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APB Opinion No. 22: Treating the Symptoms, Not the Cause

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The author examines some of the pressures that produced the Opinion and some of the problems that may result from it.

In April, 1972, the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued an opinion regarding disclosure of accounting policies (APB Opinion No. 22) and thus established a lead time of some nine months over a similar proposal by the Securities and Exchange Commission (SEC). This lead time was sufficient to maintain the prestige of the APB, but close timing of the two mandates for financial reporting reflects the interweave between the AICPA, a highly developed economy, and the SEC.

It is the intent of this article to examine some of the pressures that produced the disclosure opinion, and some of the results that may be anticipated.

An Environment of Pressure

The accounting profession has been under mounting criticism for its equivocal position in reporting matters relating to asset valuation, income determination, and earnings per share. Investors have grown wary of financial statements that, like chameleons, take on the color most becoming to management. In mid-summer, 1971, the APB released Opinion No. 20 regarding accounting changes, but this was only a preliminary to No. 22 requiring full disclosure of the accounting policies followed in preparing financial statements.

Both Opinions deal effectively with the symptoms of professional ambivalence. Neither is able to treat the underlying cause.

Increasing litigation against accounting firms, especially those in the prestigious Big Eight, unquestionably hastened the disclosure opinion by the Board. Coupled with pressure from the SEC, the APB was virtually in an emergency position.

To some in the profession, disclosure of the choice of accounting policies for a particular firm is comparable to a physician's recital of the reasons for an individual diagnosis and treatment. Disclosure, they feel, is tacit admission of the insecurity and lack of expertise the practitioner may feel. In the opinion of that segment of the profession, to require disclosure of accounting policies is to imply questionable judgment on the part of either management or the accountant.

Whatever the inference drawn by the individual practitioner, disclosure is now the prescription for fiscal years beginning after December 31, 1971, and is applicable to all audited financial statements, including those of not-for-profit entities. For reports filed with the SEC, the agency has proposed Rule 3-08, a planned amendment to Regulation S-X. This rule would require disclosure and a full explanation of the accounting policies used, including in some cases a restatement of current and prior years to conform with general practice within an industry.

The proposal was "greeted with muted applause by the accounting profession and enthusiasm by the financial analysts," according to John C. Burton, CPA, Chief Accountant of the SEC, in an address given June 25, 1973, before the Ohio Society of Certified Public Accountants. Revision of the original draft will probably contain changes sufficient to require yet another exposure draft.

Scope of the Opinion

The accountant does not, and cannot, deal with absolute truths. In recent years the accounting profession has been referred to by its own as an art, rather than a science, and the changing concept came with the discovery that there is more than one acceptable way to report business activities to the financial world. Unfortunately the art has not always been for art's sake, but sometimes for the sake of management.

APB Opinion No. 22 observes that "the usefulness of financial statements for purposes of making economic decisions about the reporting entity depends significantly upon the user's understanding of the accounting policies followed by the entity." (Paragraph 7) Usefulness, in the sense of the Opinion, is simply another word for truth.

To enhance the usefulness of statements for the investor the Opinion prescribes a description of all significant accounting policies to be included as an integral part of the financial statements. The Board's conclusion applies to not-for-profit entities as well. It does not, however, apply to unaudited interim financial statements if there has been no change in accounting policies since the last year-end.

Impact of the Disclosure Opinion

The primary impact of the Opinion is similar to the effect of the SEC proposal of Rule 3-08. Of the latter, a representative of a Big Eight CPA firm said "It will be a prod to get accounting principles established so you won't need so much disclosure." In his view, the action by the SEC demonstrates that neither the APB nor the new Financial Accounting Standards Board will be allowed to operate without considerable pressure. "And maybe that pressure is good," he added.[1]

The secondary impact is more insidious because it contains the threat of stifling creative, independent judgment. Disclosure may be one step away from full

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government regulation of the profession.

Accounting is a hybrid discipline resting somewhere between science and art. Dealing as it does with "values" it inherits a mixed bag of measurement techniques, some objective, and some subjective. Further, it is a relatively new discipline still struggling toward the evolvement of standards. Diversity of opinion is an inescapable part of the creative process, although in progressing from disorderly to orderly arrangement of principles the profession must, of course, attempt some control of judgment. The line dividing progressive direction from static control is subtle, but it must be preserved.

Specific Problems of Disclosure

Relaxing of Responsibility: Now that the accountant must present a "Summary of Significant Accounting Policies" as part of every set of financial statements prepared for a client, a new temptation to negligence will rise like a ghost, in the night hours before meeting a deadline. How easy it will be to opt for the accounting principle that represents the least work in application. Adopting the defense of communication, the disclosures may "become alibis for not improving financial statements, thereby creating a vicious circle of ever greater disclosure and more inadequate accounting."[2] The responsibility for meaningful presentation of economic facts leading to decision making cannot be passed on, ethically, to the readers by telling them what methods were employed.

Too Much Information: Disclosure not only provides the accountant with an avenue for abdication from careful judgment, it also may be the means of confusing the reader by an overgrowth of details. Situated between the illustrations and colorful prose of the annual statement, the accountant's report attempts to inform the reader of financial facts with as much clarity and precision as possible. The footnotes themselves present a tiresome maze to all but the professional analyst. Will a recital of the applied principles illuminate, or further obscure the reader's understanding?

It may be assumed that the reader of financial statements has a reasonable degree of sophistication. "He should not be expected to be an expert accountant," says Hendriksen, "yet he should have some knowledge of accounting and business."[3] The same author, in quoting Mautz and Sharaf, points out that "financial market professionals have come to act as intermediaries between accountants and investors."[4] Analysts both use and need sufficient financial information to properly exercise their professional responsibility toward those who rely on their judgment.

Duplication: Of all the possible criticism of the effects of the disclosure opinion, confusion by proliferation of detail seems the least warranted. There is, however, a certain potential redundancy of disclosure apparent from examination of a group of annual statements for 1971 prepared by six of the Big Eight public accounting firms, as shown in Table I. In compliance with earlier APB opinions and in demonstration of their own professionalism these auditors have disclosed in the footnotes information relating to principles of consolidation, translation of foreign currencies, intangibles and amortization, liability under pension plans, and various other pertinent accounting policies. One firm, possibly with prescience of impending regulations, added a "Statement of Accounting Policies."

Management Resistance: Understandably, management doubts that good effects of disclosure will outweigh the bad ones. Its fears that rival businesses may piece together helpful information from fully disclosed accounting policies are valid. On the other hand, it must be remembered that companies in the same industry negotiate with the same or similar labor unions, suppliers, and customers and therefore possess a lot of information about their competitors.

Suggested Content of Disclosure

The wording of Opinion No. 22 is generalized as to the application of disclosure. Beyond the broad accounting

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Table I
DISCLOSURE PATTERNS OBSERVED IN 1971 ANNUAL REPORTS

	Arthur Andersen	Price Waterhouse		Touche Ross	Ernst & Ernst	Haskins & Sells	Peat Marwick
Broad Operating Policies							
Principles of Consolid.	X		X	X		X	X
Translation of Foreign Currencies	X		X				
Changes of Acctg. Prin. (per APBO #20)		X**				X	
Intangibles and Amortiz.			X				
Detailed Principles							
Inventory Valuation	X		X	X	X	X	X
Liability under Pension Plans	X			X	X	X	X
Income Tax Liability	X	X**		X			
Deferred Charges							X
Commitments and Conting. Liabilities	X	X**		X		X	X
Changes in Stockholder Equity Accounts	X	X**		X		X	X
Stock Option Plans	X	X**		X		X	X
Depreciation	X		X	X	X	X	X
Computation of EPS	X	X**		X	X	X	X
Lease Agreements						X	

** Disclosure so marked was presented in a separate "Statement of Accounting Policies"; other information was provided in footnotes or in the body of the financial statements.

Since a limited number of annual reports was examined it must be assumed that absence of a disclosure pattern for a particular policy or principle may be deemed as not applicable to the particular client, rather than a disinclination toward disclosure by the audit firm.

allocations must be made between periods. The statement of financial activities would not involve allocation of any kind and, except for estimating highly probable cash effects, no other estimates or interpretations of the significance of events would be included.

The Study Group also considered the relationship between private enterprise and society. It was concluded that a financial statement objective was to report enterprise activities affecting society which could be determined and described or measured.

With regard to governmental and not-for-profit organizations, the objective determined by the Study Group was that their financial statements would provide information to evaluate how well resources were being used to attain specific goals. Performance measures would have to be quantified in terms of identified goals.

Finally, the qualitative characteristics of information included in financial statements were considered by the Study Group separately from the financial statement objectives. These characteristics would be relevance and materiality (as related to the user's decision), reliability, freedom from bias, comparability, consistency, understandability, and the recognition of substance over form.

The objectives developed by the Study Group are not revolutionary. Concepts such as the use of current values rather than historical cost and the furnishing of forecasts might be considered controversial. However, the report is a starting point and implementation is the next step.

Accounting Principles Board Disbanded

The work of the APB was not totally completed at June 30, 1973 when it was disbanded and bequeathed its many problems to the Financial Accounting Standards Board. The last four opinions issued by the APB have been and will be discussed and interpreted in other professional publications. It is our purpose here to simply remind our readers of their effective dates. These are:

No. 28 Interim Financial Reporting

All interim periods relating to fiscal years beginning after December 31, 1973

Data for the comparable interim period of the prior year should be restated to conform the prior period presented with the current period, or the effect on the prior period data should be disclosed.

No. 29 Accounting for Nonmonetary Transactions

Transactions entered into after September 30, 1973, and those recorded during a fiscal year which includes October 1, 1973

Transactions recorded in a fiscal year ended prior to October 31, 1973, should not be adjusted.

No. 30 Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions

Events and transactions occurring after September 30, 1973

Retroactive restatement may be made for previously reported events and transactions occurring during the fiscal year which includes September 30, 1973.

When comparative statements are presented, prior peiod operations of discontinued segments of a business may be reclassified as explained in the opinion.

No restatement should be made for other events and transactions occurring in fiscal years ended prior to October 1, 1973. Appropriate disclosure should be made in notes to the financial statements for differently classified similar items and transactions of prior periods.

No. 31 Disclosure of Lease Commitments by Lessees

Fiscal periods ending on or after December 31, 1973

Required disclosures are to be made for all lease agreements without regard to the date any agreement was entered into.

Publicly held companies must also comply with the expanded disclosure requirements of Accounting Series Release No. 147 issued by the Securities and Exchange Commission in October 1973. These are effective for financial statements filed after November 30, 1973.

Reporting the Needs of the Investor
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methods are not solely for the purpose of a short-term rise in income but for legitimate business objectives. Further, the differential effects of such changes should be described. This list of needs is long, and there are many problems. The Financial Accounting Standards Board has chosen topics from a list of over 30 controversial areas.

Analysts do not merely want more information, they want clear and unmuddied numbers. A little less creation and a little from analytic description from accountants would be most welcome.

Footnotes

[1]Robert S. Kaplan and Richard Roll, "Investor Evaluation of Accounting Information: Some Empirical Evidence," *The Journal of Business*, April 1972.

[2]James Lorie and Richard Brealey, *Modern Developments in Investment Management* (New York: Praeger Publishers, 1972.).

[3]Benjamin F. King, "Market and Industry Factors in Stock Price Behavior," *The Journal of Business*, January 1966, Part II, pp. 139-190; and Stephen J. Meyers, "A Re-Examination of Market and Industry Factors in Stock Price Behavior," *The Journal of Finance*, June 1973, pp. 695-705.

[4]Leasco Corp. publishes a monthly compilation called the *Disclosure Journal*. The information is selected from the SEC reports. The list of accounting citations is long.

[5]Indiana Telephone Corp. Annual Report.

[6]Caterpillar Tractor Co. Annual Report.

[7]J. C. Penney Corp. Annual Report.

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principles it particularizes only accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives

b. Specific industry principles and methods

c. Unusual or innovative applications of generally accepted accounting principles.

Conclusion

APB Opinion No. 22 with its disclosure prescriptions must be accepted for what it is — a palliative for poorly defined objectives and standards within the accounting profession. The practitioner may derive some comfort from realization that the profession has yet to mature into an art/science.

The new Financial Accounting Standards Board can, and will, contribute authoritative guidelines that will represent the best interests of the economy. The eventual effect should be a restoration of prestige to the accounting profession so that it will be relieved of the onus of explaining away its confusion.

Footnotes

[1]"The impact of SEC's new disclosure rules, *Business Week*. January 6, 1973, p 58

[2]*Objectives of Financial Statements*, (Arthur Andersen & Co.; Chicago, Ill., 1972), p 86

[3]Eldon S. Hendriksen, *Accounting Theory*, (Homewood, Illinois: Richard D. Irwin, Inc., 1970) p 561

[4]R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing*, (AAA, 1961), p 191, quoted by E. S. Hendriksen, op. cit., p 561