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Discussant's Response to Auditor Reviews of Changing Prices Disclosures

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Before addressing the specifics of the Skousen/Albrecht research, I should disclose my involvement in the subject area because of the influence it may have on my evaluation of their findings.

I am the partner in my firm with lead responsibility for the subject area of accounting for changing prices and have been closely involved for the past ten years with the efforts of the Financial Accounting Standards Board, Securities and Exchange Commission, and accounting bodies in certain other countries in this area. This involvement led to my being named chairman of the Auditing Standards Board's task force on Auditor Involvement with Required Supplementary Information. The activities of this task force resulted in the issuance of SAS 27, *Supplementary Information Required by the Financial Accounting Standards Board* and SAS 28, *Supplementary Information on the Effects of Changing Prices*. Further, I am the principal author of the Arthur Young research paper on the use of changing prices information by financial analysts, and I reported on this research at the FASB research conference in January 1983. What all this background means is that I believe that changing prices information has merit. In fact, I have helped to shape the related auditing standards and have conducted research that overlaps the subject research in the area of usefulness of FAS 33 data.

I was, as well, one of the five members of the ASB's Planning Subcommittee that evaluated and recommended AICPA participation in the funding of the subject research. And, further yet, I was one of the national office partners of major CPA firms to be interviewed by the researchers for purposes of providing input to be used in the development of their questionnaire.

These prefatory remarks should constitute full disclosure of the reasons why I may be considered a nonindependent discussant of this research paper. I can assure you, however, that I have not accepted any money or other treasures from either Professor Skousen or Professor Albrecht and have endeavored to maintain objectivity in reviewing their research paper.

Turning, then, to the paper itself, let me begin by focusing on the research objectives. As set forth in the second paragraph on the report's first page, they were:

- To determine the nature and extent of procedures used by auditors,
- To identify the costs and special problems related to the reviews, and
- To seek input from auditors concerning the perceived usefulness and auditability of FAS 33 data.

Did the researchers accomplish their stated objectives? I'd answer that with a qualified "yes"—something like "more or less."

Achievement of Stated Objectives

As to the nature and extent of procedures—I think the researchers have obtained a good handle on the nature of procedures followed by auditors in reviewing the FAS 33 information. Their findings as to the nature of auditors' inquiries, reasonableness tests, and comparisons of the disclosures to the audited financial statements are particularly informative. I have only one slight reservation. The information about auditors' procedures was obtained primarily from a review of SAS 27 and 28 and the guidance material of some accounting firms. These procedures were then listed in the questionnaire, and the respondents were asked to make certain comments about them. I wonder whether the researchers might have learned anything further had the questionnaire asked the respondents to list their own procedures.

In terms of the extent of procedures, my reservations are somewhat stronger. The researchers obtained excellent input on four of the six procedures listed, but the questionnaire did not seek similar details as to the other two: checking the mathematical accuracy of computations and test-checking to source documents. These two verification procedures, which consumed 30 percent of the respondents' review time, are not required by SAS 27 and 28. I'd be interested in learning more about them, particularly why they were performed at all, given the limited assurance objectives of SASs 27 and 28.

As to the costs of the reviews—I think the researchers succeeded in obtaining as much information as could reasonably be expected from a questionnaire approach, namely a rough indication of total hours expended, the relationship of these hours to total audit time, a percentage allocation of the total hours to each of the basic procedures, and a percentage breakdown of the hours by level of personnel involved. As I will explain later, my only reservation here is how far one can go in interpreting this rough data.

As to the perceived usefulness of FAS 33 data—Let me begin by saying that I would assign only a low priority to this objective. Information concerning the usefulness of the data is best obtained from users and, to some extent, from preparers—not from auditors. I believe this fact constitutes the reason the researchers refer to the *perceived* usefulness of the data. The use of that word suggests, and rightly so, that the research findings in this regard are only secondhand.

While I happen to agree with the researchers' finding that auditors perceive little client interest in the disclosures, I do quibble with the basis for their finding, principally the responses to the question: "How much interest does your client have in using changing prices data?" Respondents were asked to choose one of the following three possible answers to the question: "little interest," "moderate interest," or "high interest." A client with moderate interest is defined in the questionnaire as one who "uses selected changing prices data occasionally for *managerial decisions*;" a client with high interest is one who "frequently bases *managerial decisions* on inflation adjusted data." Given the choices, I would expect, as was the case, that the great preponderance of auditors would describe their clients as having little interest, defined as a client who "complies with FAS 33 only because it is a requirement."

But is it appropriate to base perceptions of usefulness solely on the extent

of use in managerial decision-making? Isn't it possible for a client to be interested in the disclosures from the standpoint of external communication with users of financial information but not from the standpoint of use by internal management? And, regardless of perceived usefulness, how many clients voluntarily provide financial information that is not required by GAAP, some regulatory body, or the like?

The researchers also supported their finding of auditor perception of little client interest based on the fact that only six respondents reported a client providing the changing prices data on a comprehensive basis. Is the fact that a company provides only the acceptable minimum necessarily demonstrative of little interest in the information?

I also question the intimation that clients have little interest because they commonly use the indexing method to compute current costs of property, plant, and equipment. Irrespective of the degree of interest a company may have in the information, wouldn't it be only logical for it to use the most cost/efficient method which produces reliable results? Contrary to the exposure draft, FAS 33 raised indexing to a level of acceptability equal to any other acceptable method of computing current cost. Further, when a relevant index of new asset price change is applied appropriately to the historical cost of an asset, I believe there is no basis for any implication that there is something suspect or second rate about the result. Moreover, many companies believe that indexing is not only the most cost-effective method of determining current cost, but is often the only practical method.

I also find it significant that the researchers have reported that 71 percent of the respondents made use of external indexes in computing current cost of property, plant, and equipment. But the significance I find is not necessarily what one would think it to be; I find that percentage surprisingly *low*. After all, FAS 33 itself suggested the use of simplified methods. In these circumstances, were I the decision-maker at a reporting company, I wouldn't hesitate to make extensive use of external indexes.

Furthermore, I never would have expected to find that appraisals were used by as many as 11 percent of the respondents or that appraisals were used in the first year and updated by means of indexes in subsequent years by another 7 percent of the respondents. Appraisals are by far the most expensive method of computing current cost. Their use by nearly one company in five points to more than little interest in the information.

My reservations about the researchers' findings as to the perceived level of client interest are not intended to suggest, by any means, that clients have other than little interest in FAS 33 information. As I said earlier, my own experience suggests that most companies, in fact, do have little interest in the information. My comments were intended only to challenge the research as a basis for supporting that conclusion.

Evaluation of the Research Findings

The nature and extent of auditor procedures—The researchers report that “the average review takes less than two percent of total engagement time and results in minor adjustments to the disclosures. Departures from FAS 33 guidelines ordinarily are not material enough to justify

modifying auditor reports.” The fact that the average review takes less than two percent of total engagement time is informative but very difficult to evaluate. Given that the information is supplementary and unaudited, one would not expect that it would require a significant portion of the total audit time. In evaluating the amount of time spent, one needs also to consider that the time reported is *incremental* time—time in addition to the time already spent in conducting the audit. As part of the audit, the auditor spends time obtaining information about the company’s industry, business, accounting system, accounting controls, etc., which reduces the amount of time he would otherwise have to spend in reviewing the FAS 33 information. Put another way, if the reviewer had not done an audit, he would need to spend a lot more time on changing prices information than that indicated by the questionnaire responses. Also, the fact that auditors are applying more than the minimum procedures called for by SAS 27 and SAS 28 supports the belief that auditors are spending all the time that is necessary to fulfill their professional responsibilities.

The researchers also state that the auditor review results in minor adjustments to the disclosures. Like a cup of coffee that is either half full or half empty, the research findings can be interpreted in two ways. The questionnaire revealed that the review procedures resulted in modified disclosures in 55 percent of the companies for one or more years. A 55 percent adjustment rate strikes me as being very high, possibly even higher than the rate of adjustment resulting from audits of the primary financial statements for these large, public companies. Also, the fact that the adjustments were made at all could suggest that they were more than insignificant, else they would have been waived as immaterial.

The last finding in this area is that there were no omissions or departures from FAS 33 guidelines that were considered material enough to justify modification of the auditors’ reports. My only comment regarding this finding is the need to bear in mind that no qualifications should be expected in light of the materiality considerations involved, the subjective judgments involved in preparing current cost information, the explicit flexibility provided by FAS 33 itself, and its experimental nature. Because of these factors, it is very unlikely that an auditor could assert that the changing prices information departs materially from the FAS 33 guidelines.

Special problems encountered in performing the reviews—The researchers observe that the most frequently mentioned problem is that the requirements of SASs 27 and 28 and FAS 33 are too general to provide much guidance. As a result, they report, it is difficult to know when the data have been analyzed sufficiently.

This finding doesn’t surprise me as much as it disturbs me. I disagree that the lack of specificity in these auditing standards is, or at least should be, a problem to auditors. Of course, my previous involvement with SAS 27 and SAS 28 makes this issue the hardest for me to remain objective about. When developing standards, standard setters can either adopt a broad, conceptual approach or a narrow, so-called “cook-book” approach. The Auditing Standards Board usually leans to the conceptual approach because of a reluctance to impose a rigid structure that might unduly restrict a practitioner’s exercise of

professional judgment. Another reason is the fact that there is more than one way to obtain audit satisfaction. Also, a cook-book approach to SAS 28 would have been incompatible with the experimental nature of FAS 33 and the wide latitude it permits preparers.

The question of when an auditor obtains sufficient comfort, when that magic moment arrives when he can lay down his pencil and eye shade, is an age-old question, and more specific procedures in the authoritative auditing literature will not provide an answer. It simply must remain a matter of professional judgment in the circumstances, and I am disappointed to learn that there are practitioners who object to this condition.

On the other hand, I do agree that FAS 33 needs more specificity, particularly in the area of current cost measurement. This is a problem which I believe should be corrected *now*. That correction, though, must of necessity recognize the inherent subjectivity of current cost information.

Another special problem noted by the researchers is that "the information is not available early enough to allow for meaningful evaluation." This response is a puzzling finding because it seems to imply that auditors were unable to review the information in accordance with SAS 27 and SAS 28, which would be inconsistent with the researchers' conclusion that auditors are performing meaningful review procedures. I really don't know what to make of this finding—I wish the researchers had pursued it.

Usefulness of data—Finally, the researchers find that requiring changing prices data to be audited (as opposed to undergoing the SASs 27 and 28 review) would not necessarily increase the utility of the information to financial statement users. As I commented previously, I believe that information concerning the usefulness of the changing prices disclosures is best obtained from users and preparers, not from auditors. More importantly, though, I don't know how to interpret this finding. It is based on responses to questions asking how much more *reliable* to external users the constant dollar and the current cost disclosures would be if they were audited rather than included as unaudited supplementary disclosures. The respondents had a choice of "not much better," "somewhat better," or "significantly better." Based solely on the responses to these questions, it would seem that conclusions can be drawn only as to the reliability of the information.

Information utility is, however, a function of two qualitative characteristics: relevance and reliability. If one is held constant and the other increased, the result should be greater usefulness. Obviously, the degree of auditor involvement with the information affects only its reliability—in a positive way, we hope. So the greater auditor involvement represented by an audit should, all else remaining equal, increase reliability and usefulness.

I can think of two reasons to explain the contradictory finding. First, it might mean that the information is perceived as so inherently imprecise that no degree of auditor involvement could possibly add to its reliability. Personally, I wouldn't agree with that, but it could be one interpretation of the finding.

Alternatively, the finding might mean that respondents perceived the relevance of the information to be not only low, but close to nonexistent. For example, assume a company decides to disclose in its annual report to shareholders that the chief executive officer wears 9½-size shoes. I doubt if anyone would find the usefulness of this information increased if the auditors

verified and reported on the size of the CEO's shoes. Even if his shoe size were reported with 100 percent reliability, the information would still be without any utility whatsoever.

I don't know which of these interpretations—or others I have not thought of—were behind the research findings. I wish they could be clarified.

Despite the reservations noted, the researchers' overall conclusions about the perceived usefulness of FAS 33 information are consistent with other research findings and may have the most significant effect on the outcome of the FAS 33 experiment. Their finding that auditors think that the requirement to disclose changing prices information on both a constant dollar and current cost basis contributes to confusion on the part of users is supported by other research and is also particularly important. So is the finding that auditors perceive that their clients believe that current cost disclosures are more meaningful than constant dollar disclosures. These findings not only highlight some of the major problems with FAS 33 but also shed light on possible solutions.

Concluding Remarks

The FASB must soon decide what to do about FAS 33. It is currently in the process of evaluating the more than 300 comment letters received in response to its *Invitation to Comment, Supplementary Disclosures about the Effects of Changing Prices*. The comments, which were due by April 25, 1984, were directed to four issues.

- Are the FAS 33 disclosures a generally useful supplement to financial statements? If yes, why? If no, why not, and what information would achieve the objectives of changing prices disclosures?
- What should the FASB do about changing prices disclosures? Continue present or revised disclosures on an experimental or permanent basis, or discontinue altogether?
- What FAS 33 disclosures should be continued—both current cost and constant dollar, current cost only, or constant dollar only? And which specific disclosure items should be continued and what additional disclosures should be required? And, should a more standardized format be required?
- What changes should be made to improve the relevance and reliability of current cost measures?

It will not be easy to resolve these issues. Many respondents have urged the FASB to discontinue the disclosure, primarily because of the limited use made of the information by financial analysts and other external users. Focusing on the issues in those terms, however, masks the need to overcome the distortion of financial information caused by changing prices. That need is now being addressed, albeit experimentally, by FAS 33. Withdrawing FAS 33 without substituting another way of meeting the need would abandon the problem unsolved.

Clearly, the problem is not behind us. Inflation is in no danger of extinction. Indeed, continuing record deficits in federal spending threaten its resumption at punishing levels. In other areas of the world, it has never let up.

Nor does the distortion of financial information depend on continued

inflation at extraordinarily high rates. Many assets acquired before and during the most recent inflationary binge are still on the books, their carrying values irrelevant to current decision making, and, over time, the cumulative effects of even low rates of inflation seriously distort asset values and income measures.

Nevertheless, the great indifference of users to FAS 33 information, indicated once again by the Skousen/Albrecht research, remains one of the principal findings of the FASB's experiment. It will undoubtedly be a significant consideration in the FASB's ultimate decision. So will some of the other Skousen/Albrecht findings, such as the unusual flexibility in computation provided by FAS 33, the resulting need for added specificity should the disclosure requirement be continued, the confusion to users resulting from the requirement to present the information on two competing bases, and the preference for current cost information over constant dollar information.