1968

# Closing the Audit Gap

Leonard M. Savoie

# CLOSING THE AUDIT GAP

by

Leonard M. Savoie

before

The 20th National Credit Conference

of

The American Bankers Association

Americana Hotel
Bal Harbor, Florida
January 30, 1968

# CLOSING THE AUDIT GAP

I appreciate the opportunity to appear at this Twentieth National Credit Conference of the American Bankers Association, especially because I have some things to say concerning the accounting profession and its role in the American economy today. It is a role that has been changing, bringing to the profession new challenges, new pressures.

The growth of the accounting profession can be attributed in part to the need for an independent examination and report on financial statements for credit purposes. This need has paralleled a similar demand by a growing number of investors for this kind of service.

## IMPROVING PROFESSIONAL STANDARDS

The accounting profession has made rapid progress in improving accounting and auditing standards over the past half century. But progress has not been at an even, measured pace. Then, too, the needs of users of audit reports have been advancing and this also has occurred at an uneven pace.

One of the earliest authoritative pronouncements on accounting principles in the United States came about through cooperation with bankers. A pamphlet called "Uniform Accounting" was prepared by the American Institute of Accountants in 1917. It was accepted by the Federal Reserve Board and submitted in 1918 to banks, bankers, and banking associations throughout the country for their consideration.

There have been other periods when significant progress was made in accounting improvement. One such period was in the 1930's when, inspired by the critical financial situation that gripped the nation, the Securities Acts of 1933 and 1934 called for audits of publicly traded companies by independent public accountants. At that time, the American Institute was working with the New York Stock Exchange in developing accounting principles to serve as a basis for financial reporting. This was the period during which the phrase "generally accepted accounting principles" originated.

Today, some 50 years after the issuance of "Uniform Accounting" and after more than 100 further technical pronouncements, and with accounting and auditing standards at an all time high level, we are going through still another period of intense activity and great progress in raising standards even higher.

The growth of the economy continues to confront the profession with new demands for interpreting and evaluating financial information. Also, there have been shifts in demands upon the accounting profession in that, to some degree, the focus of attention has been directed to investor needs rather than creditor needs.

## CHANGING NEEDS FOR FINANCIAL INFORMATION

Banks too have become investors as well as creditors. They are no longer predominantly in the business of lending for short terms. The head of a major bank told me recently that more than 70% of his bank's loan portfolio is in long term loans to corporate borrowers. He went on to say that this shift in composition of the portfolio calls for a shift in credit evaluation procedures of the bank.

Credit analysts more and more are looking at financial statements in a manner similar to the way security analysts and investment bankers look at them. Balance sheet liquidity, although not to be ignored, has declined in relative importance compared with a company's earning capacity.

The number of stockholders in the United States has increased to a current figure of about 24 million, and many of them have become quite knowledgeable in the area of financial reporting. The profession of financial analysts has assumed an important role as advisers to these millions of stockholders. The earnings per share figure has become of major importance in investment decisions -- price-earnings ratios and earnings trends have become key indicators. Also, the public has placed increasing emphasis on the comparison of earnings per share of different companies.

ALTERNATIVE ACCOUNTING METHODS

The discovery that generally accepted accounting principles include alternative methods of dealing with the same type of transaction in similar circumstances brought on public discussions some five years ago. For example, alternative methods for charging income for pension costs by similar companies could result in substantial differences in reported earnings.

Also, comment centered on accounting for material non-operating gains and losses, the different impacts on earnings resulting from acquisitions treated as purchases or poolings of interest, variations in accounting for research and development expenses, accounting for income taxes, and so forth.

I would like to put the subject of alternative accounting methods in some perspective by dwelling briefly on the process of producing accounting principles.

Accounting principles are intellectual creations. They are devised by men engaged in a process of reason, applying the distillation of their practical experience to the economic realities of the time.

In contrast with the laws of physical science, accounting principles cannot be proved or disproved by reference to absolutes in nature. It is not surprising, therefore, that over the years more than one accounting practice has developed for various business situations.

The existence of these alternative accounting methods has long been debated in the profession. One school of thought has been that there should be one, and only one, acceptable way of dealing with a given set of circumstances. The other school has been that modern business is so complex and varied that "a given set of circumstances" in one company may be <u>similar</u> to circumstances in another company but rarely <u>identical</u>, so that to impose single, rigid principles upon all cases would frustrate rather than advance efforts to portray business facts as accurately and meaningfully as possible.

About three or four years ago this debate erupted beyond the profession. Some security analysts and financial writers, for example, complained that, by selecting from among alternative accounting methods, a corporate management could make its profit just about anything it wanted -- and that as long as the accounting principles employed were "generally accepted" an independent auditor would be obliged to give the resulting financial statements a "clean" opinion.

This was overstatement. For instance, a management could not switch back-and-forth in its accounting methods; its accounts had to be consistent from year to year. Nevertheless it was true that one company might account, say, for its pension costs one way, and another company another way. So, it would be difficult if not impossible for any one without inside information to compare one company's costs in this category -- and hence the effect on profit -- with the other company's.

## NARROWING AREAS OF DIFFERENCES

For years the profession had been moving to weed out accounting principles that might have become outmoded or superfluous, but the process was not very dynamic and the spate of criticism in the public prints shook CPAs. It also brought about a degree of unification within the accounting profession.

Members of both "schools" -- i.e., the single-set-of-rules proponents, and advocates of some flexibility -- were in general agreement that the number of alternative methods could be reduced with benefit. Differences in corporate reporting, which were not clearly due to differences in underlying facts, should be eliminated.

RESPONSIBILITIES FOR ACCOUNTING PRINCIPLES

The task was shouldered by the Accounting Principles Board of the American Institute of CPAs. The Board's staff was increased; it scheduled more frequent meetings, set priorities, and otherwise geared itself to meet the situation.

Why the Accounting Principles Board? What is its mandate, its authority?

As an institution in the private sector, the AICPA does not have the power of an agency of government -- SEC, ICC, FPC, etc. Like other organizations of professionals, its power rests on its special expertise in its field, prestige, persuasion.

The basic responsibility for financial statements, and for the underlying accounting methods, rests with corporate management. Independent auditors have a separate responsibility to third parties -- bankers, stockholders, the general public -- in expressing a professional opinion on the fairness of presentation of these statements. The AICPA, as the professional organization of CPAs, has the responsibility for setting standards for guidance of its members.

A circumstance that enhances the persuasiveness of AICPA is that the SEC requires financial statements of corporations within its jurisdiction to be audited by independent accountants. No management contemplates with complete indifference the prospect of an auditor's report which is anything other than the standard formal endorsement of the financial statements. A management may argue with the auditor. But if the auditor declares that the company's statements do not meet his profession's standards and that he will be obliged to register a reservation in his public report, the management will usually follow the accounting principles he recommends. The governing Council of the AICPA gave the Accounting Principles Board added muscle in 1964. It adopted a resolution requiring all members of the AICPA to note in financial statements of companies which they audit any departure from accounting practices stipulated by the Board.

This action by Council covers not only the 12 Opinions, as the Board's pronouncements are called,but also some 50 bulletins issued by a predecessor committee, which remain in effect unless, or until, modified by the Board.

These are concerned with virtually all aspects of accounting, including leases, pension costs, and reporting of net income, to name just a few.

DEVELOPING AN APB OPINION

The first step in developing an Opinion is a research study of the subject. The results are circulated to knowledgeable people for comment.

A subcommittee of the Board is then appointed to prepare a draft of an Opinion. In the course of its preparation, consultations usually are held with committees of trade associations in industries that will be affected by the proposed Opinion.

The draft is considered by the entire Board. When the Board is satisfied that it covers the subject properly, the draft is reproduced in several thousand copies and "exposed" for comment to leading accountants, financial executives in industry, government agencies, and stock exchanges.

Redrafting usually follows in light of the comments received. Finally the Board votes on the matter and, if the Opinion receives an affirmative vote by two-thirds of the 19 members, it is issued to the profession.

CHANGES EFFECTIVE IN 1967 FINANCIAL STATEMENTS

This careful, deliberative process has produced a number of final pronouncements that are having an important impact on financial reporting. For example, annual reports issued in 1968 will reflect four new APB Opinions which became effective for calendar year 1967 financial statements.

The most significant of the four is Opinion 9, Reporting the Results of Operations. It deals with net income and the treatment of extraordinary items and prior period adjustments, as well as the computation and reporting of earnings per share.

Opinion 9 concludes that net income should reflect all items of profit and loss recognized during the period, except for prior period adjustments. Extraordinary items will be shown separately as an element of net income for the period. A statement format is specified which gives equal prominence to income before extraordinary items and net income.

The second main part of Opinion 9 deals with the computation and reporting of earnings per share. The Board strongly recommends that earnings per share be disclosed in the statement of income. This is the first time that accountants have assumed responsibility for an earnings per share figure in annual reports, although they have for many years included earnings per share figures in prospectuses.

In addition to the basic computations of earnings per share, Opinion 9 calls for supplementary computations showing reduced earnings per share that would result if preferred stock or debentures were converted into common stock. With the increasing popularity of convertible debentures and convertible preferred stock, many companies should be making these supplementary disclosures.

Another APB Opinion of significance is No. 8, Accounting for the Cost of Pension Plans. It clarifies pension accounting principles and narrows practices while still permitting a rather wide latitude in methods. The Opinion does prohibit the pay-as-you-go and terminal funding methods and it states that accounting for pension cost should not be discretionary. All of its specific technical requirements are intended to spread pension cost over appropriate periods by systematic and rational methods.

APB Opinion 7, Accounting for Leases in Financial Statements of Lessors, sets forth the Board's views on accounting for the revenue and expense related to property leased to others. It describes the traditional operating method where rent is reported as revenue according to the provisions of the lease, and the financing method where a portion of the rent is treated as interest and is reported as revenue in relation to the unrecovered investment, and sets forth conditions under which each method is appropriate. This Opinion is of particular concern to lease-finance companies, some of which will have to change their practices to follow the financing method as decribed in the Opinion.

The fourth APB Opinion which became effective for 1967 statements is labeled Omnibus Opinion-1966. It is a catchall of items which need attention, but do not warrant a full separate Opinion. Some of the items may cause major changes in accounting. One is a requirement in consolidated financial statements to adjust investments in unconsolidated domestic subsidiaries for accumulated undistributed gains and losses since acquisition. For sizable investments previously carried at cost, this could improve reported earnings. Another requirement for consolidated financial statements is the inclusion in consolidation of subsidiaries whose principal business activity is leasing to affiliated companies. Thus, it is no longer possible to keep debt off the balance sheet by placing it in a leasing subsidiary.

## OBSTACLES TO APB PROGRESS

Even this brief rundown of specific accounting improvements gives an indication of the solid accomplishments of the Board. But it sheds no light on the formidable task that remains to be done. The Board faces a number of basic problems in carrying out its duties.

In the first place, changing conditions present new tasks. The proliferation of private pension plans, the merger movement, or changes in the tax structure -- all these things bring accounting problems in their wake.

In the second place, the fact, already noted, that accounting principles are a product of intellect and cannot be checked against external nature, makes differences of opinion within the profession itself virtually inevitable.

Finally, the Board's efforts to improve and rationalize accounting principles often provoke strong reaction in the business community.

## ACCOUNTING FOR INCOME TAXES

An example of this type of response occurred late last year in connection with a proposed APB Opinion on Accounting for Income Taxes. So vociferous were the objections, particularly to that part of the Opinion having to do with handling of the investment tax credit, that the Board adopted, and has issued, the Opinion only as it affects allocation of income taxes. It has taken back for further study the part dealing with the tax credit.

The main requirement of the final Opinion is the full provision for income taxes in the same period that income is reported, regardless of whether taxes are actually paid at that time. This will limit the methods by which corporations report income tax expense to shareholders.

The exposure draft was also responsive to the public demand for elimination of unnecessary obstacles to comparisons by recommending a single method of accounting for the investment credit. Informed opinion is nearly unanimous in agreeing that there is no logical justification for the use of more than one method of accounting for the investment credit. But it has been most difficult to get a consensus on which method should prevail. The Board will give it another try in 1968.

CONVERTIBLE DEBT

The year 1967 also saw strong opposition to the APB arise in connection with another accounting problem. The Omnibus Opinion issued a year ago calls for the allocation of a portion of the proceeds received for bonds convertible into stock, or bonds issued with warrants to purchase stock, to the conversion privilege or to the warrants. This accounting results in an additional imputed bond discount that has to be amortized against income as long as the bonds are still outstanding. Application of this accounting method to bonds issued with warrants has caused no difficulty at all. But use of the method for convertible debentures has brought forth from investment bankers and others a storm of protest -- and some new information on the subject. As the issue is very complex, it is back for restudy by a subcommittee of the Board, with a definitive pronouncement promised by the end of 1968. In the meantime, companies may follow the accounting called for by Opinion 10, but if they do not, they will have to show on the income statement a supplementary proforma earnings per share figure adjusted for the dilution that would occur if the debt were converted.

FINANCIAL STATEMENTS OF BANKS

Still another example of industry opposition to improved financial reporting can be found in the case of commercial banks. Here, not the APB but a separate Committee on Bank Accounting and Auditing has had a bank audit guide in the course of preparation for about ten years. The length of time required reflects the difficulty of getting agreement on accounting principles among the CPAs on the Committee as well as continued opposition from the banking industry and the bank regulatory agencies. Meanwhile, bank financial statements put banks among industries with the poorest financial reporting to investors. Bank statements do not even present a figure for net income. But those bank financial statements examined by CPAs will soon have to show net income and reflect a number of other accounting improvements. For the Committee has finalized its bank audit guide; it is now at the printer and will be distributed in March. The APB is expected to take the necessary action to make its Opinion on Reporting the Results of Operations applicable to bank financial statements.

TOWARD GREATER COMPARABILITY

Notwithstanding its trials and tribulations, the Accounting Principles Board is persevering in its study and tightening of accounting principles. The profession is confident that, by holding fast to its aim of serving and protecting the public, it is helping to preserve and strengthen the free enterprise system.

But we have no doubt that unless continued progress is evident -- unless unnecessary obstacles to comparison of earnings per share are eliminated -- public criticism will be revived and the SEC will press for results.

I should make it clear at this point that neither the Institute nor the SEC has the objective of rigid uniformity in accounting. The objective is to eliminate alternative accounting treatments not justified by differences in circumstances -- and to specify criteria for determining when different accounting treatments do apply.

Absolute comparability of earnings per share will probably be unattainable, because there will always be an element of judgment in the application of accounting principles, even though the principles themselves are fairly standardized. But we believe that the investing public will insist on the elimination of unnecessary and confusing differences in accounting which increase the difficulty of making reasonable comparisons among companies as a basis for investment decisions.

CONGLOMERATES

Many thorny problems are on the APB agenda for the year ahead. One is the subject of disclosures of financial information by segments of diversified companies.

In September of last year, the Board issued a Statement, as distinct from an Opinion, on this subject urging diversified companies to consider reporting supplemental financial information on segments of their business that are clearly separable into different industry lines. Before recommendations can be made as to how much of this kind of information, if any, should be reported, additional facts must be determined by research and practical experience.

This is an area in which more definitive reporting methods may be forthcoming at a future time. It is another example of an economic development requiring new accounting guidelines -- and it is also another example of a controversial area where strong industry opposition has already shown up.

BUSINESS COMBINATIONS AND GOODWILL

Falling in nearly the same category is the problem of business combinations and goodwill. The current wave of business acquisitions and mergers could not have taken place without the tax laws permitting tax-free exchanges and the almost complete freedom of management to choose between purchase accounting and pooling-of-interests accounting. The AICPA's Accounting Research Division will in a very few months issue a major research study on accounting for business combinations and goodwill. At that time, or perhaps even sooner, a subcommittee of the Accounting Principles Board will begin developing points for decision in preparation for drafting an APB Opinion. I would not hazard a guess as to the Board's ultimate solution of this problem. But any recommendation that is more restrictive than our present loose guidelines will surely spark heavy opposition -- particularly from merger-minded companies. Tightened accounting principles may well shape the nation's trend in corporate mergers.

PRICE-LEVEL ACCOUNTING

Still another major subject before the APB is price-level accounting. The Board has a proposed Opinion nearly ready for outside comment -- it should be exposed by summer. And this could prove to be a very timely issuance. Accounting does not now recognize the declining purchasing power of the dollar, even though inflation has occurred during most of the last thirty years. Following a major research study on this subject, the Board has developed a draft Opinion which will recommend supplemental disclosures of key financial information adjusted in terms of a constant level of purchasing power. The draft Opinion contains detailed steps for guidance in applying the technique of price-level adjustments. There is little doubt that for most companies price-level accounting will produce significantly different operating results than historical-cost accounting. Will this be accepted? Will companies make the recommended supplemental disclosures? We hope they will as the additional information can help greatly in analyzing a company's performance. But with lower earnings to be reported by most companies, we can look for resistance ranging from mild and passive to strong and highly vocal.

A STRONG APB PIPELINE

The APB pipeline is also full of a number of less exotic subjects that are expected to yield improved accounting in the near future. One such project involves determination of criteria for applying changes in accounting methods -- i.e., what changes should be reflected in income of the current year, prospectively over future years, or retroactively in past years? Other projects relate to such troublesome problems as developing recommendations for accounting for industrial product research and development expenditures, and specifying preferred accounting treatment for problems peculiar to the extractive industries. There are many other subjects on the very full agenda of the Accounting Principles Board and the Accounting Research Division, but the foregoing gives a good idea as to the nature and significance of their work.

AUDITING STANDARDS

The AICPA is also active in raising auditing standards. The Committee on Auditing Procedure has issued thirty-nine Statements on Auditing Procedure for the use of CPAs in examining financial statements. Only recently the Committee issued a statement providing guidance for the CPA in making clear the extent of his responsibility when his name becomes associated with financial statements that are unaudited. Another recent statement concerns audit working papers that are needed to document the CPA's examination.

COOPERATION BETWEEN BANKERS AND CPAS

The accounting profession and the banking industry have a long history of cooperation in areas of mutual interest, in fact, as far back as ancient Babylonian times. We know of banking activities as early as 2,000 B.C. -- about the same time scribes were carving accounting records of barter exchanges on clay tablets.

More recently, however -- exactly two years ago -- Mr. J. Howard Laeri spoke before this same conference and referred to the "Audit Gap" -- and also to mutual cooperation between bankers and accountants. I have already spoken at some length of efforts to raise accounting and auditing standards in a manner that is closing the audit gap.

As to mutual cooperation, one of Mr. Laeri's suggestions was the establishment of a National Conference of Bankers and CPAs. It is timely to note that this recommendation has been put into effect, with substantial benefits already apparent. Although there had been earlier committees of the American Bankers Association and of the American Institute of Certified Public Accountants, this National Conference has emphasized the continued need for this kind of cooperation and has spurred joint activities.

One of the positive accomplishments has been the issuance under joint sponsorship of a booklet entitled, "The Auditor's Report - Its Meaning and Significance." This booklet explains the auditor's report as it exists today and is a first step in arriving at audit reports which are more responsive to the needs of bankers. Appropriate groups in the National Conference are now reviewing it to determine what changes the bankers might like to see. Thus, the plans are set for a continuing, mutually beneficial dialogue.

The National Conference is also preparing a booklet entitled, "Financial Statement Provisions in Term Loan Agreements." Its purpose is to provide CPAs, bankers, and legal counsel for banks with a practical guide to the development of term loan provisions concerning financial information.

Another project under consideration by the National Conference is the development of a supplementary questionnaire which would be completed by the CPA to accompany financial statements. The supplementary questionnaire would provide additional information required by banks.

Beyond these specific activities, the National Conference is in a position to work in other areas of mutual interest.

One project being discussed informally is a symposium on corporate financial reporting for senior executives in banking, financial analysis, corporate financial management and public accounting. Its purpose would be to delineate responsibilities for financial reporting and search for a better understanding of the significance of these responsibilities.

CONFIDENTIAL RELATIONSHIPS

A fruitful possibility for improved communication lies in the area of confidentiality of relationships. Business management rightfully expects both the banker and the CPA to treat his financial affairs on a confidential basis. The auditor, in seeking confirmation of bank deposits and loans, must have the authorization of the client before the banker will provide this confirmation. Similarly, the banker who wishes supplementary information from the CPA cannot expect the CPA to disclose it without the client's permission. Yet all too often banker-CPA communication is a one-way street -- from banker to CPA. This communication always takes place because auditing standards require the CPA to obtain confirmation of bank balances. But it has become the exception for the CPA to provide the banker with supplementary information. The CPA cannot present it voluntarily -- he is limited to what he can say in his opinion on the statements he has examined. Here is an area where both groups might prevail upon their mutual customer and client to establish a line of communication that could prove beneficial to all.

Another area where cooperation between bankers and CPAs can help each group to help themselves lies in the adherence to accounting and auditing standards. Unfortunately, there is still less than complete compliance with the standards of the accounting profession. No one is in a better position to see substandard work than the banker. Recognizing the need to improve compliance with standards, the AICPA a few years ago set up a Practice Review Committee as an educational endeavor. The plan is for bankers or others questioning the quality of audit work to submit the audit report to the AICPA for review. AICPA staff removes identification to make the report anonymous and gives it to a high-level panel of leading CPAs. Their evaluation is then given by the staff to the CPA involved for his education -- there are no disciplinary aspects of this proceeding. Some solid benefits have resulted from this activity, but very few reports have been submitted by bankers. Presumably this can be traced to their reluctance to turn over confidential information about the bank's customer. Perhaps the National Conference can find some way to change the machinery of the practice to overcome this obstacle.

We are making progress, progress in cooperation between our two professions. And in the National Conference of Bankers and CPAs, we have the vehicle for achieving still more cooperation.

We in the accounting profession are keenly aware of the responsibilities placed upon us by the dynamic changes confronting the economy today. We will continue to be responsive to the demands of the times.