revolutionary has been assured that American will continue to provide operating finances as might be required. American apparently feels a moral obligation to the stockholders who came in on the public offering. You wonder out loud whether American would be willing to put that commitment in writing. The Revolutionary treasurer suggests that they probably would not, simply because they could not afford to encumber their own financial picture with a legal obligation. You point out that unless American will give some form of written commitment — or unless Revolutionary can line up some firm source of financing — you will have to reflect this new uncertainty in your audit report on Revolutionary's financials. The treasurer observes dryly, "How can it be any worse; your opinion is already subject to all of our assets. Do you mean you're now going to be subject to our liabilities as well?"

**HOW WILL THIS NEW DEVELOPMENT AFFECT YOUR OPINION
ON REVOLUTIONARY'S FINANCIAL STATEMENTS?**

Accounting for Hindsight

Chicago Properties is a publicly held company dealing in all kinds of commercial real estate, but specializing in apartments and condominiums. Since you have been assigned to the engagement, the mainstay of the company's business has been the development and construction of apartment complexes which they ultimately sell to individual investors or tax shelter partnerships.

One of the company's best customers is a local entrepreneur, Mr. T. M. Wacker. Mr. Wacker bought one of the company's apartment projects in 1975; he bought two more in 1976; and he bought a large complex in 1977. There were no sales to Mr. Wacker in 1978; however, during the 1978 audit, your staff tells you that the 1977 transaction has been rescinded and the \$800,000 profit which had been recorded last year has been reversed this year. The profit on that transaction was very material to 1977's earnings, and the reversal is a material part of the 1978 loss.

You look back at your 1977 work papers and see that the transaction was structured as follows:

Downpayment in cash	\$ 200,000
Downpayment by bank letter of credit	800,000
Note receivable	<u>4,000,000</u>
Total Sales Price	\$5,000,000
Cost	<u>4,200,000</u>
Gross Profit	<u>\$ 800,000</u>

The work papers show that the note receivable was examined and confirmed. Last year's audit team obtained a Dun & Bradstreet report on Mr. Wacker, and it showed that he was a man of some means but perhaps "cash poor." His credit was not seriously challenged, however, because all the notes he issued in previous transactions had been paid off in advance.

Your people also had gotten a confirmation from Mr. Wacker's bank confirming that they issued a letter of credit in favor of Chicago Properties drawn against Mr. Wacker. In effect, the bank confirmed that they would pay \$800,000 to Chicago Properties on demand; Mr. Wacker was apparently committed to either pay the bank or take out an \$800,000 bank loan in satisfaction of the bank's payment to Chicago Properties. The letter of credit was good for 180 days, issued at the date of the sale October 1, 1977, and expiring March 31, 1978, three months after Chicago Properties' December 31 year-end.

As it was originally structured, this 1977 transaction met the criteria specified in the American Institute of Certified Public Accountants Audit Guide, "Profit Recognition on Sales of Real Estate." For completed apartment houses, the guide requires a 20 percent downpayment, and Mr. Wacker's combination cash/letter of credit totalling \$1,000,000 exactly qualified.

You ask what happened to the Wacker transaction and the client's controller explains that Mr. Wacker asked for a 90-day extension of the letter of credit in March and then again in June of 1978. Finally, in September he acknowledged that he did not have enough cash or borrowing power to meet his commitment and he asked to be excused. The controller explained that, although the apartment complex was not fully rented, it was a showplace and Chicago Properties was happy to take it back. Besides, management felt they could "not lean too heavily" on Mr. Wacker because of their long-time business association.

You inquire into that long-time association in more detail. You find that Mr. Wacker prepaid all of his earlier commitments to Chicago Properties because he was able to resell the apartment houses quickly — as soon as he got them rented up. In fact, earlier transactions appear to follow a pattern — new sales to Mr. Wacker closely followed his payments on earlier purchases, and these payments themselves followed resales by Mr. Wacker of the apartment houses.

Rhetorically, you ask the controller whether Mr. Wacker really intended to go through with the 1977 transaction unless he was able to sell the apartment complex before the letter of credit expired. The controller assures you that Mr. Wacker will be happy to confirm his honest intentions and that the management of Chicago Properties will give you a letter of representations attesting to the bona fides of that transaction. When you ask why the company let Mr. Wacker extend the letter of credit twice and then let him out from under the deal, the controller explains condescendingly, "You don't kick a good customer when he's down."

**WHAT WILL YOU DO ABOUT THE \$800,000 PROFIT RECISION
IN THE 1978 FINANCIAL STATEMENTS?**

Contingencies

The controller of Big Deal Stores calls to complain that your auditors are creating chaos in his Executive Office. Specifically, he complains that your senior has been arguing accounting with the company's insurance manager. The senior suggested that the company treat all of their premiums as deposits and that casualty expense be accrued based on actual loss experience. The controller goes on, "He tried to tell me that Statement No. 5 from the Financial Accounting Standards Board prohibits income smoothing and permits accrual of a loss only when a loss can be measured. I told him that SFAS No. 5 prohibits income smoothing by insurance *companies*, but it says nothing about insurance *policies*." You ask your senior to come by the office that afternoon.

Your senior reports his side of the story: "I didn't say that all their insurance premiums should be treated as deposits. But, I really don't think their public liability policy should be considered insurance." He explains that Big Deal carries a large public liability policy with Lloyds of London. Premiums for the policy are based on the company's loss experience during the last five years. He argues that the company should have no expense in any years when they have no claims. But if they have a bad year with a number of claims filed, that year should bear *all* of the cost of those claims. He says, "The spirit of SFAS No. 5 is to prohibit income smoothing and, specifically, it says that insurance premiums must be treated as deposits unless the insurance company has in reality accepted the risk."

Together, you review the provisions of SFAS No. 5. The controller is correct in his understanding. The original purpose of the Statement was to stop insurance companies from providing general, unspecified catastrophe reserves. But your senior's understanding of the Statement is also correct. The Statement says that a loss should be accrued only when both of the following conditions are met:

- a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b) The amount of loss can be reasonably estimated.

The objective of the Financial Accounting Standards Board Statement seems clear — income smoothing is no longer acceptable. Although the Lloyds' policy is primarily a cash flow smoothing device, it effectively smooths income as well. Still, you have got to wonder whether the Financial Accounting Standards Board was thinking about Big Deal's policy with Lloyds when Statement No. 5 was written. After all, every insurance premium is based on the insured's experience, at least to some degree. Your senior has raised an interesting problem.

**HOW SHOULD BIG DEAL ACCOUNT FOR ITS
PUBLIC LIABILITY INSURANCE?**

STUDY GUIDE

Contingencies

Objectives of the Case

This case should focus the students' attention on the general nature of contingencies and contrast them with incurred expenses or costs. The case asks whether payments for insurance are in substance premiums paid which should be charged to expense or are in substance insurance deposits which should be carried as assets. By indirection, the case also should focus the students' attention on the possibility that Big Deal chose that particular type of insurance policy as an income smoothing device.

Distinctions between contingencies to be recorded and contingencies to be disclosed are often obscure, as would seem to be the case at Big Deal. Accordingly, there may be no right or wrong solution to the Big Deal case. Most students probably would agree that "income smoothing" is bad and should not be permitted. However, that is not to say that circumstances at Big Deal automatically brand their accounting for public liability premiums as an income smoothing device. Again, no right or wrong solution may be evident.

In all likelihood, the students will emphasize the issue of materiality in their attempt to arrive at a decision, but that should not be the focus of the case. Yet, it is quite true that in some years, in almost any company, the impact of the difference in accounting could be material, whereas in other years the impact would be inconsequential. Still, focus on the general nature of contingencies.

Applicable Professional Pronouncements

Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies"

Business Assumptions and Other Data

Every insurance policy is experience-based to a certain degree, and the more experience-based it is, the more it is like self-insurance. Statement on Financial Accounting Standards No. 5 discusses why true self-insurance is not really insurance. It is that discussion that framed the question raised in the case study. Some of the common gradations of insurance and self-insurance seen in practice involve: (a) situations where a number of companies deposit monies in a common fund to be available in cases of casualty with risk protection nonexistent as the casualty costs will be paid ultimately by the damaged company; (b) situations where elements of real protection (insurance) and elements of self-protection or "self-insurance" both are present, as is common in many retrospective rating policies such as illustrated in the case study; and (c) situations where all, or substantially all, of the risks of loss are insured by an insurance company. Even with the specific provisions of Statement of Financial Accounting Standards No. 5, it is difficult to know whether a contingency or a business risk as this case shows, should be ignored; whether it

should be recorded; whether it should be disclosed in a footnote; or whether it should be the subject of a qualification in auditors' report.

The original project which culminated in Statement of Financial Accounting Standards No. 5 had its origins in the SEC's concern over certain insurance companies which were effectively smoothing income over the years by use of catastrophic or similar reserves. Though Statement of Financial Accounting Standards No. 5 was issued as a general purpose Statement, covering gain and loss contingencies of every nature, it is heavily concerned with insurance reserves, illustrated in numerous examples in Appendix A of the Statement.

Any number of companies have retrospective rating policies of one kind or another, and Big Deal illustrates one such type of policy. In practice, the accounting often follows that at Big Deal. Whether that should be, is not receiving a great deal of attention within the profession at present. Because of its apparent conservatism, it finds tacit acceptance, yet the conservatism is illusory for in any year a company could sustain a catastrophic loss that would be measured in the earnings statement in a future year or years when the retrospectively rated premiums are charged.

The students may be aware that the insurance carrier is fully liable to successful claimants, irrespective of whether it is able to recoup its loss payments from the insured company through future premium increases. For example, following a catastrophic loss, or an ordinary loss for that matter, a company may cease business and cancel its insurance. Or, a company may cancel its insurance following a major loss in order to shift the burden of the loss to the insurance carrier. The latter course of action would seem improbable in an ongoing company as such action can reduce, or completely remove, the possibility that other insurance carriers would find their risk an acceptable insurance risk.

Discussion

Statement of Financial Accounting Standards No. 5 defines a loss contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability. When a loss contingency exists, the probability that the future event or events will occur can range from very probable to reasonably possible to remote. The Statement provides that

an estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

- a) Information available prior to issuance of financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b) The amount of the loss can be reasonably estimated.

One of the primary motivations for Statement 5 was preventing the accrual of arbitrary loss reserves by corporations in general, and so-called "catastrophe reserves" by insurance companies. That's why both conditions are to be met prior to the accrual. Before those conditions were imposed, some companies would accrue reserves in good years or in

years with major operating losses (i.e., the “big bath” syndrome). This accrual would benefit income in future periods or, in general, have a smoothing effect on income. The Financial Accounting Standards Board felt that such smoothing was inappropriate and did not reflect economic reality. Managements do not necessarily agree that smoothing is bad, and neither will the students.

Reserves for self-insurance are a type of loss contingency reserve that is generally not allowed by Statement of Financial Accounting Standards No. 5. The Statement argues against self-insurance as follows:

At the date of an enterprise’s financial statements, it may not be insured against risk of future loss or damage to its property by fire, explosion, or other hazards. The absence of insurance against losses from risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a contingency exists as defined [above]. Uninsured risks may arise in a number of ways, including (a) noninsurance of certain risks or co-insurance or deductible clauses in an insurance contract or (b) insurance through a subsidiary or investee to the extent not reinsured with an independent insurer. Some risks, for all practical purposes, may be noninsurable, and the self-assumption of those risks is mandatory.

The absence of insurance does not mean that an asset has been impaired or a liability has been incurred at the date of an enterprise’s financial statements. Fires, explosions, and other similar events that may cause loss or damage of an enterprise’s property are random in their occurrence. With respect to events of that type, the condition for accrual . . . is not satisfied prior to the occurrence of the event because until that time there is no diminution in the value of the property. There is no relationship of those events to the activities of the enterprise prior to their occurrence. Further, unlike an insurance company, which has a contractual obligation under policies in force to reimburse insureds for losses, an enterprise can have no such obligation to itself and, hence, no liability.

Though it is clear that the Board believes that there should not be reserves for self-insurance established, it is less clear when dealing with insurance policies covering possible losses. It seems to feel that if a company purchases insurance against a loss and if the risk of loss is indeed transferred to the insurance company, then the premium may be expensed. However, it goes on to say:

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such.

This last quote seems to be the key consideration in the case. The narrow issue is to decide whether the risk of loss has been transferred from Big Deal Stores to the insurance company, or, in other words, whether the policy provides for indemnification. Pragmatically, it is true that insurance for major companies is determined on their individual loss experience and may be, in effect, self-insurance through payments of premiums. The Financial Accounting Standards Board seems to indicate that such premiums should be treated as deposits, but this may be an overly rigid interpretation of Statement of Finan-

cial Accounting Standards No. 5. If the insurance policy provides indemnification, the premiums should be expensed.

The broader issue in the case is the distinction, generally, between contingencies that should be recorded and those that should be disclosed or not disclosed. The students should recognize the broader issue in their discussion while at the same time addressing the narrow issue. This case involving a public liability policy was presented because it was compatible with the initial focus of the Securities and Exchange Commission on the use of contingency reserves as a means of either (1) providing a reserve for unknown future losses likely to occur or (2) leveling income over a period of years, or both.

The discussion should help students to see that in dealing with contingencies, of whatever type, the accounting is most often in shades of gray.

The Solution

In the case at hand, the decision was to accept the accounting followed by the client in charging the insurance premiums to expense when paid. As a practical matter, casualty insurance for major companies, irrespective of the type of policy; may be determined to a large extent by their own loss experience; also, as a practical matter, the client in the case at hand could terminate the insurance and close off any future premiums based on retrospective rating. (Such action would not be likely, however, because of the probable effect on attempts to obtain insurance from another insurance carrier.) Experience under Statement 5 will doubtless provide more and more guidelines on which to base insurance decisions in borderline cases.

Profit Recognition

Our client, Sunflower Ship Building, began construction of two seagoing drilling rigs designed for service in North Sea oil fields. When they had invested about \$30 million in the two rigs they ran short of cash and realized that at least \$30 million more was necessary. Coincidentally it became apparent that there was a serious shortage of drilling rigs and that their work in process had considerable value. Sunflower was approached by Cash Inc., a personal investment company wholly owned by a wealthy individual. Cash Inc. offered to buy a 50 percent interest in the two drilling rigs under construction, to pay 50 percent of the cost incurred to date and 50 percent of whatever future construction costs might be incurred. In addition, Cash offered to pay Sunflower a \$5 million premium for the opportunity to buy in at this time.

The two parties negotiated a deal and formed a partnership. Sunflower donated its work-in-process inventory as its capital contribution and Cash Inc. contributed \$30 million in cash. In addition, Cash paid the promised \$5 million directly to Sunflower. The partnership then negotiated a line of credit with a group of banks to be sure to have sufficient funds to complete the rigs if construction costs should exceed the estimated \$60 million. In their agreement, the partners state their intention to lease the drilling rigs to independent exploration companies — several already have expressed an interest in chartering the rigs. Sunflower is to be responsible for the completion of rigs should the costs exceed the estimated \$60 million plus the amount provided by the line of credit. Sunflower will also act as leasing agent, for which it will earn a nominal fee.

As you review Sunflower's year-end financial statements, the controller explains that the cost of the work in process was simply transferred to an account called "Drilling Rigs Partnership." The \$5 million premium has been included in this year's income; the controller smiles, "It's an ill wind that blows no good."

DO YOU AGREE WITH THE CONTROLLER'S PROPOSED ACCOUNTING?

STUDY GUIDE

Profit Recognition

Objectives of the Case

There are indeed problems surrounding profit recognition as this case illustrates. Accounting practice and accounting literature abound with revenue recognition criteria applicable to specific situations (none of which is exactly on point in this case, however). There is not much in the way of authoritative guidance when it comes to general revenue recognition rules. The nonauthoritative Accounting Principles Board Statement No. 4 gives some guidance. Consequently, the objective of the case should be to promote the students' discussion of the general rules and the varying interpretations that might be applied in this case and that could result in dramatically different answers. At the same time, the students should recognize that changes in the fact situation in the case, though apparently not all that distinguishing and important, could also result in dramatically different answers. And, as is true for so many major transactions, the students should discuss whether the substance of the transaction is materially different from its legal form.

Applicable Professional Pronouncements

Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles," paragraphs 147 through 153

Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures," paragraphs 30 and 36

Industry Accounting Guide, "Accounting for Profit Recognition on Sales of Real Estate"

While the real estate references are not applicable to personal property, for which no similar guidance is given in AICPA literature, they should offer some guidance in determining the appropriate accounting.

Business Assumptions and Other Data

It can be assumed that the present estimated cost of \$60 million is a realistic estimate that likely will not be overrun. The degree of reliability in the estimate may or may not affect a student's analysis of the requirement that Sunflower is to be responsible for completion of the rigs. While this responsibility could take any number of forms, each of which may affect the various solutions, it should be assumed that the responsibility is about as suggested. If more monies are needed to complete the rigs they will be advanced by a group of banks and then by Sunflower, and such advances will not affect the respective partner's equity interest or profit-sharing percentage and will be repaid by the partnership to Sunflower in due course.

The case makes no suggestion that Sunflower and Cash, or their respective principals, are related parties, and arm's length should be the assumption. Had the parties been related, the students may perceive a different accounting solution from that applicable to arm's-length trading. The students may discuss the possibility that the parties became related upon execution of the partnership agreement. Though the state of the art is unsettled on this point, the parties were unrelated at the pertinent time in this case.

In arriving at the substance of the transactions, the students should pursue a line of discussion directed toward the fair value of the rigs at the date of the transaction with Cash. Without knowledge of fair value, a realistic conclusion as to what is the substance of any transaction becomes a matter of luck. The students should also recognize that determination of fair value is not easy where the property involved lacks an active trading market, is only partially completed, untested, and void of sale or lease commitments. It should be assumed here that the best estimate of fair value of the two rigs in their present state of completion is \$40 million.

Discussion

Joint ventures and partnerships are increasingly common, and for several reasons. The risk inherent in major projects often makes sharing a necessary strategy. Accounting rules permit investments in these ventures to be handled on the equity basis, which usually means the debt of highly leveraged ventures is not reflected in a participant company's financials. Further, the formation of a joint venture may signal the transfer of assets in a taxable event, if structured in an appropriate manner, thus resulting in a stepped-up basis to the venture. Larger depreciation charges may then be deducted against venture income. The above business considerations are not directly related to the solution of the case; yet students may want to discuss them in the context of how such ventures and partnerships are, increasingly, a necessary business method.

Students who have some background in federal income taxation may recognize that Section 721 of the Internal Revenue Code provides that no gain or loss is recognized to the partnership or the partners upon a contribution of property to the partnership in exchange for a partnership interest. Further, the illustrations of partnership accounting presented in some advanced accounting texts conform to the tax treatment. Also, a question arises when cash is received by the partner as a result of, or in a transaction related to, the transfer to the partnership. The tax law would probably look to the form of this transaction; that is, "a premium for the opportunity to buy in," and treat the \$5 million as ordinary income. At a minimum, it would be treated as a receipt of boot in a tax-free exchange which becomes taxable to the extent of any boot received less than the gain. Though these tax considerations are inapplicable as accounting principles, they may be pertinent to the students' thought processes in selecting a solution.

The state of the art in 1981 remained unsettled as to the appropriate accounting for the formation of a partnership or joint venture under the circumstances described. Some may view it as a financing transaction, with Cash being the lender of \$30 million for an unspecified interest return equal to 50 percent of future profits reduced by the \$5 million paid directly to Sunflower. Others may view it as the contribution of property to form a partnership, accompanied by receipt of a fee for allowing another party to participate in future operations. (This seems to be the legal form.) Still others may view the transactions as a sale of a one-half interest in the rigs for \$20 million with a concurrent contribution by

each joint owner of its one-half interest in the rigs plus \$15 million cash to a partnership formed for the purpose of completing and operating the rigs. And, others may see the substance of the transaction still differently.

Where the interpretation is that of a sale of a one-half interest, further consideration should be given to what is called the "seller's (Sunflower's) continued involvement." The quoted term derives from the Industry Accounting Guide for real estate transactions. Though not applicable to sales of personal property, the guide should figure in the students' thought processes because the transactions are similar; guidance for personal property is not covered by professional literature. In this case, the students should discuss whether the agreements to be responsible for completion of construction of the rigs and to act as leasing agent affect the accounting solution. The discussion should include whether reasonable estimates can be made of the future costs of development (in excess of \$60 million plus the bank line of credit) and also of the cost of leasing activities to be performed for nominal compensation.

Cost of Goods Sold - and Otherwise Disposed of

On April 1, 1980, your client, Radetronics Corporation, an SEC-reporting company, acquired Korphone, Inc., a manufacturer of portable radios. Your acquisition investigation included observing Korphone's March 31, 1980 inventory, which consisted mainly of purchased parts — transistors, speakers, tubes, and such — kept in a controlled storeroom. The inventory was carefully taken and your people on the observation team were well satisfied.

During the year, you reviewed Korphone's system of internal control and came away with some serious concerns about the controls over inventory and cost of goods sold. There appear to be adequate controls over receiving and shipping: the company is reasonably assured that it pays only for what it receives and that it bills all of the finished goods shipped out. But there is no perpetual inventory system to control quantities of purchased parts, nor does the accounting system establish book value control over the inventory every month-end. Cost of goods sold is determined by the traditional formula: beginning inventory plus purchases less the ending inventory equals cost of goods sold.

Because of the control weaknesses — the lack of any perpetual records or book value controls — you insisted that your people observe the physical inventory at December 31 rather than at an interim date. Your manager reported that it went off without a hitch. He also told you that he inspected the storeroom and was satisfied with the physical controls over the purchased parts. Further, he observed the guards at the gates and was impressed that the employees all stopped to have their lunch boxes inspected.

Nonetheless, he is still concerned about Korphone. The gross margin from nine months of radio production is about 40 percent of sales, which is consistent with last year's results. But gross margin percentages month to month vary dramatically, from 52 to 35 percent. The variance is not due to product mix, because the company's cost/price worksheets indicate a standard 50 percent spread between cost build-ups and planned sales prices. Your manager says he has looked everywhere but cannot find an explanation of the variance in monthly gross margin statistics or the variance between the planned gross margin and actual. And, he points out that every percentage point change in gross margin is worth \$200,000 annually at the bottom line and of course the variances are even more significant to the earnings.

When you discuss this issue with the client's controller, he acknowledges that your people have raised an interesting question. He even acknowledges that the problem may be due to employee theft of very small, very expensive purchased

parts. The controller asks that you send a letter detailing your findings and your recommendations, but concludes, “to be honest, I have to tell you that we’re not going to do anything drastic at Korphone. Our labor relations are good, but tenuous. We’re not about to establish any controls which might upset our people or stir up the water in any way. And besides, the company is very profitable as it is, and is meeting the projections we established when we bought it.” As an afterthought he adds, “I’m not at all sure that a more elaborate control system would pay for itself.”

When you report the results of this meeting to your audit staff, the manager suggests that the traditional line on the income statement be expanded to read, “Cost of Goods Sold and Stolen.” But then he asks seriously, “OK, so we tell management about the weaknesses in the system; should we insist that the stockholders be told too, by mentioning it in a footnote?”

HOW WILL YOU ANSWER YOUR MANAGER?

STUDY GUIDE

Cost of Goods Sold - and Otherwise Disposed of

Objectives of the Case

The question posed by the manager on the engagement may concentrate the student's attention:

- (1) on the auditor's responsibility for adequacy of financial statement disclosure of real or suspected irregularities and of weaknesses in internal control;
- (2) on the auditor's professional and implied responsibilities for detection of irregularities; and
- (3) on the auditor's exercise of judgment in the discharge of those responsibilities.

But, there is more to the case. The student should also focus on:

- (1) the difficulties of evaluating whether additional controls would be cost effective;
- (2) the uncertainty that thefts in fact have occurred;
- (3) the difficulty in categorizing the control weaknesses as material weaknesses;
- (4) the possibility that control weaknesses may fit some design or pattern of management operations; and
- (5) the possibility that the financial statements omit a contingent asset should thefts in fact have occurred that are recoverable from the company's insurance carrier.

Applicable Professional Pronouncements

AICPA Codification of Statements on Auditing Standards Sections 320.32 and 302.46, "Auditor's Study of Internal Control"; Section 331.09, "Inventories" (SAS-1)

Statement on Auditing Standards No. 16, "The Independent Auditor's Responsibility for the Detection of Errors and Irregularities"

Statement on Auditing Standards No. 20, "Required Communications of Material Weaknesses in Internal Control"

Statement on Auditing Standards No. 30, "Reporting on Internal Accounting Control"

Foreign Corrupt Practices Act - Section 13(b) of Exchange Act of 1934

Business Assumptions and Other Data

The controller said the month-to-month variance in gross margin *may* be due to employee theft — and at this point, there could be a number of explanations. The standard cost/price work sheets could be in error, such that product mix in sales will result in varia-

tions in gross margin. Or, some of the internal recordkeeping activities inadvertently could produce the monthly variances. Or, the month-end physical inventories could be inaccurate, as can be envisioned easily for work in process. Or, the monthly pricing could contain errors. It is easy to suspect employee theft, but there *can* be answers other than theft.

The case does not categorize the control weaknesses — material or otherwise. Management tends to think the weaknesses are not material as evidenced by the controller's comment that the company is not going to do anything drastic. Yet, the weaknesses are potentially material. And if they are, then the company may be in violation of the Foreign Corrupt Practices Act, which requires SEC-reporting companies to maintain an adequate system of internal control. Material weaknesses and potentially material weaknesses should be discussed with the client's legal counsel to obtain their opinion as to whether a violation of the act has occurred.

Statements on Auditing Standards Nos. 20 and 30 contain no language suggesting inclusion of comments regarding material weaknesses in a footnote or in an accountant's report. However, in practice, comments about weaknesses in internal control have appeared with some regularity in published reports on SEC-reporting companies, but most of these companies have been facing financial difficulties. In healthy, ongoing companies, such comments are the exception. But the pattern of disclosures could change with more experience under the Act — there is still little to go on. Some students may recall that the case of *Adams vs. Standard Knitting Mills, Inc.* (United States District Court, Eastern District of Tennessee No. 8052) is very much on point. The Court found in *Adams* that the failure of the auditor to disclose or compel management to disclose in the financial statements the fact that the company audited had serious and continuing electronic data processing control problems constituted a material misrepresentation.

As no theft loss has yet been established, the possibility of a contingent receivable from the insurance carrier seems remote. While the potential of insurance recovery sometimes motivates managements to investigate further the possibility of employee theft, Radetronics' management has no intention of stirring up its employees or their union.

The overall operating results presumably are fairly stated, assuming no potential insurance recovery. That being the case, the classification of employee theft, if indeed it did occur (or the absence of some kind of disclosure), may be the only thing incorrectly stated. Employee theft and shoplifting losses are commonplace, reputedly aggregating staggering sums annually that are seldom if ever recovered. In practice, managements most often view such irregularities as another cost of doing business — one that cannot be avoided. The retail industry, for example, has lived with such thefts seemingly forever, and even plans for them. Such theft losses conventionally are included in the caption "cost of merchandise sold" with seldom a second thought, to the end that the manager's suggestion to add "and stolen" appears to be in jest.

But one should not pass over this jestful suggestion in too much of a hurry. The "business as usual" syndrome may be on its deathbed, and the manager's suggestion shows incisive thinking — "Does it have to be that way because it has always been that way?" The SEC says, definitely, "No." For example, their position is that bribes should be disclosed, even though relatively small in relation to the financial statements, and should not be "buried" in operating costs as has always happened in the past. Admittedly, bribes and theft have different characteristics, but the disclosure principles appropriate for each may not be so far apart.

New reporting movements, those that buck the tide of "business as usual," often come obliquely, as is the case with bribes. The profession often has not anticipated but has reacted (and at times slowly) and thus has received unwelcome criticism. In the mid-to-late 1970s substantial concern was expressed over auditors and auditors' reports and internal control. Congress (Senator Metcalf and Representative Moss, initially) voiced some of those concerns; the SEC, others; and the so-called Cohen Commission on Auditors' Responsibilities, still others. Insofar as internal control is concerned, the impact of these and other studies seems to be in the direction of public reporting on the adequacy of internal control by management and auditors, at least for publicly held companies. The SEC apparently is dedicated to having auditors express their opinion on the adequacy of internal control and may even try to tie such opinion into an evaluation of compliance or noncompliance with the accounting requirements of the Foreign Corrupt Practices Act. But substantial resistance remains, and the internal control reporting or disclosure requirements were unsettled at the beginning of 1981.

Accounting for Doubtful Real Estate Loans

New World Development Co. is developing a new community to consist of single-family homes, condominiums, and retail establishments. Because of the economy, progress has been slow, and New World has dramatically scaled down its planned activities. Management is confident that the project will ultimately prove out but, in the near term, intends to let the development hibernate.

Earlier in the current fiscal year, New World sold a piece of the property to a local partnership with the understanding that the partnership would construct a shopping center. The sale was for \$1,000,000 — New World got \$250,000 in cash, took a \$750,000 note, payable in equal annual installments of \$75,000 a year over ten years plus interest at ten percent, and recognized a \$750,000 profit. New World's "hibernation" policy is obviously going to delay the cash-flow payout from the proposed shopping center. The partnership has not yet committed any funds to the construction of the center and as the fiscal year draws to a close, there is some talk of default on the note.

New World has been scrambling to find alternatives to prevent the partnership from defaulting and several proposals are under consideration. Another development company has offered to buy the shopping center site from the partnership for \$600,000 cash. The partners have suggested that they sell the land and settle the note for a \$600,000 lump sum payment. As a second possibility, the partners have also agreed to stick with the original deal if New World will give them a three-year moratorium on the note, suspending requirements for principal and interest payments. They offered to pledge additional collateral on their loan in an effort to induce New World to agree to the moratorium. Of course, there is a third alternative — New World can simply let the default happen, repossess the property, hold it for a while, and then sell it again when the project comes out of hibernation.

New World's president is concerned with the accounting implications of these alternatives and calls to ask your advice. He explains that the company's financial position is such that they can afford to wait out the hibernation period. The company has over \$2,000,000 in equity and has access to an \$8,000,000, eight percent, five-year revolving credit agreement. He explains that this decision on the alternatives might be influenced by the accounting impact. He has concluded that if he accepted the cash deal, he would have to step up to a \$150,000 loss today and he is reluctant to take that kind of loss in the current year's earnings. And yet he observes that a bird in the hand is always worth two in the bush. Before he makes any final decision, he wants your advice.

**HOW DO YOU ADVISE REGARDING THE REQUIRED ACCOUNTING
FOR EACH OF THE THREE ALTERNATIVES?**

Depreciation

The Pension Reform Act has been an opportunity and a challenge for your client, Comprehensive Financial Services (CFS). CFS operates a series of mutual funds, particularly designed for pension funds and similar fiduciary institutions. CFS's customers can pick and choose from a wide variety of funds with a wide variety of investment objectives. Under the Pension Reform Act, trustees are responsible to maintain a specified level of diversity in their funds' investment portfolio. And CFS's shopping list of diverse funds gives them an important marketing edge in the competition for pension business.

The pressure for diversification has stimulated the imagination of all the investment services. CFS, like many of its competitors, offers a mutual fund investing in real estate. The CFS real estate fund, which has purchased a number of apartment houses, hotels, and commercial buildings, is a little different from common stock funds, and CFS has asked all of the participants in the fund to leave their moneys invested for a specific period. But, the real estate fund is similar to the common stock funds in many important ways: participants expect to share in the cash flow from rentals, and they also expect to share in any appreciation. In fact, CFS promotes the real estate fund as an appropriate place to put long-term money where appreciation is a principal objective and promises to provide its financial statements on a "current value" basis, based on annual appraisals of all of the properties. The fund is a closed-end type, such that sales or purchases of units of ownership by the fund would be unlikely.

CFS's treasurer has called you in for advice. He stands looking at a mockup of the financial statement for the real estate fund, and he looks perplexed. He has thought through the balance sheet presentation — the real estate investments will be shown at their current value, with original cost shown parenthetically as a reference point. He also has an income statement roughed out, as follows:

Rental Revenues	xxx
Other Income	<u>xxx</u>
	xxx
Property Costs	xx
Administration Costs	<u>xx</u>
Operating Income	xxx
Gain in Current Value	<u>xx</u>
Net Income for the Year	<u>xxx</u>

The treasurer explains his question about the earnings statement: "Our people have conflicting ideas. Some say we should charge the rental operation with depreciation expense, picking the depreciation up as an increase or a decrease in the appreciation. The logic for that presentation is that it provides an income statement more comparable to other real estate entities. On the other hand, others in our group argue against a depreciation charge because depreciation is not relevant to an investor who is looking for appreciation. Some have even suggested that increasing the gain in current value for an arbitrary depreciation adjustment will confuse and maybe even mislead. I can see merits to both arguments." He asks, "What do you think?"

WHAT DO YOU THINK?

Audit Planning

You are considering your audit plan for work on Together, Inc., a large multi-industry company that has been privately held but now is negotiating with an underwriter regarding a sale of securities to the public. You realize that segment information will be required for the first time, and based on guidelines in Statement on Financial Accounting Standards No. 14 (segment information), three segments with the following revenue percentages should be reported this year:

Ponderous (heavy equipment manufacturing)	60%
Speedy (transportation)	14
Solar Window (technology)	6
	80%

Solar Window sales were three percent of total sales last year, and one percent in the preceding year, with the corresponding percentage declines generally at the expense of Ponderous. The growth in sales in the technology unit has excited the prospective underwriter.

You have asked the manager on the job whether the disaggregation of information (initial reporting for Solar and Speedy) should affect the audit plan and personnel assigned this year.

You have been trying to keep up with current developments and you have read the two auditing standards: (1) Segment Information and (2) Planning and Supervision. Your initial reaction is that they will have an effect on this year's plan so you express the following concerns to your manager:

1. "Because about 60 percent of the company's business is in the heavy manufacturing segment, and because other segments have been acquired only in the last four or five years, most of our audit engagement personnel have gotten their experience in the heavy equipment manufacturing business. Do our people adequately understand the other elements of the company's business that must now be separately reported?"

2. "Based on a quick reading of the segment auditing standard, I am somewhat troubled by paragraph 8, which seemed to say that if a matter is important to an investor's understanding of a trend within a segment, it could be material to the financial statements taken as a whole, even though on a quantitative basis it would not appear to be so. And that's a change in the way we view materiality when reporting on financial statements."

**WHAT ARE SOME OF THE CHANGES, IF ANY,
RELATED TO SEGMENT INFORMATION, THAT YOU WOULD
EXPECT TO SEE IN THE AUDIT PLAN FOR THIS YEAR?**

Auditing — Confirmations

This is your first year as partner in charge of the audit of the All-American Bank. All-American is a publicly held bank in excellent condition; it has been a client of the firm for several years. Two years ago the bank installed a highly computerized system for processing transactions. The system and all related controls have been tested and relied upon in all audits since the installation. Generally, prior years' audit tests of both transactions and balances have revealed very few errors in the processing of transactions.

Audit planning has begun: the supervisor and senior on the engagement are designing the year-end audit program and specifically are trying to decide on the scope of confirmation of the demand deposit (checking) accounts. When you took over the audit you asked the staff to make the maximum effective use of statistical sampling. Tests of the system have been performed and indicate the proof and transit function is operating effectively as are other controls related to demand deposit accounts.

As of the confirmation date, there are 40,000 accounts totalling \$100,000,000. Earnings before taxes for the year are expected to be about \$500,000.

The senior presents the following plan for confirming the accounts:

Because the system is strong, he reasons that he need not look for specific errors, but instead he should look for a total dollar assurance. Variables estimation will be used to achieve a precision of \$12,500. This amount represents one-half of the financial statement measure of materiality, where materiality is five percent of expected earnings before taxes. Since internal control can be relied upon, a low reliability level can be used — say 70 percent. However, sample size will still be large (he estimates 1,000) so negative confirmations should be used to reduce follow-up work.

The supervisor believes a different plan is appropriate; he argues that:

Since internal control is good, a low reliability level is appropriate. However, the objective should be to discover an error if one should exist, not to measure whether hypothetical errors could be material for adjustment purposes. On that basis, an attribute approach would be used and sample size would be based on a zero expected occurrence rate and an upper precision limit relating to the population being tested (say one percent). This would result in a small sample of about 120 items. Positive confirmations would be used to assure that a supportable conclusion is reached for each sample item. Only if an error requiring an adjustment is found would a variables estimate based on materiality be necessary.

WHICH APPROACH WILL YOU HAVE THEM USE?

Prior Period Adjustments

Following successive loss years, the management of Universal Gloom determined that a retrenchment was absolutely necessary. Accordingly, they drew up plans to discontinue certain models, to close one of the plants, and to purchase rather than produce various component parts. The planned retrenchment did not qualify for accounting as a discontinued operation of a segment of the business (APB Opinion No. 30). Curtailment itself was to be costly: management estimated that the plant closing would cost \$1,500,000; recognizing the now obsolete inventory would cost an additional \$500,000. But, management also was confident that future reduced operations could be profitable.

The financial statements for the year ended December 31, 1978, included a \$2,000,000 provision for the curtailment costs, and the annual report included a detailed description of management's plans.

Following the presentation of the retrenchment plan at the annual stockholders' meeting in April, 1979, a proxy fight unexpectedly ensued. As a result, old management was replaced by a new management group that promised to "turn the business around" by expanding rather than contracting the business.

During the remainder of 1979, new management undid all of prior management's retrenchment plans and went on an aggressive campaign to find new profitable markets for all of their products, and with some success. Universal still lost \$1,800,000 during 1979 but the last quarter was profitable and the backlog was at an all-time high.

The new treasurer calls to ask your advice about the previously provided reserve. He explains that the marketing V.P. would like to keep the reserve around, "just in case." The president, however, would simply like to eliminate the reserve currently, because the reversal would give Universal its first profitable year for some time. But the treasurer has been arguing that the reversal should be treated as a prior period adjustment, or even as correction of an error. He would like to see the \$2,000,000 provision eliminated from the 1978 statements. He reasons that the change in management nullified old management's plans, and that change should also nullify old management's reserves.

**HOW SHOULD UNIVERSAL GLOOM ACCOUNT FOR THE
\$2,000,000 RESERVE AT DECEMBER 31, 1979?**

STUDY GUIDE

Prior Period Adjustments

Objectives of the Case

This case raises several fundamental questions:

1. Are the financial statements the reflection of management (which can change completely from year to year) or the company (which has a perpetual life of its own)?
2. Do financial statements reflect the results of a discrete period or do they reflect a continuum?
3. Is it more important to preserve the integrity of the prior years' presentations or the integrity of the current year's income measurement?

Specifically, the case asks the following questions: How should the traditional financial statement techniques be used to report what has really happened to Universal Gloom? And, if traditional techniques seem inadequate, should an alternative be followed?

The case also can be viewed by the students as a classic case of "rule book" accounting, where answers are derived based on the book rather than on an analysis of what may be preferable. The students may discuss the types of evidential matter necessary to sustain a position that the reserves are no longer needed. The case should promote an understanding of the evolution of the concept of prior period adjustments and the fact that the FASB has virtually eliminated them except for specified corrections of errors and for retroactive adjustments. Further, the case should promote an understanding of what constitutes a correction of an error, an extraordinary item, and an unusual item which is not extraordinary.

The diverse points of view of management individuals regarding the reserve should lead to a discussion that touches on the motivations of each officer, and the students should be encouraged to explore their own motivations in formulating their answer.

Applicable Professional Pronouncements

Accounting Principles Board Opinion No. 20, "Accounting Changes," paragraphs 36-37

Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations," paragraphs 19-26

Statement of Financial Accounting Standards No. 16, "Prior Period Adjustments"

Business Assumptions and Other Data

Many financial analysts feel that a current-operating-performance concept of income measurement provides a most useful bit of information for prediction of future stock prices. In years past, pursuit of the current operating concept seemed to occasion all kinds

of prior period adjustments, which invariably were debit, or charge, adjustments. For some reason, always supportable in one fashion or another, most credit adjustments were not considered prior period adjustments at all, but rather current period income. The abuses of prior period adjustments, whether real or imagined, were of concern to the profession and presumably of greater concern to the SEC. Since the early 1950s, it has been advocating a "clean surplus account."

The abuses diminished after Accounting Principles Board Opinion No. 9 appeared in 1966, and there has been a gradual elimination of current operating performance as a generally accepted method of income statement presentation. The operating performance concept received a further setback upon issuance of Statement of Financial Accounting Standards No. 16 in 1977, largely at the instigation of the SEC. These pronouncements continue to cause dissatisfaction among certain users of financial statements and ultimately may result in further revisions of the rules regarding extraordinary items and prior period adjustments, particularly when the focus is swinging toward predictive reporting. At present, there is no accounting standard regarding matters presented in this case that adequately serves all valid user interests. The "clean surplus" interests are presently served, but less so the users who want to understand one year's operating results in relation to other years and in relation to prospects for future years.

The case study gives little in the way of facts to support the position that the reserve is no longer necessary. The change of plans regarding retrenchment and one profitable quarter followed by a record backlog of orders, while encouraging, may not be sufficiently strong evidence that indeed the reserve is needed no longer. What is the economic reality? Whether reversal of the reserve is appropriate is part of the case study, and it is probably the most difficult issue to resolve. Those discussing the case may come to the conclusion that the reserve should be retained in the accounts until some future operating results show that it is no longer needed. The facts cited are not convincing one way or the other. However, the discussion assumes that the correct conclusion is to reverse the reserve and that the management and the auditors have produced or seen documentation to support that conclusion.

Discussion

It appears that Universal became a completely new company in 1979, with totally new management and new plans. However, under current accounting rules, the advent of new management does not constitute justification for a new accountability. If new management had bought Universal Gloom, the company would have gotten a "fresh start" and its assets and liabilities possibly could have been stated at fair value, using concepts followed for business combinations accounted for as a purchase, and the reserve would have disappeared. (Controversy continues within the profession and elsewhere as to whether purchase-type accounting, often referred to as "push-down" accounting, can be applied in the separate financial statements of an acquired company. Nevertheless, "push-down" accounting has been used on a number of occasions.) But, no purchase was involved; that concept won't soon extend to those situations where the corporate share ownership continues unchanged. Though we might like to do so, we have not yet been able to say new management has "in effect" or "in substance" purchased the business and new accountabilities are required. Had such accounting been appropriate, it would have resolved the reserve issue.

The mixed motivations of the various parties involved (not uncommon) are of interest. One's motivations should not dictate the choice of accounting methods; yet, in practice, they often are found to be persuasive or influential. The vice president seems to want a "nest egg" that he can use in the future when earnings may not be up to par (the "hidden reserve" ploy, akin to the "new broom" ploy); the president seems bent on showing a profit in his first year at the helm; and the treasurer seems to be striving for objectivity in the current year's income, as he perceives objectivity, by keeping the extraneous \$2,000,000 credit out of 1979 operating results. The case gives no clue as to the motivations of the auditor; yet, such motivations exist. A typical auditor will rebel against any position that gives a company a profitable year with an accidental bookkeeping entry. And, in the same way, a typical auditor will not want a "hidden reserve" to remain on the books, lest it lead back into future income statements to obscure unprofitable operations.

Because Statement on Financial Accounting Standards No. 16 effectively rules out the possibility of a prior period adjustment, except for correction of an error, four possible alternatives exist within the framework of generally accepted accounting principles. These are:

1. Correction of an error requiring prior period adjustment, restating the comparative 1978 financials, as discussed in paragraphs 13 and 36 of Accounting Principles Board Opinion No. 20.
2. Presentation as an extraordinary item in the 1979 financials, as discussed in paragraph 20 of Accounting Principles Board Opinion No. 30.
3. Presentation as a 1979 income item but disclosed as a separate component of income from continuing operations, as discussed in paragraph 26 of Accounting Principles Board Statement No. 30, relating to unusual or infrequently occurring items.
4. Presentation as a current income item in the 1979 statements resulting from a change in accounting estimate, as discussed in paragraphs 10, 11, 31, and 33 of Accounting Principles Board Opinion No. 20.

The reversal of the reserve would qualify as a correction of an error, and thus as a prior period adjustment, only if the reserve resulted from any of the following:

- a. a computation error;
- b. a mistake in the application of accounting principles;
- c. an oversight or misuse of facts.

The establishment of the reserve may have been a management error, but given these three criteria as a definition, it cannot be considered to be an accounting error. Therefore, accounting for the reversal of the reserve as a correction of an error requiring prior period adjustment is inappropriate.

Since it has been determined that the reversal cannot affect 1978 statements, it must be a current year (1979) item. Because the item is unusual and has not been a continuing occurrence for the company, the question of accounting for the reversal as an extraordinary item should be considered. However, since a plant closing and inventory write-downs are not abnormal to a manufacturing business, the establishment of the reserve in 1978 was not an extraordinary item. Likewise, the reversal of the reserve in 1979 does not seem to

meet the criteria for an extraordinary item; as upward and downward adjustments of reserves are commonplace.

The accounting choice would thus seem to reside between that of an "unusual or infrequently occurring item" (APB Opinion No. 30) or a "change in accounting estimate" (APB Opinion No. 20). The accounting result of either choice is the same; that is, a credit to 1979 income. However, if the choice is that Accounting Principles Board Opinion No. 30 applies, disclosure must be made of the facts on the income statement or in notes to the financial statements. If Accounting Principles Board Opinion No. 20 is considered applicable, no disclosure requirement exists, although disclosure is recommended if the effect of the change in estimate is material. In the latter case, the president, if he so chooses, could refuse to disclose the reversal of the reserve and remain in compliance with generally accepted accounting principles; a recommendation in an Opinion is just what it says. Arguments can be made to sustain either position; yet the ultimate selection will be of no importance if the company proposes to make full disclosure under any circumstances.

The accounting treatment in either case increases 1979 income by \$2,000,000. The auditor should insist on thorough disclosure in the footnotes, should the company object to disclosure. Further, a recommendation to set out the provision and the reversal as a single line item in the 1978 and 1979 comparative income statements would be appropriate.

Even with disclosure, this technically correct answer is not totally satisfactory. The treasurer seems to have the correct answer — get the \$2,000,000 credit out of 1979. But, the "rule book" does not allow for such an answer. Users of financial statements typically think of "net income" as operating income. The bottom line figure on the 1979 income statement (and the earnings per share figure) benefits from a significant nonoperating credit.

If management and the auditor conclude that, because of unusual circumstances, the inclusion of the \$2,000,000 reversal of reserve in current 1979 income makes that year's income statement misleading, they could depart from GAAP and report the reserve reversal in a manner considered not misleading. What constitutes "unusual circumstances" is a matter of judgment and involves the ability to support the position that adherence to a promulgated principle would be regarded by reasonable people as producing a misleading result. In this case study, the judgment call could be considered close by many practitioners and their clients. If the decision is to depart from GAAP, the auditor's report would need to describe the departure, the approximate effects, and the reasons why compliance with the promulgated principle would result in a misleading statement. It is fair to state that most auditing firms and most client companies are quite reluctant to depart from GAAP and report with a so-called "Rule 203 Opinion."

Historical Cost Accounting

The President of East Coast Enterprises had been looking for a merger candidate that would give his company an entry into the lucrative California market. He was finally able to purchase the West Coast Corporation, an old, well-established company. East Coast paid a premium over book, although almost everyone was satisfied that the price was fair. East Coast's acquisition team reported that West Coast had used a relatively simple accounting system. Capitalization policies were very conservative; West Coast's financial statements understated the fair value of its assets. On the other hand, vacation pay had been expensed as paid and pension accruals were on the low side; they were based solely on the actuaries' computation of cash needed.

When the acquisition was consummated, East Coast's accounting people went through the West Coast balance sheet, item by item. They obtained appraisals on all of West Coast's tangible property and established values for various assets and liabilities in accordance with East Coast's accounting policies. They allocated East Coast's total purchase price over West Coast's individual assets and liabilities and produced a new opening balance sheet which effectively capitalized retained earnings and the premium paid over book value, on the theory that new West Coast represented a "fresh start." A summary of the balance sheet data for old West Coast (Column A) and new West Coast (Column B) is shown in the attachment.

Because West Coast still has bonds outstanding in public hands, separate financial statements of West Coast will be required. You meet with the controllers of East Coast and West Coast to discuss the preparation of those separate financials, and it is apparent that you have stepped into a buzz saw. The East Coast financial people have assumed that West Coast's financial statements would be prepared on the parent's cost basis, using the same asset and liability numbers as will be used when West Coast is consolidated with East Coast. However, the West Coast financial people believe that the West Coast financial statements should be presented using West Coast's original costs. They argue that, legally, West Coast is no different now than it ever was and that East Coast's costs and West Coast's costs are entirely different. You are a bit surprised, though not displeased, when your manager on the engagement speaks up amidst the hassle, adding a third view. He says, "Why not let the goodwill show only in consolidation and leave the retained earnings showing in the separate statements of West Coast but adjust assets and liabilities to East Coast's costs?" (Column C). East Coast's controller turns to you and says, "You'll have to issue an audit report on West Coast's separate statements. Which numbers present West's balance sheet in accordance with generally accepted accounting principles?"

**WHICH ALTERNATIVE FAIRLY PRESENTS WEST COAST —
IN ACCORDANCE WITH GENERALLY ACCEPTED
ACCOUNTING PRINCIPLES?**

Historical Cost Accounting

Financial Data Attachment

(\$000 omitted)

	(A) Old West	(B) New West	(C) New West
Current Assets	\$ 40,000	\$ 40,000	\$ 40,000
Property, Plant & Equipment	100,000	150,000	150,000
Intangibles	15,000	—	—
Goodwill	—	10,000	—
	<u>\$155,000</u>	<u>\$200,000</u>	<u>\$190,000</u>
Current Liabilities	\$ 20,000	\$ 30,000	\$ 30,000
Pension Liabilities	—	10,000	10,000
Long-term Debt	80,000	80,000	80,000
Stockholders' Equity			
Common Stock	25,000	25,000	25,000
Retained Earnings	30,000	—	30,000
Additional Capital (comprising the portion of premium over book value paid by parent related to the company's tangible assets)	—	—	15,000
Additional Capital (comprising capitalized retained earnings and premium over book value paid by parent company)	—	55,000	—
	<u>\$155,000</u>	<u>\$200,000</u>	<u>\$190,000</u>

(A) Historical cost basis

(B) Goodwill recorded by the acquired company; retained earnings not carried forward

(C) Goodwill not recorded; retained earnings carried forward

STUDY GUIDE

Historical Cost Accounting

Objectives of the Case

In its most general sense, the case should raise the question of whether the entity concept of accounting is applicable for the life of the entity. Can events during an entity's lifetime destroy that concept in favor of others? The case should bring into focus a discussion of the business purposes served by financial statements of an acquired company and the needs of the various users of such statements.

This case demonstrates some of the many problems that develop in accounting for business combinations, and it should develop an understanding of the principles of purchase accounting as they relate to business combinations, namely, revaluation of assets and liabilities of the acquired entity to fair market values at the date of acquisition, and allocation to a goodwill account of the excess of the purchase price paid over the fair market value of the net assets acquired. Also, the discussion should demonstrate the unsettled state of the art in situations such as described, and should show that financial statements of components of a business enterprise prepared on a current value basis are in limited use. Further, it raises the question of whether simultaneous presentation of financial statements of the same entity on more than one measurement basis constitutes fair reporting and whether both presentations may be said to conform to generally accepted accounting principles.

Separate financial statements for West Coast are required in order to provide bondholders with information concerning their investment. The specific question is: Should West Coast's statements be based on historical costs as presented in previous financial statements issued prior to acquisition, or should the financial statements be based on the purchase price paid by East Coast, or on some other basis?

Applicable Professional Pronouncements

Accounting Principles Board Opinion No. 16, "Business Combinations," paragraphs 66-96

Financial Accounting Standards Board Discussion Memorandum, "Business Combinations and Purchased Intangibles," paragraphs 399-408

Burton, Palmer, Kay, *Handbook of Accounting and Auditing*, page 30-26

Defliese, Johnson, MacLeod, *Montgomery's Auditing*, Ninth Edition, pages 692, 696

Business Assumptions and Other Data

There are no authoritative professional pronouncements which deal directly with reporting on the separate financial statements of an acquired component as illustrated by this case study. Accounting Principles Board Opinion No. 16 is silent about whether a new

accounting basis used for an acquired company's assets and liabilities recognized in a combined enterprise's financial statements should also be used for those assets and liabilities in separate financial statements of the acquired company. The *Handbook of Accounting and Auditing* and *Montgomery's Auditing* discuss the matter and point out the unsettled state of the art, as does a 1976 FASB Discussion Memorandum that presents arguments for both sides.

For a number of reasons (e.g., the existence of common or preferred minority interests or financial arrangements with others), an acquired company may need to issue separate financial statements at the time of, or subsequent to, a combination. In this case, the need for separate audited financial statements of West Coast derives from the public ownership of its bonds. Presumably, the need for separate statements would disappear if the bonds were retired, unless other outside interests, such as trade creditors, bankers, customers, or the like, have sufficient influence to compel continued issuance.

When preparing separate statements, management should have in mind the needs of the users — including users of concern. However, even if the managements of both companies were clairvoyant, they probably could not conceive of the alternative accounting best suited to the needs of the various users. The case is essentially silent as to why East Coast and West Coast maintain their positions on what is the appropriate accounting. The case is also silent as to whether the use of parent cost basis would be acceptable to the bondholders for purposes of testing compliance with the debt instrument. Typically, the debt instrument requires compliance within the framework of generally accepted accounting principles. And that gets back to the question of what is generally accepted in such situations.

Were the bondholders to accept any method so long as the auditor opined that the method conformed to GAAP, this case dramatizes the impact of one method versus another method where, as in this case, the bond indenture contained a number of restrictive covenants. For example, use of parent cost would result in up to \$50,000,000 additional depreciation over time and thus reduce earnings by a corresponding amount, while at the same time reducing earnings available for dividends to the parent under a restrictive debt covenant. Or, were historical costs of the acquired company used, it would have \$25,000,000 less cushion in complying with restrictive covenants based on stockholders' equity.

A number of complex tax considerations are usually inherent in acquisitions such as this and in subsequent reporting of operations. They are not discussed here because tax accounting is not the issue of the case study.

Both companies have shares registered with the Securities and Exchange Commission, so they and their auditors certainly should preclear the accounting treatment adopted, particularly in view of the indecisiveness of the Securities and Exchange Commission and the Financial Accounting Standards Board and of the mixed views within the profession.

Regulatory accounting deserves mention: in certain regulated industries, for example the savings and loan industry, recording any goodwill in a purchase transaction as described would probably be prohibited. Following the regulatory requirements would present a dilemma to any auditor who insists that generally accepted accounting principles require the use of parent cost in reporting on an acquired subsidiary. The auditor may be trapped and may have to take exception in the report because of the regulatory accounting followed.

Discussion

The students should spend some time discussing some of the anomalies in the entity and proprietary concepts present in today's practice. The word "entity" should focus the students on the two most frequently discussed concepts, the accounting (or reporting) entity and the legal entity; one may differ from the other in various respects. What we should be most interested in here is the accounting (reporting) entity. A legal entity typically is bound by close definition. An accounting or reporting entity tends to be more flexible, a fact that is duly recognized in Accounting Principles Board Opinion No. 20, *Accounting Changes*, which covers the subject of reporting a change in the entity.

The students also should discuss the conceptual differences in the proprietary theory and the entity theory. Consolidated statements in the present state of the art do not portray a legal entity; some would say they do, but indeed they portray an accounting or reporting entity (though subject to change in certain circumstances). Others would disagree, where minority interests are shown, and would contend a proprietary entity is portrayed — that is, the consolidation is from the viewpoint of the parent's shareholders alone, excluding the equity of shareholders of the subsidiaries.

If we assume the proprietary concept is valid — that, indeed, what is reported on stems from proprietary interests within the entity rather than the entity itself — the door is open to consideration of the main issue in this case; that is, are we dealing with a consolidation of entity interests or a consolidation of proprietary interests? And, if the latter, does a change in proprietorship establish new accountabilities?

This area is addressed in the AICPA's *Technical Practice Aids* (which provide non-authoritative examples and commentaries on accounting issues), in the following reply to an inquiry regarding the proper accounting basis for properties of an acquired company in separate financial statements:

Paragraph 17 of Accounting Principles Board Opinion No. 6 states, "The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market, or current values which are above cost to the entity." This statement is not intended to change accounting practice followed in connection with quasi-reorganizations or reorganizations. The acquisition of a company by another company would not by itself constitute a 'reorganization.' It would not be proper to restate the assets in the financial statements of the acquired corporation.

If there was any likelihood that financial statements based on cost to the acquired company and financial statements of the same operation based on cost to the parent company were being prepared for distribution to others (and if an auditor's opinion is expressed, such distribution should be assumed), it would appear necessary to footnote one of the financial statements to indicate that other statements were being prepared on a different basis. It would be more appropriate to prepare such a footnote for the financial statements of the acquired company.

Assuming the students accept the above nonauthoritative answer as the appropriate one, would their position be the same if the assets and liabilities were transferred to another company, Subsidiary X, formed for the purpose of acquiring West Coast? In substance nothing has happened. The proprietary interests are the same in either subsidiary; only the legal entity has changed from West Coast to Subsidiary X. Yet, the students might be expected to favor new valuations in Subsidiary X and accounting convention would require such new valuations. The old valuations could not be carried through. So

their discussion should center on why the accounting method chosen for West Coast should acknowledge the "paper" form of a subsidiary and not its substantive form.

Below are comments taken from the 1976 Financial Accounting Standards Board Discussion Memorandum. In support of retaining historical cost as long as the legal entity remains, some have contended that, in connection with a combination in which a new accounting basis is recognized in the combined enterprise's financial statements, any separate financial statements of an acquired company should retain the existing accounting basis. Their primary reason is that the acquisition of a company represents a change in its ownership but does not establish a new accounting basis in its financial statements under the historical cost accounting framework. The reporting entity did not acquire any assets or assume any liabilities as a result of the combination. According to this view, recognition of a new accounting basis based on a change in ownership, rather than on a transaction on the part of the company, is undesirable. Further, the acquired company may have entered into credit or other agreements with others, with terms related to financial statements or other financial data prepared on the existing accounting basis. Restatement of the financial statements to recognize a new accounting basis could create problems in determining or maintaining compliance with various financial restrictions under those agreements or in calculating amounts that are based on income before income taxes, net income, or other financial data. Also, restatement could cause difficulties in comparing that company's financial data with those for prior periods, though restatement of the company's financial statements of prior periods to give retroactive effect to the new accounting basis could help provide comparable data.

The same Discussion Memorandum also says some have contended that where a new accounting basis is determined to be appropriate in the combined enterprise's financial statements, any separate financial statements of an acquired company should also recognize that new accounting basis. Their primary reason is that such financial statements would provide information that is more relevant to users in making investment and credit decisions. According to them, as part of an exchange transaction — the combination — the acquired company's aggregate cost has been established and current values have been estimated for its assets and liabilities. Presentation of the assets and liabilities based on the resulting new accounting basis, rather than on their carrying amounts prior to the combination, enables financial statement users to estimate better the acquired company's future cash flows.

Also, an acquired company's financial statements that recognize the new accounting basis would be prepared on a consistent basis with the combined enterprise's financial statements. If the acquired company's financial statements were to retain the existing accounting basis, readers might be confused by the different accounting bases used in the two sets of statements. Some have indicated that recognition of a new accounting basis in the acquired company's financial statements would give rise to nominal, if any, incremental costs and may even provide a cost savings because the combined enterprise's financial statements, which include the acquired company, would be prepared on the new accounting basis in any event.

The controversy has not been resolved in the years since 1976. The Accounting Standards Executive Committee prepared an Issues Paper on the subject, but the Financial Accounting Standards Board did not take it under consideration. Earlier, in 1973, the SEC tentatively considered adopting rules for SEC-reporting companies, but the rules were never adopted.

Aside from the general arguments identified by the Financial Accounting Standards Board in its Discussion Memorandum, some further specific arguments are noted, first, as to those favoring retention of West Coast's old historical costs:

1. Fair value accounting is the ultimate answer to many accounting problems but it is not yet accepted. At present, generally accepted accounting principles are based on cost. To depart from West Coast's historical costs and use the values as allocated by East Coast is tantamount to booking appraisal values.

2. West Coast is a legal entity and its reported capital should not be affected by who owns it. The legal entity has capital stock and paid-in capital based on transactions between the company and its owners. Legal capital structure should not be changed by transactions among shareholders.

3. The price paid by East Coast is not cost to West Coast. The price simply represents East Coast's estimate of the potential earning power of East Coast and West Coast combined. The values in excess of West Coast's original net worth are East Coast's assets and should not be included with those of West Coast.

4. In defense of the old historical cost, some would argue that publicly traded companies change their stockholding makeup significantly during any one year. And yet, the values reflected by those stock market transactions are not integrated into the entity's basic financial statements.

5. The purpose of the separate financial statements on West Coast will be directed to a legal audience, the bondholders. Insofar as the bondholders are concerned, their rights have not changed and, therefore, it could be argued that the basis of the financial statements reported to them should not change.

As to those favoring a new accounting basis (often referred to as "push-down" accounting, complete or partial), some further arguments are:

1. If East Coast had purchased the net assets of West Coast, the assets would be stated at East Coast's acquisition price. Accounting Principles Board Opinion No. 16, paragraph 21, says that whenever there is a purchase, the acquirer should record the economic substance of the transaction, to wit:

a. "The bargained costs of assets acquired less liabilities assumed, not the costs to the previous owner."

b. "Expenses and net income after an acquisition computed on the bargained cost of acquired assets, not on the cost to the previous owner."

It is emphasis of form over substance to preserve historical costs simply because the legal shell continues to exist.

2. There should not be two sets of financial statements for a company, both of which "present fairly." It is illogical to have one set of financial statements which present fairly the separate operations and balance sheet of West Coast based on historical costs and one set of financial statements which present fairly the operations of West coast in combina-

tion with its parent, based on the parent's cost. And, in consolidation, no alternatives exist; parent cost must be used.

3. There may be a continuing legal entity known as West Coast, but when East Coast acquired the West Coast stock, the substance of West Coast disappeared, and a new economic reality was created. It clearly will be a different company as a part of the East Coast empire. No matter what basis is used for presenting the West Coast financial statements, the operations of West Coast after the acquisition will not be comparable with preacquisition operations. It would be misleading to include "old" West Coast and "new" West Coast in a five-year summary of earnings.

4. The nearest thing to a professional pronouncement on this issue is Accounting Principles Board Opinion No. 16 regarding accounting by the acquiring company (not the acquired company). The accounting procedures proposed by East Coast follow the provisions of Opinion No. 16 quite literally. The resulting proposed balance sheet would be appropriate for consolidation.

Auditing firms are split on the accounting to follow, with perhaps the larger number favoring continuance of historical cost in the separate financial statements of an acquired company. The use of historical cost has even greater support where a sizable minority-interest ownership remains in the acquired company. For example, no firm is known to be advocating a new accounting basis where only 51 percent of a component company was acquired.

On the assumption that a new accounting basis would be adopted, the students should discuss (a) whether retained earnings reported should include only earnings subsequent to acquisition, (b) the percentage ownership by the parent that would sustain the adjustment of asset and liability valuations, and (c) disclosures that should be provided in the separate financial statements as a consequence of the acquisition. If the new accounting basis is not adopted, the disclosure questions would still be present.

The two reference books noted above both seem to favor "push-down" accounting. However, neither takes a position on what to do with retained earnings of the acquired company at the date acquired. If one views the acquisition as a "fresh start," much as in a quasi-reorganization or reorganization, then, presumably, retained earnings would be closed out and become a part of additional capital. Or, if Subsidiary X were used in the acquisition, as discussed above, such retained earnings would disappear. Further, in favor of elimination, any retained earnings added in the future would be of a different character because of the new valuations in use. Those in favor of carrying such retained earnings forward could say that such earnings have some legal basis, that they are indicative of amounts that may be available for dividends, and that they show what earnings the company has accumulated over its corporate history.

In the present case, East Coast acquired 100 percent of West Coast so the question of minimum percentages never arose in the consideration of whether to use "push-down" accounting. Not all acquisitions are at 100 percent, and the students' discussion of where the break-off point should fall should be interesting. As noted above, no strong support seems to exist at the 51 percent level, at least not since the Securities and Exchange Commission withdrew its proposed rule generally requiring revaluation when 50 percent or more stock was acquired. But somewhere between 51 and 100 percent may lie a sensible breakpoint. *Montgomery's Auditing* states a preference for limiting the "push-down" to

100 percent acquisitions, or nearly so, such as 90 percent acquisitions, following somewhat the 90 percent pooling theory.

Also, not present in this case is any minority interest in the common or preferred stock of West Coast. Had there been any, the confusion as to what to do would be heightened still further, and a "what if" question on the subject could be posed to the students. They almost certainly will have differing views, and there is surely no authoritative literature to run to for an easy answer. The *Handbook of Accounting and Auditing* has this to say about the interesting problem facing those accountants supporting the "push-down" approach when the acquired subsidiary is not wholly owned:

. . . Because the parent company obviously didn't purchase it, the minority interest must be maintained on its previous historical cost basis. The minority shareholders do not share in the additional capital resulting from the restatement, nor do they share in the depreciation, amortization, or any other charges or credits based on the differences between restated amounts and historical cost. As a result, when the purchase cost is to be allocated to the net assets of the subsidiary, a question arises whether to allocate only a percentage of the fair value increment or decrement based on the parent's ownership percentage or to allocate 100 percent of it. Obviously, the allocation of 100 percent could result in a total fair value assignment in excess of the purchase price, since the parent acquired less than 100 percent ownership of the subsidiary

The Handbook goes on to say that the allocation should be done on a proportional basis, and in theory there are many variations possible where a minority interest remains. It says further that there are relatively few "push-down" examples available, and none with a large-majority interest percentage. On the other hand, *Montgomery's Auditing* would seem to suggest that the minority interest must also reflect the changed values.

An additional consideration the students should discuss is the treatment of goodwill in the separate financial statements. If the financial statements for West Coast are based on the price paid by East Coast, \$10,000,000 of goodwill is created. Should the goodwill be included in the West Coast financial statements (Column B) or should it be included only in the consolidated financial statements of the parent and the acquired company (Column C)? Some professionals consider restricting goodwill to the consolidated statements somewhat on the basis that only purchased goodwill should appear on a balance sheet, and in this case West Coast did not purchase the resultant goodwill. These accountants would distinguish between revaluing existing assets and creating, as it were, a new asset. Accountants favoring inclusion of goodwill on the balance sheet of an acquired company believe that to be a natural consequence of substituting parent cost in the acquired subsidiaries' balance sheet.

Letter of Representations

As partner in charge of the office, you have been consulted and asked to recommend a course of action in an unusual client situation. Here, briefly, are the facts you have obtained after interviewing the engagement partner, controller (chief accounting officer), and executive vice president (chief financial officer) of the company involved, Mighty Magic Widget Makers, an American Stock Exchange company:

- The controller has refused to sign the letter of representations.
- Because he believes the controller's knowledge of corporate activities is so important, the engagement partner intends to take a scope qualification in his report, citing the controller's refusal to sign the representations letter.
- The oil shortage is beginning to raise the cost of electric power, and there is even concern about possible brownouts.
- The controller is concerned about the effect of a possible power shortage on the sales of the company's main product, Mighty Widget Home Air Conditioners. He believes a larger inventory valuation allowance (an additional 10 percent) should be provided. By any measure, this is material.
- Other members of the company disagree. Significantly, the chief executive and chief financial officers reason that the oil shortage may keep people at home more, enhancing the salability of the Mighty Widget Home Air Conditioner. In fact, they believe that the inventory valuation allowances, if anything, are excessive this year.
- The engagement audit team believes that the valuation reserve is adequate.

Both your technical expertise and your skills with difficult clients are well known.

HOW WILL YOU ADVISE THE AUDIT PARTNER?

STUDY GUIDE

Letter of Representations

Objectives of the Case

The objectives of the case are to promote the students' thinking on (1) the purpose and importance of clients' letters of representation, (2) the reliance auditors can place on them, and (3) the significance of differing views among client management as to the fairness of financial statements. Specifically, the case asks how best to resolve the issue presented by refusal of a management person to sign a company's letter of representation to its auditor. A broader objective is to illustrate the need for an auditor to do something when furnished with information, oral or otherwise, that the financial statements may be materially misleading — whether that information comes from a signatory to a letter of representations or from someone else. The case could also focus on who should have to sign a letter of representations.

Applicable Professional Pronouncements

Statement on Auditing Standards No. 19, "Client Representations"

Montgomery's Auditing, Ninth Edition, page 335 (nonauthoritative)

Business Assumptions and Other Data

Disagreements between members of a management team are commonplace. Corporate "infighting" at times seems to be the norm rather than the exception. However differences between management team views as to the reliability of the financial statements, as illustrated by this case, are not now commonplace. By the time the financials are ready to be issued and the letter of representations signed, differences regarding carrying amounts of assets and liabilities are usually resolved, or, as may happen in more cases than known, simply "swept under the rug" as an expedient or for some other reason. If the required representations are not obtained, Statement on Auditing Standards No. 19 is quite clear in requiring a qualified opinion, but that is the kind of opinion not likely to appear in practice.

The students might try drafting a qualified opinion covering the circumstances in this case. But, that draft is likely to be so ludicrous as to be unissuable. In one way or another the uncertainty should be resolved. Limited search for such a qualified opinion disclosed only one instance where a disagreement between members of management reached the reporting stage — and that was one more than was expected. In that case, the management team could not agree on the carrying value of certain assets. The accounting firm, one of the large ones, gave an initial report explaining the circumstances and categorically deny-

ing any opinion until such time as management decided what the company's financial statements were to look like.

The company involved was an SEC reporting company. Thus, the disclaimer of opinion may have been no more than a ruse to force agreement among management people on the asset valuations; for a certainty, the Commission would not accept the disclaimed opinion in any 1933 Act filing and most likely would find it unacceptable in any 1934 Act filing.

In contrast, many members of management teams sign representation letters without giving them the least attention. How often perfunctory signatures are obtained by auditors is not known; in all probability the occurrences are extensive — and certainly more extensive than the auditors would prefer. An attitude exists in some companies that if this is what the auditors want, give it to them. Countless examples can be seen in practice to lead to a conclusion that management did not take the letter seriously. For example, the management group of a savings and loan association signed a letter that contained, in error of course, a representation that the association had made provision “for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of prevailing market prices.”

Statement on Auditing Standards No. 19 does not require controllers to sign letters of representation; it does suggest that normally the chief executive and the chief financial officer should sign the representations. The students need to know that, in this case, the auditors' firm policy, rather than professional literature, requires the controller to sign the representations. Such a policy requirement may exceed, but does not seem to exceed, professional requirements that state the representations “should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations.” That professional pronouncement would seem sufficiently broad to let the auditor pick and choose the signatories on the basis of the auditor's perception of who is responsible and knowledgeable.

The case does not give the nature of the impairment causing the controller's concern for additional valuation allowances; nor does it give those data for allowances already on the books (believed excessive by the chief executive and chief financial officers). The students may assume that in each case the allowances proposed or recorded relate to impairment through change in price levels. In the case of the allowances booked, the change in price level was related to one specific model with less efficient output. In the case of the proposed additional allowances, the change in price level anticipated was generally “across the board,” involving over 60 percent of the models.

Discussion

Any number of different views are observed as to the purpose of a letter of representations, and probably most can be considered appropriate. To understand how this case should be resolved, the students should have in mind the purpose of clients' representations. Some of the comments from Statement on Auditing Standards No. 19 that are pertinent to identification of the purpose are:

Written representations from management ordinarily confirm oral representations given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are subjects of the representations.

The auditor obtains written representations from management relating to its knowledge or intent when he believes they are necessary to complement his other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain corroborating information concerning matters that are also the subject of written representations . . . the auditor should obtain a written representation to provide confirmation of management's intent. Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of management's representations is reasonable.

Other comments from other sources say, for example, that the purposes of the letter are to impress upon management its responsibility for the financial statements, to show that the auditor has made proper inquiry of company officials as to various matters not otherwise determinable, or to document responses to inquiries directed by the auditor to the client.

Part of the "confusion" about the purpose of the letter of representations stems from the breadth of the matters covered, their lack of homogeneity and their varying degrees of audit corroboration and audit interest. Some matters relate to "intent," which is almost impossible to corroborate in an audit sense. Examples would be intent not to repatriate foreign earnings; intent to close down a product line or a business segment; or intent to re-finance short-term debt as long-term. Some relate to physical presence or bulk and can seldom be corroborated in an audit sense. Examples would be availability of all books and records to the auditor; availability of all the board minutes and their completeness; or absence of communications from regulatory agencies. Some relate to accounts that have been extensively audited. Examples would be proper recording of material transactions or provision to reduce excess or obsolete inventories to net realizable value. And a great number falls somewhere between the extremes above, such that the extent of audit corroboration necessary is uncertain and, in practice, varied. Thus, the students should perceive that the purpose of the letter is manifold because of the characteristics attached to items covered. As to the air conditioner inventory, they should view the primary purpose as that necessary to complement the other auditing procedures, and the secondary purpose as being to confirm management's intent not to discount sales prices to amounts below cost.

The students should discuss the extent of reliance auditors can place on management representations. The extent of reliance is subject to the same homogeneity fact pattern as above. In some cases, reliance is essentially absolute, as in representations of management's intention. In other cases, the audit work is paramount, with the letter of representations serving as little more than "in-house" confirmation, as in representations regarding reduction of excess or obsolete inventories to net realizable value. And in a great number of cases, the extent of reliance is uncertain and varied.

The Securities and Exchange Commission takes the position that auditors should not rely on management representations but should corroborate them through auditing procedures. And auditing literature generally accords with that position. So the enigma the students should recognize is that auditors are told they should not rely on management representations or that such representations are not a substitute for the application of necessary auditing procedures; but the facts are that, in varying degrees, dependent on the

subject matter, the auditor must rely on such representations because there exist no corroborating procedures, or only limited corroborating procedures.

While the students should understand this enigma, it is hardly present in the Mighty Magic case, because significant auditing procedures can be applied. The principal missing ingredient, that generally can be reached only by representation, is whether management intends to mark down its air conditioners to sell at below cost. Here the letter of representations is critically important — and unless the auditor's examination "reveals evidential matter to the contrary, his reliance on the truthfulness of management's representations is reasonable."

With regard to the inventory allowance question, the auditor should be satisfied that the products in inventory are moving satisfactorily in the post-balance-sheet period. And to that extent, any representation by management is simply corroborative. However, the auditor cannot know what management intends to do with its product prices or with its marketing programs and so must rely on the representations of management as to its intent to move the merchandise in inventory at a price that will recover the cost. That is an important theoretical distinction which the class should understand. And in the context of this case, the controller should be asked whether he has any evidence of management's intent to discount the merchandise in inventory, or whether he has any knowledge of marketing problems the company has encountered.

The students may ask what is meant by "management." No definition is given in Statement on Auditing Standards No. 19, and they should be able to come up with their own definitions. They could use as guidance the definitions given in Statement on Auditing Standards No. 6, "Related Party Transactions" (1975), or Statement on Auditing Standards No. 30, "Reporting on Internal Control" (1980), each of which differs to a degree from the other. The point of concern would be whether the controller is "management." Giving a person a title that sounds like management does not make a person part of management, if that term is adequately defined.

The Statement on Auditing Standards seems to say only that the representations letter should be signed by the chief executive officer and the chief financial officer. Some might be tempted to argue that a controller is not "management" but is a secondary officer, and that his signature is not really necessary on the letter of representations. It could be argued that the auditor should simply accept the letter signed by the president and the chief financial officer. Such was the position of the other two officers, and that position was not unreasonable in the context of the language of Statement on Auditing Standards No. 19. It might also be argued that the inventory reserve is not so much an accounting determination as it is a marketing strategy determination. Therefore, it might be argued that the auditors ought to have a separate letter from the marketing vice president expressing his views about the future of the questioned product.

The case should afford an opportunity for the students to discuss the basis for the positions taken by the controller and by the other two management people. They should also consider the motivations of the individuals as undoubtedly they will not be the same. Presumably the controller has more bullets in his belt than the one marked "oil shortage." To quantify that phrase alone into dollars of inventory write-down, as he seems to have done (because the amount is said to be material), seems improbable at best, unless he simply used a broad-brush approach and plucked ten percent off the wall. His position should not be capricious. By the same token, the other two executives must have more to support their position than is apparent from reading the case; that is, the oil shortage

“may keep people at home more.” The students may show some concern over the disparity in stated positions regarding the amount of the allowance:

Controller - low side by material amount

Other executives - excessive

Auditor - adequate

The students may sense that the auditor is a bit ahead of himself with a conclusion of “adequate” when the company seems unable to find an acceptable number.

The students might be inclined to explore whether the problem and solution would be different had the controller refused to sign based on a lack of information sufficient to decide the allowance rather than on a perceived misstatement. In comparison to auditors’ reports, the first position would seem comparable to an “unaudited” disclaimer; the second, to an “adverse opinion.” And the latter should seem more onerous to resolve.

Some of the alternative solutions to be explored include the following:

- Leave out the controller as a required signatory, as discussed above. The omission would require appropriate approval within the auditing firm, because omitting the controller would be a violation of firm policy.
- Encourage the controller to sign a letter he does not believe in. There is a question of principle at stake here. The auditor must stand up for the controller’s right to express his views, and the auditor must avoid coercion, or apparent coercion.
- Modify the letter to put in the controller’s belief. In this way the controller can record what he honestly believes regarding the inadequacy of the reserves and include such a statement in the letter of representations as his personal qualification of the fairness of the financial statements.
- Attempt to convince the controller the reserves are adequate. The auditor would need very strong audit documentation to take this stance. In effect that would be saying the auditor is better informed as to the reasonableness of the inventory than is the controller.
- Attempt to convince the two senior executives that some upward adjustment of the allowance is required. The above admonition also applies here — very strong audit documentation would be needed.
- Stay out of the conflict until it is resolved. The auditor should figuratively lock the three executives in a room until they reach an accord, which is a good theoretical answer because it emphasizes management’s responsibility for a fair presentation of the company’s financial position.
- Refer the matter to the Board of Directors and ask that they commission such investigation as is necessary to resolve the disagreement. Such an investigation could include the use of independent market researchers or other outsiders.
- Conclude that the action of the controller is capricious. The controller may be carrying a large-sized grudge — he may have been bypassed for a promotion; he may have been bypassed for salary increase and bonus; he may have been told he should start “looking” as the company is looking for a replacement; or he may have other real or imagined grievances. He may be trying to “get even.” The case does not suggest

capriciousness (and in this case it was not suspected), but the students should be aware that employee grievances have affected, and will continue to affect, responses furnished to auditors.

Some students may suggest that the case study is really an inventory valuation problem and less so a letter of representations problem. Having been told by a responsible employee that something is wrong with the inventory valuation, the auditor has little choice but to audit until satisfied — irrespective of who signs the letter of representations. For example, had the plant manager, instead of the controller, expressed the same concerns, the auditor would be confronted with essentially the same problem, the difference being the plant manager is not a signatory to the letter.

Each officer signing the letter of representations has a heavy responsibility for fair presentation. If in good faith, as opposed to capriciousness, an officer is contending that the financials are misstated, the auditor would be well advised to obtain concurrence of all signatories before signing his own name to a certificate. *Montgomery's Auditing* takes a somewhat similar position (page 335), though perhaps from a somewhat different viewpoint.

Some students may want to discuss the apparent economic distress facing this company if the controller is right, or even close, and the company cannot recover the cost of producing its principal product. Though not a part of the case study, the students should realize that auditors should be mindful of the economic environment that surrounds specific accounting and auditing issues.

The Solution

The auditors took the position that they would not issue, in this circumstance and most likely in any other circumstance, their unqualified opinion so long as a necessary signatory to the letter of representations contended in good faith that the financials were materially misstated. Nor were the auditors interested in issuing some peculiar qualification running to failure to sign the letter of representations. If the three executives could not come to agreement, the matter should go before the Board of Directors for further investigation and action and until all parties were in agreement, the audit opinion would be withheld. If the company demanded an opinion before agreement, the opinion would probably be a denial, or perhaps a qualification, but running to uncertainty in the inventory valuation and not to failure to sign a letter. The client was advised that both of the latter opinions would probably be unacceptable to the Securities and Exchange Commission, so the company should get on with the business of preparing statements acceptable to the three executives and the Board and, if they want a clean opinion, to the auditors as well.

The alternative of having the controller express an adverse opinion on the inventory valuations in the letter of representations was not acceptable. To proceed with a clean audit opinion in face of the controller's adverse opinion would expose the auditors and others to unacceptable professional and legal risks, and especially so if sales of the Widget Air Conditioner fell through the floor.

The additional allowance required by the controller may or may not have been necessary; but officers responsible for companies' financial statements had better make themselves heard if they believe the financials to be materially misleading, just as the controller did here. The Securities and Exchange Commission is looking more and more to financial

and accounting officers to stand up and be counted in spite of top management pressure (as witness, for example, ASR 267). So disagreements between company management personnel, such as shown here, may become more commonplace and, though a bit sticky from the audit side, should further the progress toward reliability of financial statements submitted for audit.

New Client Acceptance

A recently promoted partner, Mr. Atlast, was appointed Treasurer of Community Fund Raising Foundation. There he worked closely with Mr. Pillar, the President of the foundation. Mr. Pillar is sole owner of a mini-conglomerate engaged in franchising laundries and developing real estate. Mr. Atlast was quite excited when Mr. Pillar suggested that they get together to discuss the possibility of an audit since Mr. Pillar was planning on "going public."

Mr. Pillar said he was familiar with the work of Mr. Atlast's audit firm from an association many years ago in another city when Mr. Pillar was involved with another company. After further discussion and a cursory review, Mr. Atlast learned that Mr. Pillar's present company was successful and profitable and that its audit fees should be substantial. Mr. Atlast told Mr. Pillar, with appropriate words of thanks, that indeed his firm wanted the work and he casually mentioned that his firm required approval of all new clients by at least one other partner in the firm, but that it should be of no concern to anyone.

Mr. Atlast began his new client investigation which would be submitted for approval to a partner in the executive office. Mr. Pillar was found to be a highly respected member of the community, active and highly placed in a number of charitable and civic organizations. His company was highly regarded by his banker and his attorney (who was a member of one of the more prestigious legal firms in town). The Dun & Bradstreet contained no negative information about his company or about him.

To round out the investigation, Mr. Atlast called up Mr. Post, the partner in the Haddit, Mississippi, office who had handled the firm's previous audit work. Mr. Post, now retired, had a number of things to say:

His last audit of the Mississippi company, Realee, Inc., occurred some 12 years ago. Realee was a publicly held company engaged in real estate activities. Mr. Pillar, the chief executive officer, owned some ten to twenty percent of the stock. Post described Pillar as having been a "real little hot shot, maybe 28 or 29."

During the firm's next to last audit of Realee, Mr. Post insisted, over strong objection by Mr. Pillar, that the company reduce the carrying amount of an apartment house held for sale from \$600,000 to \$200,000, based on appraisals obtained by Mr. Post. This adjustment was made. But, in the first quarter of the following year, the apartment house was sold for \$600,000 to a trust and a profit of \$400,000 was reported. Mr. Post and his audit team pressed for identification of the purchaser. Mr. Pillar said he did not know and could not find out the names of the principals of the trust.

The audit was at an impasse. The matter was about to be taken up with the Board of Directors when search of the County Recorder's records showed the property recorded in the name of Mr. Pillar himself. Stamps affixed to the deed indicated a purchase price of \$50,000.

Without power of subpoena, Mr. Post was unable to prove that the property had been sold, using the trust as a "strawman," directly to Mr. Pillar, who had lied about it to the auditors. Nor was Mr. Post able to identify the source of the \$600,000 cash paid Realee by the trust, but he believed it was the same \$600,000 Realee paid for consulting services to a company that had engaged in reciprocal sales with Realee in the past. But, as he told the Board, he was confident that his analysis of the available data was correct.

Following the meeting of the Board, Mr. Pillar resigned, and within a year Realee was out of business.

Further, during the years of Mr. Pillar's management, Realee had engaged in other questionable transactions, primarily "parking" transactions and reciprocal sales, which had been appropriately adjusted in the audit process.

Disturbed by Mr. Post's story, Mr. Atlast spent the next few days weighing the pros and cons of taking on this engagement. He finally concluded that after 12 years Mr. Pillar must have matured to a point where he would no longer lie to auditors or engage in shady deals as he had in Haddit. The fact that he wanted to come back to the firm seemed proof enough that he would not pull the Haddit tricks again. Mr. Atlast packaged all the new client investigation data and shipped it off to an executive office partner requesting his approval.

You are the partner in the executive office.

**SHOULD YOU APPROVE ACCEPTANCE OF
MR. PILLAR'S COMPANY AS A NEW CLIENT?**

Attorney/Auditor Responsibility

As a member of the corporate law department in a major New York law firm, you have frequent occasion to work with your clients' auditors. In particular, the auditors send letters every year asking you to tell them about any contingencies or uncertainties hanging over mutual clients. Their letters of request conform generally to the model letter that seems to satisfy the requirements of the American Bar Association and the American Institute of Certified Public Accountants. Your firm, as a matter of policy, has always tried to cooperate with the auditors' requests. However, you know that some attorneys remain reluctant to answer those letters because of their concern that it may increase their own liability — and because it may jeopardize the client-attorney privilege.

In an attempt to dispel some of that reluctance and to better identify the various responsibilities, the accountants and the attorneys agreed some years ago (1976) to a compromise procedure. That procedure, in substance, may be summarized as follows: The client will list and evaluate all of the legal contingencies facing the company; the auditor will review files, minutes, and other documents in an attempt to corroborate that listing; and, as a final step, the auditor will ask the attorney to confirm that listing and to add any other information that the attorney thinks should be mentioned. Based on that listing, a decision to disclose or accrue a contingency will be made. Both the AICPA and the ABA agreed that the attorneys have some kind of a professional obligation to advise their clients regarding disclosure of material contingencies in their financial statements and if a client refuses to comply with that advice, the Bar has agreed that the attorney should consider resigning from the engagement.

Lawyers' responsibilities regarding their clients' disclosure obligations have been the subject of considerable discussion, and in time there may be further clarification and guidance on this sensitive matter. The 1976 compromise between the Bar Association and the Institute helps a bit, but you wish there were more and better professional guidance — particularly as you sit in your office staring vacantly at the standard form of legal letter just received from the auditors of National Consumer Products requesting your reply regarding that company's litigation, claims, and assessments. You say to yourself, "It's decision time again."

Answering the letter would be a snap were it not for one minor — or perhaps not so minor — item. You remember clearly what you have in your files on that item. It concerns a possible Federal Trade Commission (FTC) action against National, and it goes something like this:

Earlier this year a young FTC investigator visited the company and asked routine questions about pricing policies. He was particularly interested in several of the company's more profitable products where there had been very little price competition. After the investigator left, you and the treasurer talked to several people in the marketing department. After some emotional discussion, the group vice president admitted that he and his peers in the competition met several times each winter at a ski resort to discuss product pricing. He denied fixing prices, but admitted that prices for all comparable products are very much the same. You advised him to steer clear of any such meetings in the future, and it was agreed that the company would simply wait to see what happened next. According to your records, very little has happened. The FTC investigator visited the other companies in the industry, but there have been no new developments in the last 90 days.

And, with equal clarity, you recall the treasurer's admonition, on more than one occasion, not to disclose the visit by the FTC to the auditors. The gist of his comments was to the effect that "all we'll do is run up a lot of expensive time, and waste a lot of my time, arguing with the auditors about whether we should disclose in our annual report the possibility of a lawsuit that may never be filed — after all, our man says he did not fix any prices."

It is not clear that this matter is enough of a "material contingency" to require disclosure in the financial statements. Still, you have never had to worry this much about the disclosures in a client's financial statements before. In other situations, all the relevant data had been "on the table," and you had been able to discuss the accounting side of the question with the auditor to add perspective to the legal side. But now you seem to be on your own and you are not comfortable with that responsibility; but it is beginning to look as though you will have no alternative but to accept it.

You sit there in your office torn between your time-honored responsibility to accommodate your client's request for attorney-client privilege and your nagging feeling that this investigation by the FTC might well be something that you have a responsibility to see disclosed to the investing public and others. One thing is clear, if you do not disclose the matter to the auditors, the chances of it being disclosed this year in the annual report are almost nil.

**AS AN ATTORNEY, WHAT WILL YOU DO WITH YOUR KNOWLEDGE
OF THE FEDERAL TRADE COMMISSION INVESTIGATION?**

STUDY GUIDE

Attorney/Auditor Responsibility

Objectives of the Case

Clearly, the objective of the case is not to educate auditors and accountants in the practice of law. Nor is the case intended to imply that auditors and accountants can solve legal questions, such as the one faced here. Students may properly question, then, “Why stick us with this case? That is for lawyers to solve.” And, that is true. But, this case is designed to illustrate the amount of responsibility attorneys assume for the public reporting of their clients and to demonstrate the heightened dilemma faced by attorneys whose clients would withhold from their auditors information that may be essential to a fair presentation of financial position. General counsel have presumably had some responsibilities for adequacy of disclosure all along, but their responsibilities have come more and more into focus as experience is gained in applying the compromise procedures between the Bar and the accounting profession, which culminated in Statement on Auditing Standards No. 12. Also, there is an increasing public concern about the responsibilities of practicing attorneys as evidenced in the Securities and Exchange Commission’s action against White and Case in the National Student Marketing matter. The fact is that practicing attorneys are under increasing pressure to acknowledge an obligation to the public which is beyond their advocacy obligation to their immediate corporate clients.

The case also illustrates how much the auditors have delegated to the attorneys as a result of the provisions of Statement on Auditing Standards No. 12. Auditors may always be dependent on attorneys, but the Statement on Auditing Standards and the formal position papers from the Bar Association highlight that dependence. The auditors consider themselves responsible for the adequacy of the disclosures in clients’ financial statements; however, when it comes to disclosure of potential legal problems, auditors may not even have an opportunity to exercise that judgment — the judgment may be exercised for them by the clients’ attorneys.

Discussion of the case should give the students some of the auditor’s insight into the nature and import of inquiries and investigations by administrative agencies.

Applicable Professional Pronouncements

Statement on Auditing Standards No. 12, “Inquiry of Client’s Lawyer Concerning Litigation, Claims, and Assessments,” particularly Exhibit II — American Bar Association Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information

Statement on Auditing Standards No. 19, “Client Representations”

Handbook of Accounting and Auditing, Burton, Palmer, and Kay, Chapters 29, 44, and 46 (nonauthoritative)

Business Assumptions and Other Data

In this case a major concern of the attorney seemed to be preservation of the attorney-client privilege, and the Statement of Policy of the Bar Association identifies the protection of that privilege as "fundamental." A bit of background regarding privilege taken from the *Handbook of Accounting and Auditing* and other sources should add perspective for nonlawyer students. The *Handbook* (Chapter 44) indicates that the attorney-client privilege is the only privilege derived from common law but goes on to say that a common-law privilege may be modified or abolished by statute. As privileges of any kind act as a derogation of a court's search for truth, they remain under careful scrutiny. The day of judge-created privileges is said to be probably past in federal courts or administrative proceedings. While that development may or may not have a bearing on the privilege of the attorney in this case to withhold information on the FTC investigation from the auditor, it may suggest a gradual erosion of the time-honored privilege enjoyed by attorneys and their clients.

Some of that erosion of the sanctity of the attorney-client privilege is evident in SEC matters. Commissioner Sommer, in a speech in January 1974, said that in securities matters, other than where advocacy is clearly proper, the attorney will have to function in a manner more akin to that of an auditor than that of an advocate. In some Securities and Exchange cases attorney-client privilege could not be invoked. In others, it seemed to hold.

A brief comment about the nature of investigations may also be helpful to the nonlawyer in considering the case. In a nutshell, an investigation leaves little maneuvering room for the one being investigated. The *Handbook* (Chapter 44) says:

Investigations are perhaps most readily analogized to the discovery phase of civil litigation. There are, of course, important distinctions; an investigation is discovery that occurs in advance of the initiation of proceedings, and it is a decidedly one-sided form of discovery, with the subject of the investigation having only a very limited right, if any, to adduce evidence in his defense. And the scope of permissible inquiry during an investigation is subject to even fewer restrictions than the discovery that occurs in litigation between private parties.

The disclosure of investigations in financial statements is unsettled. Not too many years ago the SEC frowned on disclosure of their private investigations. Not so today. According to the *Handbook* (Chapter 46), the Securities and Exchange Commission now takes the position that a company and its auditors must judge materiality of an SEC investigation as in actual and threatened litigation. And, perhaps for this reason, there has been a substantial increase in the number of disclosures of SEC investigations. Would not the same approach seem valid for an FTC investigation?

Before the advent of Statement on Auditing Standards No. 19, Client Representations (1977), auditors frequently asked clients to represent whether any governmental agency had made inquiries or conducted investigations during the year under audit. Had such representation been requested of National Consumer Products, the dilemma of the attorney would be automatically resolved — assuming a truthful answer were given. However, since the issuance of Statement on Auditing Standards No. 19, auditors tend to follow the model letter in that Statement and the representations now sought probably can be answered truthfully by management without having to disclose the likes of the FTC investigation.

Representations from the model letter that might have exposed the investigation, if answered truthfully, could be interpreted — and probably are being interpreted — so as not to require disclosure of the investigation. Some of the tangential representations would be:

- No. 3 - There have been no -
 - c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

- No. 6 - There are no -
 - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
 - b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5.

- No. 7 - There are no unasserted claims that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

The case does not state whether the attorney is an officer or a director of the company. If such were the case, the attorney in the role of officer or director would be subject to the Foreign Corrupt Practices Act and, more particularly, Regulation 13b2 of the Exchange Act; he would then be required to state any material fact necessary to make the financial statements not misleading to an accountant in connection with an audit. In this case the attorney was neither an officer nor a director.

Discussion

The attorney's responsibility for maintaining attorney-client privilege seems rather clear. The attorney's responsibility regarding financial statement disclosure of unasserted claims and the like is less clear. The inquiry or investigation would seem to be in the nature of an unasserted claim; the following discussion, taken largely from the *Handbook* (Chapter 29) and from other sources about lawyers and unasserted claims, may be useful to the students in their appreciation of the attorney's dilemma.

Disclosure of an unasserted claim or assessment is not required unless it is probable that the claim will be asserted and there is a *reasonable possibility* that the outcome will be unfavorable. Unasserted claims or assessments are given special consideration in SFAS 5. Unasserted claims have been given this special treatment because (attorneys have argued) disclosure could cause the injured party to recognize the injury and assert the claim; in other words, the disclosure tends to be self-fulfilling. Attorneys were also concerned with the loss of attorney-client privilege if certain disclosures were made regarding unasserted claims.

The problem between auditors and attorneys centered around the auditors using the attorney letters to *discover* unasserted claims and the attorneys' reluctance to jeopardize privilege. Many attorneys who previously responded to auditors' requests became reluctant to respond to general requests, because they were aware of the increasing amount of litigation and believed that the less information available to outsiders, including auditors, from whom information could be "discovered" by a potential plaintiff, the better they could protect their clients from adverse consequences of litigation. The attorney-client privilege does not extend to information disclosed to an auditor, because the auditor legally does not have such privileged communication with his clients. Attorneys were adamant about giving potentially damaging information to auditors that could then be caught by "fishing" plaintiffs.

The lawyer's responsibilities are to consider an unasserted possible claim if he realizes one exists and to recognize there may be a requirement for financial statement disclosure; he does not commit to devoting substantive attention to searching for such claims. Because a lawyer is not considered an expert as to detailed disclosure requirements under SFAS 5, he should notify a responsible client officer or employee of an unasserted possible claim that the lawyer has concluded must be considered for disclosure to the auditor and should satisfy himself that the officer or employee understands the requirements of SFAS 5. Having done this, the lawyer has fulfilled his commitments unless he has concluded that the unasserted possible claim is probable of assertion; such a claim, if material, must be disclosed in the financial statements. The ABA Statement of Policy, in referring to disclosure, applies to whether or not the unasserted claim or assessment must be brought to the auditor's attention, and does not refer to the requirements of disclosure under SFAS 5. It is the client's responsibility to evaluate whether financial statement disclosure is required, and the auditor's responsibility to evaluate the appropriateness of that disclosure.

Some, however, believe that the lawyer's responsibility runs to disclosure in the financial statements and is not limited to "disclosure to the auditors." That such differing views exist is understandable. The Statement of Policy of the American Bar Association (paragraph 6) seems to suggest the responsibility runs to financial statement disclosure wherein it states:

Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. In appropriate circumstances, the lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of SFAS 5.

However, it is well to note the word “may” is used above in addressing the subject of the attorney’s responsibility, which would seem to leave considerable room for interpretation. The possibility that the “disclosure” in question means disclosure to the auditor only, as noted above, is reinforced by the Commentary (paragraph 6) to the Statement of Policy, which states:

. . . In any event, where in the lawyer’s view it is clear that (i) the matter is of material importance and seriousness, and (ii) there can be no reasonable doubt that its nondisclosure in the client’s financial statements would be a violation of law giving rise to material claims, rejection by the client of his advice to call the matter to the attention of the auditor would almost certainly require the lawyer’s withdrawal from employment in accordance with the Code of Professional Responsibility

However, the legal profession’s policy statement is not binding on a lawyer. Some attorneys may specifically dissociate themselves from the ABA Statement.

In the discussion, the group ought to deal with questions such as the following:

1. If the client insists that the attorney say nothing about the matter, what alternatives does the attorney have under the arrangements between the Bar Association and the accounting profession? The answer to the question is that the attorney may not violate the client’s confidences — but the attorney may resign from the engagement. Or, the attorney may try to persuade the client to volunteer the matter to the auditors.
2. Does the attorney have an obligation to advise the auditor of the attorney’s concerns, particularly if the disclosure question is borderline? No one really knows the answer to that question just yet. Probably, attorneys will conclude that they have no obligation to anyone other than themselves and their clients and will make this decision solely on their own. They will not involve the auditors in their decision-making until an attorney is sued for lack of disclosure. And, history shows that attorneys are seldom sued.
3. If the disclosure question were borderline, should an attorney retain another accountant as a consultant or adviser? The group might consider the implications of such a development.
4. Should attorneys go to the Securities and Exchange Commission on their own if they feel strongly an investigation should be disclosed in the financial statements? That was tried in one case:

A practicing attorney helped a client put together a prospectus to sell \$25 million in bonds. The prospectus went effective, and the offering was successful. A short time later the attorney reviewed the firm’s files on that client and noticed that there was a potential lawsuit which had been discussed by one of the other attorneys in the firm with the client’s financial vice president. The suit had not been disclosed in the prospectus even though it could have been a material fact in any investment decision. The attorney asked the client to amend the prospectus and notify all purchasers of the securities. The client refused, reasoning that the offering was successful and that the lawsuit was a remote contingency. After some agonizing, the attorney reported the

matter to the Securities and Exchange Commission which required a rescission of the offering. As a result of that attorney's actions the client fired the law firm; the law firm separated the partner; and the State Bar Association began proceedings for violating a client's confidences.

The group should not get into a discussion of the need to disclose this specific problem on this specific engagement. The discussion ought to focus on the responsibilities, in general, which attorneys may now carry in the disclosure arena.

The students may recognize or recall that where public offerings of securities are involved, attorneys for underwriters typically do a superb job in bringing forth disclosures of unasserted claims and other relevant data to a purchaser of securities. As the company selling securities is not their client, and thus not entitled to the same privileged communication, these attorneys tend to insist on disclosure of potential legal matters that may even seem remote. The list is endless of disclosures required by attorneys for underwriters that were not required by general counsel of the issuing company. A recent illustration goes something like this:

A company sold to the government approximately 80 percent of its products on a non-bid basis that generally provided for cost reimbursement and profit. The government discovered that the company was "padding" its costs through use of "shell" companies and fictitious invoices and through other means. The government notified the company by letter that it would honor the existing contracts, but when a new source of supply was established it would no longer buy the company's products. General counsel for the company advised that the government letter need not be disclosed to the auditors; the "padding" was not discovered in the audit process; and, thus, the financial statements and auditors' report gave no hint of past wrongdoings and of near-term loss of substantial business. Needless to say, lawsuits followed, including litigation against the attorney whose hands, it was alleged, were not clean on other counts as well.

In a somewhat similar case, the auditors were in a stronger role, but the attorney, as in the illustration above, opted for "cover-up." A summary of this case is:

A company was in the process of making a new tax shelter offering. It had made similar offerings in the past, and in each case had thereafter acted in the role of manager of the shelter. The president of the management company had used substantial funds for his personal benefit that by terms of trust agreements were restricted to specific uses for the benefit of the shelters. The auditors said that this misapplication of funds must be disclosed in the prospectus of the new shelter — that is, potential buyers should have knowledge of misapplication of funds in earlier shelters. The management and its general counsel were adamant that no such disclosure would be permitted nor would the company or its counsel permit the auditors to tell the underwriters and their attorneys what had happened. Contrary to the facts in the National Consumer Products case, the auditors knew of the matter and simply refused to sign their report until the underwriters were informed. Within five minutes after being informed, the underwriters withdrew from the offering, leaving for their office with a sobering comment

that should some other house go through with the offering they would surely expect to see the appropriate disclosure regarding management's misuse of trust funds.

What these illustrations seem to point out is that attorneys know what should be disclosed to the investing public even though attorneys are not trained in financial accounting and disclosure requirements. What gets in the way of doing what is right is often the desire to do what is "best" for the client. The adversary role on behalf of a client and the privilege of communication between attorney and client conspire at times to thwart fair and necessary disclosures in financial statements.

Regulation S-K of the Securities and Exchange Commission might suggest to the students that the inquiry or investigation should be included at least in the nonfinancial portion of reports required by the Securities and Exchange Commission. Under the caption "Item 5 — Legal Proceedings," the Regulation says, "In the case of proceedings by governmental agencies, disclosure is required even though the proceedings have not yet been instituted, provided it is known that the proceedings are contemplated." Of course that leaves a lot of room for contemplating what is meant by "contemplated" and by "known."

The Solution

The students will recognize that no correct or incorrect answer, from the lawyer's point of view, can be given by a layman — perhaps not even by a lawyer. Some lawyers would insist that the matter be exposed to the auditors for consideration; others would insist that there is no room for consideration — the facts must be disclosed in the financials; and still others would agree there is no room for consideration — the client's privilege must be respected and nothing said to the auditors or in footnotes. Lawyers in the first two groups presumably would need to resign, or at least "consider" resigning, should their clients ignore their advice — that is, if they are following the Statement of Policy of the Bar Association.

Presumably, until the courts or the statutes better define the responsibilities of attorneys to the public generally on financial disclosure matters, attorneys can remain silent on any number of grounds, including:

- They have not given substantive time to the issue nor has their client requested they do so.
- Amounts involved, if any, may not be material.
- Factors influencing the likelihood of an unfavorable outcome may not be within a lawyer's competence or ability to judge.
- Lawyers may lack sufficient information to conclude that it is probable a claim will ever be filed.
- If a claim were filed, lawyers may lack sufficient information to conclude that an unfavorable outcome is either probable or reasonably possible.

Auditing Commission Payments

Powerco manufactures and installs hydroelectric equipment used in power generating plants throughout the world. Each system is custom-built to the customer's specifications and each sale requires substantial engineering for design and installation.

Powerco's shares are traded on the New York, Montreal, and London stock exchanges. The company is headquartered in New York and your New York office issues an audit report on the consolidated financial statements. A significant portion of the audit work is referred to other offices, both domestic and outside the United States. As partner in charge of the job in New York, you will specify the scope of the work to be performed by each of the referral offices.

During your visit to plan the year-end work, you find that the company's international business is booming. During the year, the company got into the Middle Eastern countries for the first time, writing 13 contracts with an aggregate sales value of \$300,000,000. From your discussions with management and from scanning the documentation supporting the sales contracts, you are surprised to learn that the company used local sales agents in each case. In all of the company's domestic and European business, contracts are negotiated by a salaried sales staff, all of whom are skilled engineers. Management explained that it was necessary to work through local commission agents in the Middle East in order to establish a feeling of trust with the buyers. The contracts were arranged through five different commission agents who were paid from 10 to 20 percent in commissions (totaling \$40,000,000).

You review the contracts, and the names of two of the commission agents are familiar. You happen to remember that some years ago their names appeared in a *Wall Street Journal* article summarizing arguments between the Securities and Exchange Commission and various multinational corporations, including Ashland, Northrop, and Lockheed. You recall that, according to that article, the Securities and Exchange Commission was concerned that these commission agents, among others named in those investigations, used some of the proceeds of their commission payments to influence officials in the purchasing countries, and that later developments bore out the concern that, indeed, some of the commission payments of those agents turned out to be bribes of foreign officials.

You realize that the Foreign Corrupt Practices Act has been around since 1977 and, as a consequence of that Act, many, perhaps most, bribes of foreign officials have fallen by the wayside. You would like to think that no bribes are involved in the \$40,000,000 of commissions, but you get a sinking feeling every time you reflect on the names of two of those commission agents, on the size of the commissions, and on the Middle Eastern countries involved.

**HOW WILL YOUR PLANNED AUDIT PROCEDURES BE AFFECTED
BY THIS INFORMATION?**

Appendices

American Accounting Association Representatives Attending Trueblood Professors' Seminars

Professor	American Accounting Association Role	Year(s) Attended
Samuel Frumer	Seminar Board Committee Member	1983
Yuji Ijiri	President	1983
Harold Q. Lagenderfer	President-Elect	1983
Jay Smith	Seminar Board Committee Member	1983
Loudell Ellis Robinson	Seminar Board Committee Member	1981/82
Robert W. Rouse	Seminar Board Committee Member	1982/83
John Tracy	Seminar Board Committee Member	1982
Jerry Weygandt	Seminar Board Committee Member	1980/81
James Fremgen	Director of Education	1981
Joseph Silvano	President	1981
Donald H. Skadden	President	1980
Wanda A. Wallace	Seminar Board Committee Member	1980
Maurice Moonitz	President	1979
Frank Rayburn	Seminar Board Committee Member	1979
Jack Robertson	Seminar Board Committee Member	1979
Rene P. Manes	Seminar Board Committee Member	1978/79
David Solomons	President	1978
Leon Hay	Director of Education	1978
E. Dee Hubbard	Director of Continuing Education	1977/78
Charles Horngren	President	1977
Robert L. Grinaker	Director of Education	1977
Gary L. Holstrum	Seminar Board Committee Member	1977
Wilton T. Anderson	President	1976
Lee Brummet	President	1975
Elba Baskin	Seminar Board Committee Member	1975

**Trueblood Professors' Seminars
Touche Ross & Co. Faculty
(1966 - 1983)**

Bevis, Donald
Bintinger, Thomas
Bloom, Raymond
Bohan, Michael
Brown, Michael
Burns, Joseph
Cropsey, Jeffrey
Domingues, Robert
Fairman, Robert
Fuchs, Frederick
Gale, Andrew
Gallagher, Richard
Georgen, W. Donald
Henderson, Alan
Higgins, Paul
Kay, Robert
Konkel, James
Lavin, Norman
Loebbecke, James
Mayer, Jerry
Miller, Robert
Mullarkey, John
Murray, Richard

Ostlund, Clayton
Padwe, Gerald
Perry, Raymond
Polansky, Gerald
Presby, Thomas
Puglisi, Joseph
Robinson, Christopher
Rothermel, Robert
Sack, Robert
Shepherd, Helen
Sherman, Len
Shield, Hans
Shuma, Richard
Tang, Palmer
Taper, Eugene
Trueblood, Robert
Van Camp, John
Wall, Tom
Walters, Ralph
Ward, Bart
Waxman, Robert
Wood, Donald
Yarnall, Kent

Others

Roger Eickhoff
Carol Galante
Richard Jensen
Robert Knox
Henry Korff