2-15-1971

Accountability and the Accounting Profession. Address before Milwaukee Chapter National Association of Accountants and Wisconsin Society of Certified Public Accountants, February 15, 1971, The Bavarian Inn, Milwaukee, Wisconsin

Leonard M. Savoie

ACCOUNTABILITY AND THE ACCOUNTING PROFESSION

By
Leonard M. Savoie

before
Milwaukee Chapter National Association of Accountants
and
Wisconsin Society of Certified Public Accountants

February 15, 1971
The Bavarian Inn
Milwaukee, Wisconsin

ACCOUNTABILITY AND THE ACCOUNTING PROFESSION

Over the past few years we have been going through a period of public apprehension. We have been apprehensive over our cities, our race relations, our youth, our foreign involvements.

This apprehension has extended to the business community in a number of ways, but it seems to be particularly evident in the attitudes of the investing public toward the corporate structure in which it has placed its confidence and its capital.

More people invest in corporate stocks than ever before -- some 31,000,000 now. They are better informed, better educated and more skeptical than before. Add to this the phenomenon typical of troubled times -- that of greater concern over investments when the economy lags and stock market prices drop.

In spite of the recent market recovery and forecasts for an improved economy, the bear market of 1969-1970 and the accompanying economic slump are only too fresh in the minds of investors. They continue to be apprehensive about business performance.

Public apprehension leads to concern over accountability. The public is attempting to hold organizations, public and private, accountable for more things in more ways.

Accountability is a major issue in many walks of life. The most controversial feature of general revenue sharing proposed by the Administration is accountability. Critics contend that the plan is devoid of accountability for the billions of dollars which would be handed over to state and local governments and proponents claim accountability is enhanced.

A recent Gallup poll reported that a two-thirds majority of the public favor greater accountability on the part of teachers and school administrators regarding the progress of students in public schools. A few days ago New York City's Board of Education announced plans for developing a way to measure the effectiveness of the city's schools and their teachers and supervisors. The press hailed this as professional accountability.

So too are investors concerned with a greater accountability on the part of corporate managers regarding many aspects of the corporations in which they invest. This accountability transcends financial information and embraces social issues such as ecology, community welfare and minority groups. Improved credibility in this broader field of accounting would surely be welcome. Accounting, together with other disciplines, can provide this added credibility. Accountants now have the opportunity to assume the lead in this movement. They have the organization, the training, the discipline, the ethical code to lead. To do so they must broaden their horizons, add to their functional knowledge and embrace added specialties.

Some may question whether the accounting profession is equipped to respond to this broader challenge in view of its much criticized performance in the narrower area of the traditional accounting and auditing function. I believe that the profession has performed admirably, though imperfectly, in setting professional standards and in meeting its obligation to provide added credibility to financial information.

But the accounting profession has had a serious communications problem. It has responded to the public need for higher standards of reporting, but in doing so it has encountered dissension within its ranks and slowdown tactics from other sectors that should be supporting rather than stalling the effort.

In meeting the public demand for improved financial reporting standards, it is entirely reasonable to expect the accounting profession to take the lead in developing them. It is also important for business to understand that it too is a beneficiary of a system of fair and full disclosure and consistent reporting to the public.

In carrying out its role of establishing accounting principles, the profession has been criticized for not moving fast enough. Much of this type of criticism comes from the users of corporate reports -- investors and financial analysts -- who complain about continued permissiveness in the selection of accounting standards. On the other hand, the profession has been criticized from the opposite side of the street -- from corporate managements who hold that recently proclaimed accounting standards are too strict, too confining in their disclosure requirements.

To those who complain of lack of action, I would say the Accounting Principles Board can look back on a good track record over the past few years.

Issuance of APB Opinion 15 on earnings-per-share was a major breakthrough. The financial community had long been plagued over the looseness of the earnings-per-share data which are used in evaluating the past operating performance of a business, in forming an opinion as to its potential, and in making investment decisions. These figures traditionally had been appearing prominently in sections of annual reports that were not covered by the auditor's opinion.

The APB met this situation squarely by issuing Opinions that called for improved and standardized earnings-per-share figures -- before and after extraordinary items, primary and fully diluted -- all to be presented on the income statement, and therefore subject to the review and opinion of the auditor.

These actions were followed by two other major Opinions which became effective last fall having to do with accounting for mergers and goodwill. Dealing with these subjects created one of the most difficult struggles the Accounting Principles Board had ever been through. It was finally resolved with the issuance of Opinion 16 on Business Combinations and Opinion 17 on Intangible Assets.

Together, these Opinions established standards which eliminated questionable practices in the merger movement and brought about uniformity in the manner in which business combinations are reported.

Within the past two months, the Accounting Principles Board has issued for public comment four proposed Opinions.

Two went out in December. One calls for use of the equity method of accounting for investments in subsidiaries, affiliates, and other companies in which the holding is 20% or more of the common stock. Use of this method would increase reported profits in most cases because it recognizes the investor's share of profit when it is earned rather than when it is paid to him as a dividend. It would also require recognition of losses currently. The equity method would be extended to investments shown in parent-company-only statements in those cases where they are the primary statements furnished to stockholders.

A second draft Opinion called for an audited source and application of funds statement to be presented along with the balance sheet and income statement. Such a funds statement would contain information on changes in financial position which is not readily available from the balance sheet and income statement.

Two other draft Opinions were sent out for public comment last week. One of them would require imputing interest on long-term receivables and payables. Imputing interest deals with the substance of a transaction rather than its form. Application of this method would result in a more realistic reporting of the principal amount of the long-term receivable or payable and the related interest income or expense in terms of prevailing rates for comparable notes.

A fourth draft Opinion, now circulating for comment, covers changes in accounting methods. Since change itself creates a reporting problem, new standards have to be set forth to cope with it. Under the proposed Opinion, accounting changes would be restricted to situations where it can be demonstrated that the new method will provide more useful information to investors than the former one. When a change is made, its effect on financial statements of prior years would be disclosed as supplemental information.

Comments on these four proposed Opinions are being received now and the Board is expected to take final action on them this spring.

Meanwhile, a series of other planned Opinions by the Board is flowing through its research division and committees. Some additional pronouncements may be issued before the end of the year.

There is no doubt in my mind that the Accounting Principles Board is moving ahead at a brisk pace and that the items on its agenda are worthy of its mandate to improve corporate financial reporting in the best interests of the public.

But, in the eyes of the profession, even this is not enough. As the ad says, it has to try harder.

Last month the president of the American Institute, Marshall S. Armstrong, called a two-day conference of 35 prominent members to consider the matter. They recommended that the Institute undertake a study of ways to improve further its function of setting standards of financial reporting.

The recommendation called for establishment of two study groups, acting independently of one another. Each group would have significant representation from experts outside public accounting.

One group would review the operations of the Accounting Principles Board, and the other would seek to refine the objectives of financial statements.

Preliminary work on the establishment of these study groups is well underway, and the Institute's Board of Directors is expected to approve the overall project at its meeting next week.

Commenting on the events that led up to the formation of these study groups, Business Week magazine observed editorially last week that ". . .something like a revolutionary movement has begun to take shape within the profession".

Since accountants have been examining their function and performance over many years, to call these current efforts a "revolutionary movement" might be a little extreme. I do believe, however, that the forthcoming studies of financial reporting objectives and the setting of accounting principles to achieve those objectives will strengthen the profession in its service to the public.

Hopefully also, these studies will lead to strengthening the independence of the public accountant in the exercise of his professional judgment and in requiring adequate financial disclosures.

This matter of independence has been much in the public mind of late. Financial writers raise the question from time to time: How can the public accountant be truly independent when he is engaged by the client and paid by the client? Or, as another writer put it recently, "Does the accountant work for the stockholders, the creditors, the public -- or the management that hires him and pays his fee?"

SEC Commissioner James J. Needham -- himself a CPA -- recently expressed his thoughts on the accountant's independence. He said that the real test often comes when the accountant must make a decision on a treatment not covered by a specific APB Opinion, and that too many times the accountant rationalizes his decision by pointing out that his problem has not been dealt with in accounting literature.

There are many judgments, estimates and materiality factors involved in financial reporting that place a strain on the credibility of the auditor. Continued existence of alternative accounting principles adds to this strain. In spite of the rapid pace of the Accounting Principles Board in eliminating needless alternatives, choices will be available for some time.

As long as choices exist among various accounting principles, and judgment is a factor in determining operating results, pressures will be applied upon the auditor. Ways should be found to strengthen his hand.

One method that seems to be growing in use is to provide an auditing committee of the Board of Directors of a company. Such a committee is composed mainly of non-officer directors. This gives the auditor an influential group with whom he can discuss any difference in judgment he may have with the client's operating management. It also gives management an opportunity to express its views.

But even this avenue may not be sufficient. The auditor should have the right to communicate with his real client -- the investors, the shareholders and possibly even the general public. He should have the privilege of speaking at shareholders' meetings, including, if he is replaced, the first meeting following his withdrawal from the engagement. I recognize the possibility that the auditor is also fallible and that his view may not be correct. But, at least he should have the opportunity to make it known to those to whom it could make a considerable difference.

The American Institute has already moved toward requiring an auditor to make known his findings in cases of a dispute with his client. The Institute's committee on auditing procedure has issued a statement which calls for the auditor to make disclosures when management does not take steps to correct erroneous financial statements; the auditor must disclose to appropriate regulatory bodies, and to each person known to be relying on the statements, any material facts that he has discovered after issuance of his report which would have caused his opinion to be different.

Having taken this step, the profession should, I believe, push for disclosure of additional matters of controversy with the client management. One approach would be for the SEC to require the auditor to notify the Commission of any unresolved controversy with client management regarding the fairness of financial statements or proposed accounting treatments.

Those in the public practice of accounting who are members of the American Institute are subject to the disciplinary force of the Institute's code of professional ethics. This code, which requires members to direct attention to any material departure from generally accepted accounting principles, has been a strong force in improving performance of auditors, but it applies only to Institute members in public accounting practice who are associated with financial statements.

Some would define the accounting profession to include only those in public accounting practice, and a case can be made for this line of reasoning.

Others would define the profession much more broadly to include all who are educated in accounting and engaged in related work. There is much to be said for this argument too. But, it is also plain that those who are not in public practice are not subject to a code of ethics which calls for adherence to generally accepted accounting principles. Individuals may have personal ethical standards, but they are not obliged to abide by professional standards when they are associated with financial statements.

I believe that accountants in industry should be a part of the profession broadly construed and that they should adhere to technical standards of the profession. If all accountants were united in a common dedication to professional standards, surely this would greatly strengthen the role of accounting and would add mightily to the extended role of the profession in improving accountability.

Six years ago, I suggested to an NAA audience that their organization develop a code of ethics for management accountants. This stirred up some interest and my comments were published in Management Accounting. But, I am not aware of any follow-through and I suspect that virtually no progress has been made in this direction in the intervening period. I acknowledged that enforcement would be difficult but concluded that an attempt should be made to set up and enforce a code of ethics.

About one-third of the membership of my own organization, the American Institute, are accountants in industry who have left the practice of public accounting. We, at present, have no means of getting them to comply with our own professional standards. So perhaps instead of exhorting other organizations to take action, we should produce something along this line within the Institute.

An interesting development abroad has recently come to light. The Institutes of Chartered Accountants in the United Kingdom have placed the following paragraph in the explanatory foreword to their new series of Statements of Standard Accounting Practice:

> "The Council expects members of the Institute who assume responsibilities for financial accounts (signified by the association of their names with such accounts in the capacity of directors or other officers, auditors or reporting accountants) to observe accounting standards. The onus will be on them not only to ensure disclosure of significant departures but also, to the extent that their concurrence is stated or implied, to justify them. The Council, through its Professional Standards Committee, may inquire into apparent failures by members of the Institute to observe accounting standards or to disclose departures therefrom."

Since SSAP No. 1 was issued only last month, it will be some time before we see the effect of this first move to enforce professional standards on accountants in industry.

I think the American Institute should attempt a step in this direction. Here we have not followed the British practice of having directors or officers sign financial statements. Yet Institute members in industry could surely be identified as having responsibility for financial statements.

A subject related to this concept of broader corporate responsibility will be discussed at a meeting scheduled for next November in the New York area. It will be conducted as a symposium to inquire into business ethics surrounding corporate financial reporting. Attention will be devoted to ethics of public accountants, security analysts, financial executives, and bankers. Sponsors are the American Institute of CPAs, Financial Analysts Federation, Financial Executives Institute and Robert Morris Associates.

Whether the accounting profession is broadly or narrowly construed, we are having trouble convincing the general public that accountancy is a profession.

Business Week noted that "accountants are still not quite a self-governing profession in the way that doctors, lawyers and parsons are."

When Ralph Nader last month proposed a code of professional integrity for professionals employed by corporations and government, he ignored accountants completely, although he noted specifically physicians, lawyers, economists, engineers and scientists. He urged

Congressional action and professional society participation to enable employed professionals to maintain professional integrity -- as well as their jobs -- in the face of employer actions which may violate professional knowledge. I do not know whether we should feel relieved or outraged because Mr. Nader ignored accounting. But, I do believe we should not regard lightly suggestions of this nature.

Please note that Mr. Nader was talking about government as well as corporate employers. In the field of government Admiral Hyman Rickover has already challenged the General Accounting Office to become the conscience of government. Notwithstanding the Admiral's criticism, I believe the GAO is well along the trail toward becoming just that. It is much closer to being the conscience of government than the accounting profession is to assuming a similar role in the business community. It would be unfair to carry the analogy too far, for it is much easier for a single centrally-directed agency to attain such a major objective than it is for a huge amorphous group of thousands of separate decision-making units.

Yet I am optimistic that the accounting profession, broadly defined, can make conspicuous progress toward further influencing the conscience of business by requiring greater accountability. The key to this progress lies in unity. I am encouraged that the practicing profession is now united in support of the Institute's efforts to improve its function of setting accounting principles. I am also hopeful that that effort will attract the support of professional accountants who are not in public accounting practice.

I am not calling for the mingling of the roles of public and private accountants. For each has his separate and distinct function and responsibility.

And I am not calling for elimination of dissent or for automatic acceptance of professional knowledge from a central fount of wisdom. For all responsible professional views must be considered in arriving at professional standards.

I am calling for a wholehearted spirit of cooperation from all accountants in all accounting positions, who aspire to be considered professionals. This means there must be recognition that professional standards can be set and that they should be set by the profession in a manner that best serves the public interest. It means that some of us may have to set aside our cherished preferences in favor of consistent professional standards developed in an orderly fashion by properly constituted professional bodies. It means that professional accountants, in public practice and in industry, should see that professional accounting standards are followed in all financial statements with which they are associated.

If all professional accountants can agree on appropriate ways to develop standards and to adhere to them in practice, the accounting profession will be well on its way to attaining the higher degree of accountability the public demands and deserves.

#######