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Financial Statements

Interim Statements — The Auditor's Involvement

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Almost from the time that John C. Burton became the Chief Accountant of the SEC, warning flags signaled an eventual bout between the accounting profession and the SEC over auditor involvement with interim financial statements.[1] This column deals with quarterly statements. Issuance of APB Opinion No. 28 on interim statements served as the catalyst for the SEC challenge for auditor involvement in interim financial statements. The SEC entered the arena with the exposure of a reporting standard that outlined specific procedures to be followed by the company's independent auditor in reviewing interim statements. The Auditing Standards Executive Committee (AudSEC) of the AICPA countered with its own proposed standard on "Limited Review of Interim Financial Statements." The round ended with the SEC release of ASR No. 177 and AudSEC's issuance of SAS No. 10. Both were effective for fiscal years beginning after December 25, 1975. The results of this early "interim" round might be called a draw since there was no "knock down" by either side. Both sides dealt some strong blows. At the moment both are in their respective corners drawing on available resources in preparation for the next round.

APB Opinion No. 28

APB Opinion No. 28, "Interim Financial Reporting" issued in May, 1973, and effective for fiscal years beginning after December 31, 1973, delineated application of Generally Accepted Accounting Principles (GAAP) and reporting practices for interim financial statements of *publicly traded companies* issued for external reporting purposes. Its principal objective was to "provide guidance on accounting and disclosure issues peculiar to interim reporting and to set forth minimum disclosure requirements for interim financial reports of publicly traded companies." (Paragraph .06) (A publicly traded company is one whose securities are traded in a public market on either a stock exchange or in the over-the-counter market.)

Prior to the issuance of this opinion interim report preparers had little guidance from APB Opinions, Accounting Research Bulletins, or accounting literature. A wide variety of practices existed with little application of GAAP to such statements; their form and content tended to be very brief with only a minimum of data reported. Only selected amounts from the income statement for only the current quarter were reported in many instances. At the end of the fiscal year, the results for the entire period often bore little resemblance to the sum of the quarterly totals. The fourth quarter results were seldom reported in a separate statement. The reported earnings for the first three quarters often exceeded the total for the year; many accounting changes and major adjustments for losses were not reported until the fourth quarter. In some instances companies reported profits for each of the first three periods but a loss for the year. Such practices led to further erosion of user confidence in interim statements. Independent auditors seldom had any involvement in any but the annual statement.

Applicability of GAAP. The generally accepted accounting principles used in the preparation of the latest annual report should be used in reporting the results for each interim period unless a change in accounting policy or practice has been adopted. (The reader is referred to paragraphs 12-30 of the Opinion for examples of these instances.) These primarily relate to seasonal revenues, costs, or expenses, and to income tax provisions. Extraordinary items — disposal of a segment of a business, and contingent liabilities should be disclosed separately and included in the determination of net income for the interim period in which they occur. Accounting changes should be reported in the period in which the changes are made; preferably such changes would be made during the first interim period of the fiscal year.

Reporting practices. A tradeoff of the detail in interim reports for more timely information is accepted and guidelines for minimum disclosure of summarized interim data are given. Reports should be issued for all four quarters with the following constituting the minimum disclosure: (Paragraph 30).

1. Sales or gross revenues, provision for income taxes, extraordinary items . . ., cumulative effect of a change in accounting principles or practices, and net income.
2. Primary and fully diluted earnings per share data for each period, determined in accordance with the provisions of APB Opinion No. 15.
3. Seasonal revenues, costs, or expenses.
4. Significant changes in estimates or provisions for income taxes.
5. Disposal of a segment of a business and extraordinary, unusual or in-

frequently occurring items.

6. Contingent items.

7. Changes in accounting principles or estimates.[2]

8. Significant changes in financial position.

The data presented in either summary or detail form must be reported for the current quarter and the current year-to-date or the last twelve-months-to-date *together* with comparable data for the preceding year. Management is encouraged to include balance sheet and funds flow data at interim dates. A footnote in the Opinion emphasizes that the required minimum disclosures do not constitute a fair presentation of financial position and results of operations in conformity with GAAP.

Questions. The reasons for the applicability of this Opinion to publicly traded companies only are not disclosed. Since it appears that the summarized information in interim financial statements is not intended to "fairly present" the results of operations or financial position, is it appropriate for the Board to establish disclosure requirements for only a limited group of companies? Does this have the effect of regulating only that group? Are we approaching the point of a different set of GAAP for different entities? Such a policy recalls proposals of early professional leaders that GAAP should only apply to corporations meeting specific requirements. Why should the Board encourage *only* publicly traded companies to publish balance sheets and funds flow data at interim dates? Would such information not be of equal assistance to security holders of other firms?

The Challenge is Issued and Answered

Once the APB had recognized the existence of legitimatized interim statements Mr. Burton served notice to the profession that it would be desirable to involve independent auditors in quarterly reports filed with the Commission. Proposed rules requiring substantially increased disclosure of interim financial information were released in December, 1974. They would also require publicly listed companies to disclose, in footnote fashion, quarterly income information in published annual reports. Such footnotes could not be labeled unaudited. The release alluded to the hope of the SEC of getting independent accountants involved in the quarterly reporting process. In this manner the SEC was prodding the profession into formulating some sort of standards for reporting interim results.

The proposed rules brought an almost immediate response from the profession. AudSEC was given the charge of meeting the challenge. Generally, the members of the profession desired as little involvement as possible in such statements due to the fear of increased legal liability and the resistance of clients to increased auditing costs. Fresh in the memory of accountants are the Yale Express, Westec, and National Student Marketing cases (to name just a few) that involved interim statements. Suggestions for auditor involvement ran from that of no involvement to continuous audits. Professional groups warned that the required footnote (disclosing quarterly results) would become a part of the annual report. As such, it would be covered by the auditor's opinion and would in turn extend the auditor's liability to the quarterly reports.

On April 15, 1975, AudSEC issued an exposure draft on "Limited Review of Interim Financial Information." This suggested that the auditor might perform a limited review of interim statements as an aid to management. An opinion would not be rendered for a review of such a limited scope; thus, the results of the review would be released to management rather than to the investing public. The public release of the two documents signaled the beginning of several months of sparring between the principal contenders.

ARS No. 177

On September 10, 1975, the SEC released Accounting Series Release (ASR) No. 177 that contained rules for interim financial reporting. The new rules on quarterly data went into effect for fiscal periods beginning after December 25, 1975. The principal requirements affecting such reports are included. The reader is referred to the release itself for the complete text.

Disclosure of selected quarterly financial data in notes to *annual published financial statements* is required for publicly traded companies. The Commission requires footnote disclosure of net sales, gross profit, income before extraordinary items, cumulative effect of a change in accounting policies or principles, net income, and per share data for each quarter within the two most recent fiscal years. Proposals for disclosure of such information outside the financial statements were rejected. Some had contended that such information could be contained in the president's letter to shareholders.

The independent public accountant will necessarily be associated with the interim data in the footnotes to the annual financial statements. The Commission relented on its initial proposal that it was not prepared to have these data labeled "unaudited." It agreed to a set of limited review procedures which auditors would be expected to follow when they were associated with a set of financial statements which included such unaudited footnotes. These review and reporting procedures would satisfactorily set forth the SEC's expectations as to the auditor's responsibilities when footnotes were marked "unaudited." However, the Commission noted that interim financial data was under review by AudSEC and that historically the SEC has not been required to set standards which underlie independent public accountants' reports because the profession has previously developed appropriate standards and procedures. It further stated that if AudSEC adopted a statement on Auditing Standards prior to December 10, 1975, which set forth standards and procedures to be followed in connection with interim data that adequately protected the interests of investors, the SEC would withdraw the section of the rule dealing with such procedures and standards. (AudSEC issued its Statement in time to meet the deadline.)

The Commission considered and weighed the costs and benefits of mandatory involvement of independent accountants in quarterly reports and decided that the mandatory involvement was necessary in the interest of investors.

The requirements for Form 10-Q, the quarterly report required of most SEC-registered companies, are substantially changed. Comparative balance sheets, income statements (quarter and year-to-date), and funds statements are now required. They may be somewhat condensed and only certain footnotes must be included. Management is also required to analyze material changes in operating results by making three separate comparisons: current quarter to comparable quarter last year, current year-to-date and last year-to-date, and current quarter to preceding quarter.

SAS No. 10

In December, 1975, AudSEC issued Statement on Auditing Standards (SAS) No. 10, "Limited Review of Interim Financial Statements." The statement recognized that the involvement of independent CPA's with interim financial information may range from that limited to informal consultation such as advice on accounting principles or disclosure, to the other extreme where involvement may include an examination of such statements in accordance with GAAP. SAS No. 10 is intended to provide guidance concerning a limited review that is considerably different from an audit. The Statement describes the nature, timing, and extent of procedures that the independent CPA should apply to interim information when the accountant has been engaged to make a limited review of that information.

The objective of such a limited review of interim data is to provide the accountants with a basis for reporting to the Board of Directors on matters that they think should be brought to its attention. A limited review does not provide a basis for the expression of an opinion. (The reader is referred to the complete statement.)

Procedures for the limited review are described. They consist primarily of inquiries and analytical procedures concerning significant accounting matters. The procedures that the accountant should apply would ordinarily be limited to the following: (Paragraph 10).

1. Inquiry concerning the accounting system and any significant changes in the system of internal control to ascertain their potential effect on the preparation of interim financial information.
2. Analytical review of interim financial information by reference to internal financial statements, trial balances, or other financial data to identify and inquire about relationships and individual items that appear to be unusual.
3. Reading the minutes of stockholders, board of directors, and committees of the board of directors to identify actions that may affect the interim financial information.
4. Reading the interim financial information to consider . . . whether the information to be reported conforms with GAAP.
5. Obtaining letters from other accountants, if any, who have been engaged to make a limited review of the interim financial information of significant segments of the reporting entity, its subsidiaries, or other investees.
6. Inquiry of officers and other executives having responsibility for financial and accounting matters concerning preparation and content of interim statements.

Performance of the above procedures satisfies the SEC and permits the independent CPA to designate the required footnote disclosure on interim data included in the financial statements covered by the auditor's report as "unaudited". They also constitute the appropriate standards and procedures that should be followed when the accountant is requested to make a review of Form 10-Q when the client desires to state in the 10-Q that a limited review of the information has been made by an independent CPA.

The Next Round

What is happening while the contenders pause in their corners? Many problems are surfacing. Should interim financial reporting periods be considered as separate ones that stand alone, or as ones that are integral parts of the annual report? Also, particularly troublesome items in APB Opinion No. 28 concern the provision for income taxes and seasonal operations. Other problems brewing are: 1. those surrounding SAS No. 1 requirements regarding the disclaimer of an opinion when the accountant's name is associated with an unaudited report; 2. the potential conflict between the auditor's role in assisting management in the preparation of interim statements; 3. the fear that investors may rely on auditor's unaudited interim statements by failing to understand the significance of the limited review of the auditor; and, 4. the possibility that the auditors may be widening the scope of their potential liability by their association with the statements.

On April 28th the FASB announced the appointment of a twelve-member task force on interim financial reporting. The project will involve reconsideration of APB Opinion No. 28. "Stated broadly, the objective of the project is to determine appropriate accounting and reporting standards for interim financial statements and summarized interim financial data issued for internal reporting purposes."

The April 26th issue of *The CPA Letter* reported that a proposed statement on auditing standards to guide accountants in reporting publicly on a limited review of interim financial information has been agreed upon by AudSEC and will be mailed in the first week of May. The report form included in the draft that will be authoritative on the issuance of the statement is:

> "We have made a limited review in accordance with standards established by the AICPA, (describe the information or statements subjected to such review) of ABC Company and consolidates subsidiaries as of September 30, 19x1 and for the three-month and nine-month periods then ended. Since we did not make an audit, we express no opinion on the (information or statements) referred to above."

The interim financial statement bout between the accounting profession and the SEC is far from over. With the outcome unpredictable, financial statement users and preparers await the next round.

Notes

[1]APB Opinion No. 28 states: Interim financial information may include current data during a fiscal year on financial position, results of operations, and changes in financial position. This information may be issued on a monthly or quarterly basis or at other intervals and may take the form of either complete financial statements or summarized financial data.

[2]FASB Standard No. 3 amended APB Opinion No. 28 with respect to reporting types of accounting changes. The reader is referred to this standard issued in December, 1974, effective for interim periods ending on or after December 31, 1974.

Accounting Problems of Utilities

(Continued from pg. 10)

quick write-offs of such equipment, while generally accepted accounting principles would say the costs should be allocated over the life of the equipment.

To date, analysts and investors have not been materially harmed by the contents of utility financial statements. Public utilities have always been permitted to make a profit, thus allowing stockholders a return on their investments. Though the return to stockholders has often been small, there have been very few bad losses. Were a rash of bankruptcies among public utilities to occur, there might arise a hue and cry among the populace demanding uniform accounting so that such bankruptcies could be predicted in the future.

Just what should be the ideal accounting system for public utilities is still unclear. Also unclear is whether or not the system for utilities should be the same as is used by unregulated firms. The only thing certain is that one consistent nationwide system is needed.

Notes

[1]Consolidated Natural Gas Company, 1971 Annual Report, p. 24.

[2]Accounting Principles Board, *Accounting for Income Taxes* (New York: American Institute of Certified Public Accountants, 1967), p. 12.

[3]Alfred L. Burke, "The Investor Looks at Accounting Problems in the Utility Industry," *Financial Analysts Journal,* XXI (September-October, 1965), p. 27.

[4]*Ibid.,* p. 28.

[5]Consumers Water Company, 1971 Annual Report, p. 15.

[6]Arthur L. Litke, "Allowance for Funds Used During Construction," *Public Utilities Fortnightly,* LXXX (September 28, 1972), p. 21.

[7]Homer E. Sayad, "Consistency in Utility Financial Statements," *Public Utilities Fortnightly,* LXXX (September 14, 1967), p. 23.

[8]John H. Bickley, "Cosmetic Accounting and Financial Reporting," *Public Utilities Fortnightly,* LXXXVII (January 21, 1971), p. 21.

[9]Arthur L. Litke, "Impact of FPC Reporting and Accounting Changes," *Journal of Accountancy,* CXXXII (December, 1971), p. 61.