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## Accounting Standards and Professional Ethics

**Arthur R. Wyatt**  
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Over the years accounting standards and auditing practices have become sufficiently divorced that they almost seem to be in separate environments with only negligible overlap. While professional auditors continue to need to evaluate client applications of accounting standards, those auditors today are also frequently involved in seeking loopholes in the standards to exploit for client benefit. Auditors continue to be supportive of the accounting standard-setting process, but many times that support seems to flow more from a concern about the uncertainties associated with any revision to the current mechanism than from a residual satisfaction with recent and current FASB standards.

The increasing complexity of the world in which the auditor operates probably means that a separation of the establishment of accounting standards from the evaluation of their application was inevitable. Greater specialization arises when the environment becomes increasingly complex. Even so, the rather marked change in how auditors seem to approach the evaluations of the application of standards today, as compared to simpler times, appears to be more an attitudinal change than the necessary consequence of greater complexity, better technology, or increased specialization.

Thus, the relationship between accounting standards and the professional auditor may be less direct today than in the past. A brief look at how this relationship has changed may sharpen the focus of the current relationship. First, it may be useful to consider why accounting standards are developed today in the manner in which they are, rather than in some alternative procedure. We should recognize that when Congress created the Securities and Exchange Commission in 1934 it authorized the Commission to articulate accounting standards. Over the next few years, the SEC was fully occupied in getting organized and in dealing with many inherited problems flowing from the trauma in the stock markets over the preceding four or five years. The need to develop accounting standards did not reach a high enough level of priority for the SEC to undertake any productive activity.

At the same time, many of the leaders on the practicing side of the accounting profession were concerned about the potential ramifications of having accounting standards established by a governmental agency. Leaders of the profession, who, at that time, were also generally the top technical partners in the several leading firms, approached the SEC through the offices of the American Institute of CPAs to offer to assume the authority for the development of accounting standards. After considerable discussion, and a very close vote within the Commission itself, the Commission authorized the AICPA to

proceed with the development of accounting principles. The Commission retained both an oversight responsibility and the right to intervene should the AICPA develop an inappropriate standard or fail to deal with an issue that the Commission felt required attention.

It is interesting to note that Congress, neither in 1938 nor subsequently, has authorized the transfer of the responsibility for the development of accounting standards from the SEC to a private sector entity. The reasons for the SEC conveying authority to issue accounting standards to the AICPA are difficult to glean from the evidence available. However, it is likely that the difficulties of the task in relation to the other obligations of the Commission at that time, combined with the stature of those professionals who represented the AICPA in the discussions that led to the decision, played an important role in the SEC decision. While the accounting profession was young at that time, it had established a reputation for acting in the public interest. Practicing CPAs had consistently emphasized their independence in dealing with client concerns as well as their role in assuring users of financial statements that those statements, accompanied by an unqualified auditor's report, could be relied upon as being fair representations of an entity's results of operations and financial condition.

The AICPA retained jurisdiction over this standard-setting process from 1938 until 1972. At that time, a number of concerns about the performance of the Accounting Principles Board led to a broad review of the standard-setting process and a decision to create an independent entity to assume the authority that had been delegated to the Accounting Principles Board. The result is that for the past 15 years accounting standards have been articulated by an independent entity, one that is not a part of the accounting profession, the preparer community, nor any other professional, business, or commercial group. Recent initiatives by the Financial Executives Institute to have increased representation from within its ranks at the Board level, within the Advisory Council, and among the Trustees of the Financial Accounting Foundation suggest that the movement of this process away from the accounting profession is continuing and may proceed even further. The ramifications of an ongoing move in this direction would be interesting to speculate upon, but that speculation has to be left for another day.

With that brief historical background I would like to make some observations about the perspective of standard setters in undertaking their responsibilities and on the role of practicing CPAs, who are responsible for evaluating how the standards that are adopted have been applied by clients. Practicing CPAs are also increasingly involved in consulting with investment bankers and others on how accounting standards affect proposed transactions.

Early on, the members of the FASB undertook the development of a conceptual framework, in part so that the FASB could develop standards that had a logical cohesion and, in part, so that the results of its deliberations could be evaluated to assess whether the resulting standards flowed from logical premises or may have been the result of lobbying activities or pressure politics. While that effort has been less fruitful than many had envisioned, certain parts of the framework are likely to stand the test of time.

Among the qualitative characteristics of the Board's conceptual framework was that of neutrality. While one can argue that no one of the qualitative

characteristics is more important than any other quality on the Board's deliberations, the fact remains that the notion of neutrality is crucial to the Board's process and to the widespread acceptability of its resulting standards. The notion of neutrality within the Board's conceptual framework is that in resolving issues, the Board will attempt to reach conclusions that result in reliable and relevant information and not conclusions that favor one segment of society to the detriment of one or more of the other segments. Stated differently, the Board does not view itself as a resource reallocator in the standard-setting process. While it recognizes that resource reallocations may flow from the decisions that it reaches, and the applications of the standards that it adopts, the notion of neutrality emphasizes that in developing the standard the Board is striving to achieve reliable and relevant information and is not overtly striving to reallocate resources for the benefit of one group to the detriment of others.

Thus, at an early stage, the Board tried to emphasize that it would deal in a fair and equitable manner with various competing interests in its development of standards. This policy has a high ethical tone and, in my view, the Board deserves high marks for its 15-year history of avoiding allegations that its standards are designed to favor any given segment of our society.

Furthermore, the Board adopted an open process in which to deliberate prior to reaching its conclusions. The process is a lengthy one and invites contributions from all interested parties both in writing and orally at public hearings. Furthermore, decisions on all phases of the Board's projects are made only in open public meetings. Board policies preclude decision making of any kind behind closed doors. Again, this policy is designed, in part, to prevent allegations of improper or unethical behavior. In essence, the standard setters created an operating policy that would minimize the potential for allegations that its conclusions favored any particular constituency. Each Board member is expected to reach his conclusions on the issues under consideration only after a careful personal evaluation of the competing alternative views. A Board member is expected to assess the extent to which a given possible solution is consistent with the conceptual framework and with other standards that may be in existence. He is expected to evaluate whether the given alternatives are capable of practical application in a fair and evenhanded manner. Finally, the Board member is expected to assess whether the results that will flow from the practical application of a standard will be sensible and fair depictions of the underlying economic phenomena with which the standard is dealing.

The decisions of the Board would be easier to make if the members were immune to any lobbying activities, if the Board could be unconcerned about the reactions of constituent groups, or if the decisions could be made in private rather than in public. However, standard setting is not that simple and probably benefits greatly from the process that is in existence. That process does subject the Board members to lobbying activities, does subject the Board members to criticism from constituents who prefer alternative solutions, and does require Board members to speak up in open public meetings to express their conclusions and the reasons for them.

Given the actual environment in which standards are set, one would expect that out of 98 standards, some would reflect the effects of the lobbying and bargaining processes. The fact is, of course, that some standards do, but on

balance many of the standards fare well when evaluated against the Board's conceptual framework. Some examples of standards that appear to have been influenced, possibly unduly, by outside forces include Statement No. 13 (and its follow-on interpretations and amendments) dealing with leases, Statement No. 15 dealing with the restructuring of troubled debt, Statement No. 87, dealing with the accounting for pension plans, and, no doubt, the standard that will be forthcoming within the next few years, dealing with post-retirement benefits.

My assessment is that, given the imperfections of the world within which the FASB operates, its standards reflect more the judgments of seven independent individuals than they do the accumulated effect of influences brought to bear on those individuals by pressure groups and lobbying activities. In fact, it may very well be that current initiatives that would alter the make-up of the Board or the manner in which it operates are very much the result of frustrations experienced by lobbying groups or special interests, frustrations over their inability to have more influence over the process. Some preparers have expressed this frustration by suggesting they would do better if the standards were set by a governmental agency. After all, they have experience in lobbying elected officials and those responsible to elected officials.

Practicing CPAs have played a significant role in the standard-setting process, a role that has changed somewhat over the years. Practicing CPAs are in a difficult position insofar as developing positions on accounting standards is concerned. On the one hand, they have responsibilities to clients and on the other, responsibilities to the public. Public expectations are high that the practicing CPA is looking out for the public's interest when reporting on financial statements of its clients. To the extent the practicing CPA focuses more on one or several clients' special interests in the development or application of standards, expectations of other constituencies may not be met. In time, those expectations may change, as would also the public perception of the practicing CPAs' role.

From 1938 until 1972, the practicing profession was in the position of having to apply standards that were developed by an arm of the profession. The standard-setting process was a part of the profession, probably the most visible part. It was natural that practitioners would feel a sense of obligation, a sense of moral duty, to apply standards in a professional manner since those standards had been developed within their own profession's framework. Even so, increasing competition within the accounting profession gradually increased pressures on auditors to find solutions to accounting issues that were not always consistent with the standards adopted. By 1972, many were concerned that the standard setters (the APB) were being unduly influenced by particular client desires. In fact, the increasing initiatives by practitioners to structure an APB Opinion to meet clients' desires or to stretch APB Opinions to meet client needs was probably a key factor in the creation of the FASB.

The move away from professional application of standards accelerated further in 1972 when the FASB was created. Now the standard-setting process is outside the profession. More and more frequently, we find practicing CPAs talking about 'us' and 'them,' with the 'them' being the FASB. Any obligation that professional practitioners may have felt prior to 1972 to seek to apply well, or fairly, the standards developed by their own professional organization may well have been dissipated somewhat, and possibly increasingly so, over the

years of FASB involvement. No longer are the standards the profession's standards. They are those of an independent entity to which practitioners feel no particular loyalty.

The evidence is substantial and increasing that practitioners today often seek to find loopholes in the standards issued by the FASB and try to expand upon such loopholes. While "loopholeism" is not new, it is surely more extensive and refined than it was prior to the creation of the FASB. The process almost seems to be a game in which the role of the practitioner is to seek the shortcomings in the standard and exploit them rather than to seek the objectives within the standard and attempt to achieve them. Initiatives to seek out loopholes and exploit them most often originate from clients of practitioners or other advisers, either attorneys or investment bankers, who may be very useful to a practitioner in generating new business.

Let me give you some examples of matters that have been considered by the FASB, or that have been proposed in one form or another either by practitioners or preparers, which demonstrate attempts to avoid the application of a particular standard.

Statement of Financial Accounting Standards No. 13, paragraph 15, provides that when a rental agreement specifies an increasing level of rentals over the period of the lease, the lessee should determine the aggregate lease rentals under the agreement and charge those rentals to income on a straight-line basis over the period involved. Many of the provisions of Statement 13 are equivocal in nature, but this particular provision seems to be abundantly clear. Even so, for whatever reasons, the practice evolved, particularly in the department store industry, of disregarding this provision and accounting for the rentals on an increasing rental arrangement on a cash basis. That is, the amounts paid under the rental arrangement were expensed as paid, and the provision that the rentals were to be expensed on a straight-line basis over the period of the lease was ignored. This issue came to the attention of the Board's Emerging Issues Task Force, a group comprised mostly of practitioners. That group could not agree that paragraph 15 was clear (but also could not identify the points of lack of clarity), and the FASB was ultimately forced to issue Technical Bulletin 85-3 which took several paragraphs to, in effect, state that paragraph 15 of Statement 13 meant what it said. Had the accounting profession applied the standard, this issue would never have required the time and effort of the Emerging Issues Task Force, the staff at the Board, and the Board itself to clarify.

In 1986, the Board was embroiled in a controversy involving a savings and loan association and its financial statements to be filed with the Securities and Exchange Commission. The association involved needed additional capital. It proposed to increase that capital by issuing a kind of certificate that was styled as a "permanent income capital certificate." The label clearly was designed to lead one to conclude that the certificate was an equity certificate rather than a debt-type of obligation. The savings and loan involved was supported by its auditors in arguing that this certificate should properly be classified as equity. Analysis of the terms of the certificate, however, led the Board to conclude that the certificate had more attributes of a liability than it did of equity. It was not, in fact, a permanent certificate at all. Resolution of this matter required many meetings involving the FASB staff, the various regulatory authorities in

Washington, to say nothing of the time and effort of the entity involved and its auditors.

Within that same year, another example arose that was initiated by the Federal Home Loan Bank Board. That Board suggested that when savings and loans sold mortgages for less than their carrying amounts, the resulting debit should be classified as an asset to be amortized over a period of 10, 15 or 20 years. Around the FASB, that suggestion became known as creating assets out of losses. The argument made was that it was in the best interest of the savings and loans, and of our economy, for savings and loans to package and dispose of their "underwater" mortgages, but that if they did so and had to recognize losses they would have insufficient capital to continue in business under the capital adequacy requirements of the Federal Home Loan Bank Board. The Bank Board was proposing to overcome the failure to meet the capital adequacy guidelines by redefining the nature of an asset. The FASB concluded, however, that entities following such a practice could not classify their losses as assets if they expected to get an unqualified auditor's report.

In 1987, the FASB issued Statement No. 92 that set forth the criteria that would have to be met by a rate-regulated company if it were properly to defer costs under a phase-in plan adopted by its regulator. A phase-in plan is adopted by a rate making agency when the normal approach to rate making would require what is perceived to be too great an increase in electric rates in any one year. By phasing in that increase over several years, the regulators would dampen or delay the impact of the higher rates on electricity consumers. When a rate-making agency adopted a phase-in plan after the release of Statement 92 that did not meet the criteria in that standard, the utility would not be permitted to defer the costs in question. Under Statement 92, in that situation, the utility would be expected to charge off those costs as incurred, a procedure that would have a negative impact on both its earnings and shareholders' equity. One utility facing such a phase-in plan, a plan that did not meet the criteria of Statement 92, proposed to account for that phase-in plan as if it were a qualifying plan. Its auditors agreed to give an unqualified opinion on financial statements that embodied that accounting even though such accounting was at variance from that provided for in Statement 92. The company then approached the Federal Energy Regulatory Commission and obtained an order from it that specified that the utility should account for the phase-in plan in its regulatory statements as ordered by its regulatory agency rather than as provided for in Statement 92. With that regulatory order in hand, the utility approached the Securities and Exchange Commission requesting that it accept its financial statements with the clean auditor's report. At this point, the resolution of that request is unresolved. Should the SEC agree with the position taken by FERC, Statement 92 would be rendered ineffective.<sup>1</sup>

In 1987, the Board issued Statement 94 which provides that an entity that prepares consolidated financial statements shall include all subsidiaries within those consolidated statements unless it does not have control of the subsidiary or expects to hold it only on a temporary basis. Statement 94 is clear in its

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<sup>1</sup> The SEC subsequently denied the registrant's request, and Statement 92 appears to be working as the FASB intended.

intent. That intent was to require the consolidation of all subsidiaries except in the very limited instances of temporary control. One accounting firm has suggested that a neat way to avoid the requirements of Statement 94 would be for a company to change the fiscal year of its subsidiaries so that the fiscal year of the subsidiary was more than 93 days away from the fiscal year end of the parent company. The time interval is important because the SEC has a rule that precludes a subsidiary from being included in a consolidated statement based on its year-end results if the fiscal year ends more than 93 days from the fiscal year end of the parent company. While this suggestion is unlikely to achieve its objective, it demonstrates again that practitioners spend a great deal of time attempting to develop loopholes in FASB standards; loopholes that subvert the application of the standard from the objective that the Board sought to achieve.

The overriding question in connection with this type of behavior is whether the public interest is being served well by those who are practicing public accounting when those practitioners seem more interested in seeking out and exploiting loopholes than they do in attempting to achieve accomplishment of the objectives articulated by the standard setters.

This is probably not the time or place to speculate on the reasons why this change in attitude has evolved. Some would assert the FASB is at fault because it has insisted on writing masses of detailed rules that seem designed more to anticipate or cure abuses than to achieve some clearly articulated objective. The argument then runs that "cure the abuse" standards simply invite the development of new abuses, the seeking of loopholes. Others might argue that the principal cause of this change is the increase in commercialism, and the consequent reduction in professionalism, that has evolved within the accounting profession for a variety of reasons. This view suggests that a practitioner is not serving his client well unless he is seeking out loopholes in, and favorable interpretations of, the standards issued by the FASB. Regardless of the principal cause, searching for loopholes encourages more detailed standards to try to circumscribe abuses, and detailed, and often, arbitrary rules issued by standard setters virtually invite initiatives to seek out the defects in the standard setters.

One question that arises as a result of this changing behavior is, who is looking out for the public interest? Do those in the profession who seek out loopholes and approve the embodiment of them in their client's financial statement serve the public interest well, or are they serving well only their individual clients' interest? The issue is an attitudinal one. It might be expressed as follows: With what mind set should a practitioner approach his responsibilities in the application of accounting standards? Should he be an advocate of his clients in the sense of striving to achieve the most favorable interpretation of a given standard insofar as his client's interests are concerned, or should he be mindful of his responsibilities to the public by striving to apply the standard in the manner that best meets the objectives articulated in the standard? Should the practitioner be independent of the desires of his client and strive in his interpretation of the standards to apply them in the manner in which he believes the Board intended for those standards to be applied?

During my somewhat abbreviated tenure on the Board, I suggested, on several occasions, the following initiative to try both to improve the quality of an FASB standard and to alter the attitudinal behavior of those who were



applying it. I suggested that on a given topic, only one and as an experiment, the Board decide in advance that it would limit its standard to no more than three pages. The first paragraph of the standard would articulate as clearly as the Board could, the objective or objectives that the Board felt the given standard should achieve. The next several paragraphs would set forth the standard, and the final paragraph, prior to the implementation and effective date, would specify that the burden was on corporate preparers and independent auditors to evaluate their applications of the standard to determine whether the approach they were contemplating best met the articulated objectives set forth in the first paragraph of the standard. I was advised that such an approach simply would not work. Of course it will not, especially if it is not even attempted.

At some point, I believe many will come to realize that the FASB will be unsuccessful in a dual role of writing accounting standards and preventing abusive behavior. Accounting standards should be broad in scope rather than detailed as are today's standards. The burden for fair application should rest on preparers and their auditors. The changes in attitudes and behavior that would be required to implement this notion are enormous and not likely to be accomplished over any short period. The alternative, however, is to proceed with increasingly detailed rules that invite searching for loopholes and that place severe burdens on those practitioners who are motivated by high ethical standards.

One critical question is whether the accounting profession today has met sufficiently well its responsibilities for establishing and applying accounting standards to warrant continuation of the existing current private sector arrangement for setting standards. Surely, the SEC would never have delegated the authority for setting accounting standards in 1938 to a group perceived to place one or more special interests above the public interest. It is ironic that the public accounting profession today may be better understood than it was fifty years ago, may be more highly regarded in our society, and yet is meeting less well than it did fifty years ago, the qualities of professionalism that are crucial to the retention of its status as a highly regarded profession.

I hope that by this point, you have an understanding of the general drift of my concerns. Before I stop, however, let me pose some questions for your consideration. Can accounting standard setting survive in the private sector under the present structure? The basis for the existence of standard setting in the private sector today is to achieve fairness of financial presentation in the public interest. When practicing CPAs approach the application of standards issued with the objective to seek out and exploit loopholes, is it not probable that initiatives will arise to alter the institutional standard-setting arrangements? Does the accounting profession merit its designation as a profession if the central thrust of its application of standards is to exploit loopholes for the benefit of special interests and to the detriment of the broader interest?

These are matters that, I believe, leaders of the profession should be considering as we undertake various initiatives designed to minimize the expectation gap and enhance understanding of the role of professional auditors in our society.