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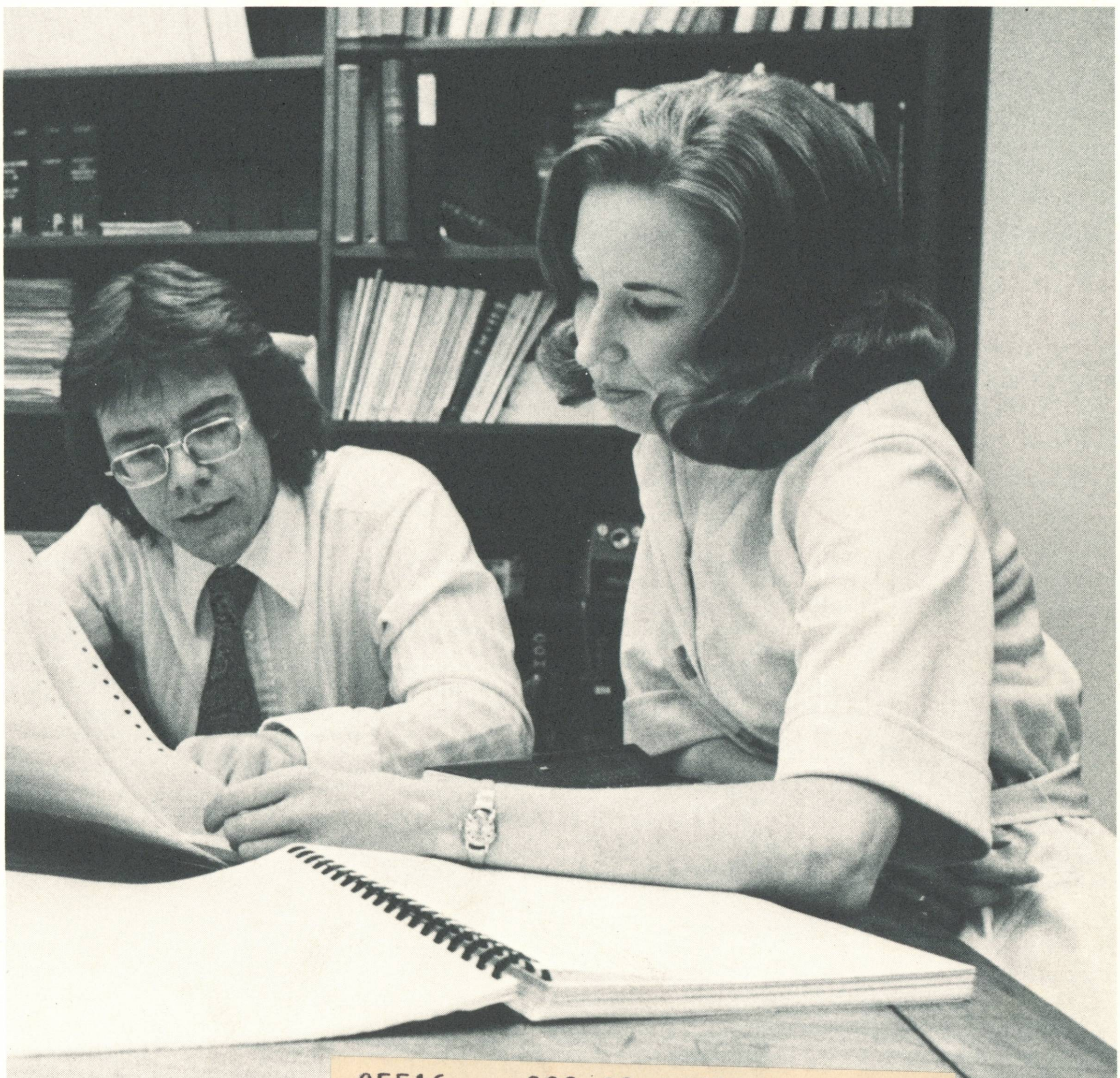

Editor
Dr. Ula K. Motekat, CPA
School of Business Administration
University of Massachusetts
Amherst, Massachusetts 01002

Associate Editor
Constance T. Barcelona
5677 Whetsel Road
Cincinnati, Ohio 45227

Advertising Sales Manager
Lansing T. Dupree
37 W. 38th St.
New York, New York 10018
Tel: (212) 239-8083

Treasurer
Anne N. Hamilton, CPA
P. O. Box 16012
Jackson, Mississippi 39206

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NATIONAL HEADQUARTERS

American Society of Women Accountants
Suite 1036
35 East Wacker Drive
Chicago, Illinois 60601

American Woman's Society of Certified Public Accountants
P. O. Box 389
Marysville, Ohio 43040

The Circulation Department
THE WOMAN CPA
35 East Wacker Drive
Chicago, Illinois 60601

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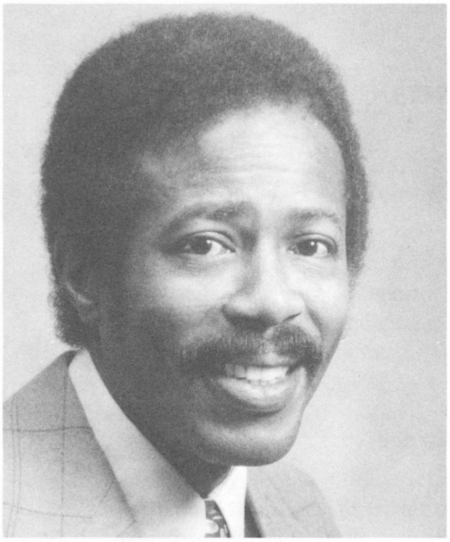
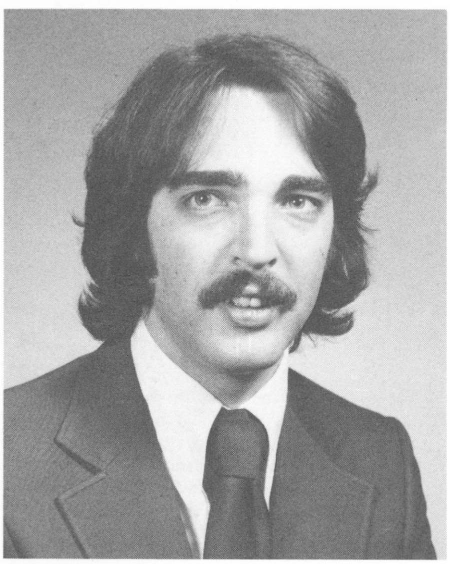
The Conceptual Framework For Financial Accounting and Reporting: Report on a Symposium



Dr. Joe J. Cramer, Jr., CPA
University Park, Pennsylvania



Dr. Charles A. Neyhart, Jr.
Corvallis, Oregon

The authors summarize the proceedings of a Symposium they organized last spring. This report was solicited by the Editor of THE WOMAN CPA, who attended the Symposium, in order to give wider circulation to the points of view expressed by the main speakers and discussants and thereby to encourage discussion of this subject in the accounting profession.

Dr. Joe J. Cramer, Jr., CPA, is Professor of Accounting and Arthur Andersen Faculty Fellow at The Pennsylvania State University. He received his B.B.A. from Texas Southern University and his M.B.A. and D.B.A. from Indiana University. He is a licensed CPA in Texas, Indiana, and Illinois.

Dr. Cramer, whose research emphasizes financial accounting theory, is the author and co-author of several books and numerous articles in professional journals. He is an active member of many professional organizations, including the AICPA where he serves on the Committee on Minority Recruitment and Equal Opportunity and the AAA where he is on the Committee to Coordinate AAA Responses to Pronouncements of Other Accounting Organizations. He has served as a consultant to the Financial Accounting Standards Board and was recently appointed by Secretary of the Treasury Simon to the Advisory Committee on Federal Consolidated Financial Statements.

Dr. Cramer was the organizer of the Symposium.

Dr. Charles A. Neyhart, Jr. is Assistant Professor of Accounting at Oregon State University. He is a member of the American Accounting Association and has been published in a number of accounting journals.

Dr. Neyhart assisted with the planning of the Symposium and was a participant in the proceedings.

"The Conceptual Framework for Financial Accounting and Reporting: Present and Future" was the theme for a Symposium sponsored by the Arthur Andersen Faculty Fellow, The Pennsylvania State University. The subject matter of the occasion related to the most pressing problem facing the accounting profession at the present time. The event was held April 29-30, 1976, in Pittsburgh, Pennsylvania. The guest list of sixty persons included representatives from academia, public accounting, the business community, professional organizations, and rule-making bodies.

Sheldon I. Ausman, Managing Partner of the Pittsburgh Office of Arthur Andersen & Co., represented the Firm with opening remarks. Three major papers were presented. William J. Schrader of the Pennsylvania State University discussed the historical approach to the conceptual framework; Arthur R. Wyatt, Arthur Andersen & Co. (Chicago) presented his views regarding the substantive content of a conceptual framework for financial accounting and reporting; and William G. Shenkir, Financial Accounting Standards Board, discussed current efforts to develop a conceptual framework. Each of the three papers was critiqued by two discussants, followed by open participation by those in attendance. Luncheon speakers were Quiester Craig, North Carolina A & T University, and Kenneth P. Johnson, Coopers & Lybrand (New York). George H. Sorter, New York University, moderated the concluding panel discussion — a synthesis of the issues and prognosis. Panelists were Johnnie L. Clark, Atlanta University, and Jacob G. Birnberg, University of Pittsburgh.

Many important issues were identified and discussed in depth. However, the group by no means reached a consensus. Essentially, the two-day Symposium confirmed that much remains to be done before agreement can be reached about the future direction of the conceptual framework.

In this article we will first summarize each of the three major papers and related discussion. We will then set forth our interpretation of the Symposium, drawing attention to the need for a definition of financial accounting and a determination of the nature and extent of the data base content of a conceptual framework for financial accounting and reporting. We believe that the need for agreement on these issues is critical to the development of a conceptual framework. We conclude our discussion by outlining the *components approach* to the disclosure of entity activities. We perceive this to be a logical and feasible approach for resolving major conflicts in financial accounting and reporting that are attributable to the existence of competing definitions of financial accounting.

A Summarization of the Major Papers and Related Discussion

Historical Approach

In his presentation, William J. Schrader sought to explain what he perceives to be critical choices confronting accountants today. He pointed out that they are not the popular choices of accounting methods nor the equally popular choices of valuation bases. These are, in his view, tertiary issues in accounting. He sees as the primary choice *what our subject matter(s) will be.*

Schrader noted significantly that every discipline is differentiated from others by its subject matter rather than its method. This observation, central to Schrader's analysis, makes it possible not only to arrive at concise definitions of various disciplines, but more importantly enables one to distinguish among different "accounting" disciplines based exclusively on their respective subject matters, or data bases. Thus, within this perspective:

> Accounting$_1$ denotes a discipline represented by current GAAP. Its data set consists of "exchanges" of consideration between the entity under observation and the rest of the universe.
>
> Accounting$_2$ denotes another discipline currently gaining substantial support. Its data set is comprised of elements of entity "wealth."
>
> Accounting$_3$ denotes another discipline of some concern to accountants. Its data set consists of "expected cash flows" of the entity.

These same fields, respectively, are *implied* in the popular references to: (1) Historical cost, (2) Current value, and (3) Discounted value.

Schrader asserted that these three fields are just as distinctive as the fields of biology or jurisprudence. It is, in his view, improper to debate these as measurements. Although complimentary disciplines, they deal with entirely different phenomena, for all of which the measurement problem remains. It is a necessary condition to Schrader's analysis to distinguish operational processes (including measurement) from what is being processed.

Schrader then directed his attention to Accounting$_1$ — delineating its fundamental elements within the context of an input-output framework and providing an interpretive evaluation of the inferences that comprise the end product of this discipline. This field, commonly considered "conventional" accounting, is defined broadly as the observation and interpretation of the historical transactions of an entity.

Schematically, Accounting$_1$ is a system with these elements:

Inputs		Accounting System		Outputs
Measured Elements of Transactions	→	Operations: The "Program" Classifying Selecting Matching	→	Income Statements (Generally "Periodic")

Inputs are screened as experiences of the entity under observation and as exchanges of economic and financial forms of consideration with the rest of the universe. Accordingly, the discipline is historical in character. "Historical" cost is the only measurement that is tenable in this discipline, because *what is being* measured is an event, an historical phenomenon. There are, to be sure, problems arising from instability in measuring units over time but the same problem is present in Accounting$_2$ and Accounting$_3$ as well. Distinguishing the reciprocal elements in the exchange and labeling them generates a data base within the system.

The "program" is directed toward the interpretation of the data base and it generates the output income statements with their inferences (i.e., judgments of the experiences or performance of the entity) called income or profit. Whatever remains in the system at any evaluation point is presented as a "balance sheet." It is not a set of objects or things, but that subset of events experienced by the entity about which judgment has been suspended or deferred.

In Accounting$_1$ the income statement is the paramount financial report; it is the only statement which can even be described in systems terms as "output." It is clearly a subset of events involving reciprocal flows of goods and services, familiarly known as "costs" and "revenues" in this discipline, rather than a statement of values or value changes. It may reasonably be represented as a "Statement of Operations," but the complementary statement listing the residues in the system is not a "Statement of Financial Condition," and much of the present criticism of accounting arises from the misrepresentation or misconception that it is.

Schrader concluded his presentation by stating that when one perceives and processes historical events, one expects to gain understanding of successes and failures; tendencies and potentialities; capacities to initiate and to adapt; indications of growth, maturity, or decline. In short, history enables one to see an entity as what it has become. Memory (history) is the indispensible prerequisite to understanding the present and anticipating the future. And those potentials are what make it worthwhile to engage in the art of Accounting$_1$.

In their respective discussions, both Mimi Burke, Financial Accounting Standards Board, and Lewis F. Davidson, University of North Carolina (Chapel Hill), were in substantial agreement with what they perceived to be Schrader's principal thesis. Davidson reiterated a number of Schrader's views, but was explicit in delineating the need to carefully define or bound the data base. The manner in which one partitions the economic system (i.e., to define the entity) is crucial in determining the nature of the output of the accounting system and the inferences one might properly draw regarding the performance of the entity.

Burke, in an extensive analysis of historical cost financial reporting (including a comparison of the historical cost, price-level adjusted, and current value bases), drew attention to the question of whether historical cost has lost its usefulness as a basis for financial reporting. Drawing on the professional literature to support her analysis, she examined carefully the popular assertions that historical cost is inadequate for the present needs of an inflationary economy or that a changed emphasis in objectives of financial reporting has rendered that basis obsolete.

In her opinion historical cost is a time-honored and time-proven basis of reporting that has provided useful information in the past, and is likely to do so currently. She noted in her analysis that historical cost has been responsibe to change as the economy has become more complex, citing numerous departures from a strict cost accounting as evidence. She admitted that major changes have been slow in coming but this may be attributable to a lack of convincing evidence of a critical need for change.

Burke noted further that, although historical cost financial statements do not satisfy all needs of users of financial statements, new proposals have not offered any solid evidence that they would be more useful. She contends that statements which purport to reflect "economic realism" may be theoretically perfect, but if this solution is unduly difficult to implement and too complex to understand, the implementation problems may well outweigh the benefits. We should be careful to be swayed not by rhetoric but by results obtained through comprehensive experimentation and study of the complex issues involved.

Burke stated that holding the line on

historical cost is not a refusal to recognize or go along with change, but a cautious insistence that substitutes demonstrate their utility and reliability beyond that which is being replaced. In the meantime, as a valid alternative basis evolves, interim measures could be adopted. Instead of abruptly replacing the historical cost basis of financial reporting, disclosure could provide the same information with less risk. Material disparities between historical cost and current value, as well as price level adjusted information, could be disclosed. Meanwhile the challenge is to develop a valid approach to portraying economic reality — one that is neither too simplistic that it does not fulfill the purpose for which it was designed, nor so complex that it confuses when it should enlighten.

Future Approach

In a presentation entitled "The Future is Now," Arthur R. Wyatt set forth his views concerning the substantive orientation of a conceptual framework. In his opinion what is urgently required is to secure agreement on a *single* conceptual framework within which existing and emerging problems can be resolved on an internally consistent basis. Wyatt argued that a framework containing excessive compromises will result in accounting standards that are internally inconsistent and of diminished understandability and credibility. In his view, the single framework is a necessary condition to the success of the FASB.

Wyatt outlined several alternatives that could possibly constitute the principal emphasis or focus of a conceptual framework. These are: (1) the *stewardship concept*, emphasizing the stewardship responsibility of management to protect real invested capital; (2) an *income determination* approach, with principal emphasis on identifying, measuring, and timing of revenues and expenses; (3) a *cash flow* framework, emphasizing past, current, or future net cash returns to investors; (4) an *asset-liability valuation* approach, with emphasis on identifying and measuring assets and liabilities and changes in them; and (5) a *user-oriented* approach emphasizing the satisfaction of information needs of financial statement users.

In Wyatt's view a conceptual framework that places principal emphasis on asset and liability measurement holds the greatest promise to the profession as a vehicle for progress and for eliminating the maze of inconsistencies that exist in present practice. Wyatt noted several advantages that would accrue to this approach. First, it would bear a high degree of relevance to economic reality, given that such reality relates to the effects on assets and liabilities of transactions and events. Second, the approach would provide a basis for de-emphasizing income, particularly as reflected in earnings per share and income growth. The focus would change to command over economic resources rather than on income measurement. Third, the approach would permit holding gains and losses to be reported in the period in which changes in economic values occur. This would tend to avoid abuses commonly associated with the timing of revenues and expenses under present realization and matching concepts.

Wyatt then went on to discuss some notions central to his proposed approach. In his view, the overall purpose of financial statements is to communicate information to users concerning the nature and value of the economic resources of a business enterprise, the interests of creditors and the equity owners in the economic resources, and the changes in the nature and value of those resources from period to period. Economic resources would be viewed as those elements of wealth that possess the three basic characteristics of utility, scarcity, and exchangeability which in combination give the resources economic value.

While some would view this objective as being based on a desire to move to wider use of current values, Wyatt contended that this characterization simply skips a step in the evolution of this conceptual framework. Only after agreement is reached on fundamental issues does one face the question of measurement. Measurement in terms of current values simply appears to be the preferable approach to achieving the objective of communicating the best information available.

With respect to the role of cost, Wyatt contends that the proposed approach does not demand abandonment of the transactions-oriented cost basis. Cost will, in many instances, provide a reliable means of conveying value information. However, Wyatt was of the belief that this approach will effect an attitude change in accountants so that they will acknowledge value information as the goal and will regard cost simply as a means of conveying such information. Cost would lose its status of an objective and the relevance of cost would be challenged when significant value changes in economic resources emerge.

Wyatt observed that a conceptual framework that focuses principal attention on the economic resources and the equity interests in them and that adopts a current value measurement basis also determines the companion earnings concept. Periodic earnings will be determined by the change in the owners' equity shown by comparative balance sheets, after a provision for the maintenance of owners' capital to reflect the effects of inflation and after allowing for additional investments by owners and distributions to owners. The purpose of the income statement would be to provide a summary analysis of the significant events and factors that gave rise to an increase or decrease in the net economic resources of the entity for the period. Only those changes resulting from additional investments by, or distributions to, the owners would be reflected outside the income statement.

The format of the income statement would be somewhat different, including a number of elements not commonly found in income statements currently. Wyatt suggested the following format:

1. Operating income — with emphasis placed on disclosing the magnitude of fixed and variable expenses rather than more traditional breakdowns. Such disclosure would be important in assessing risks with respect to the future.

2. Special or unusual items (operating or nonoperating).

3. Significant holding gains and losses.

4. A one-line provision to maintain invested capital in real terms.

In his view no single measurement approach will likely prove to be of maximum utility for all assets and liabilities. Rather, this appears to be dependent on the functional nature of the economic resources.

Wyatt concluded his presentation by declaring that we cannot continue to postpone the task of identifying the conceptual framework of financial accounting. Once we have settled upon this single conceptual framework we can begin to attach the implementation problems that would arise in a system relying much more heavily on current values than on historical costs. Additional contemplation of our dilemma may no longer be possible. What we urgently need today are some bold steps that will put the accounting process back into the reality of economic activity.

Sybil C. Mobley, Florida A & M University, raised a number of substantive issues in her discussion of the Wyatt paper. Principally, she failed to understand Wyatt's concern with "emphasis" or "focus," feeling that he completely disregarded the interdependence and articulation of the balance sheet and income statement. In her view, the dual impact of economic activity is a fact and it is not a matter of placing emphasis on one side or the other — it is a matter of recording both effects accurately and completely.

She noted having great difficulty in identifying a conceptual framework, finding nothing in Wyatt's proposals to indicate the development of interrelated, internally consistent concepts. Rather than advancing a conceptual framework she contended that Wyatt assumed a conceptual framework and concentrated on alternative principal emphases or themes — which, by identifying some things as principal, are accorded priority. This is to say that accountants will make sure that a certain item is right which automatically implies that other items will be "less" right. Mobley argued that a sound, conceptual framework must be based on ideas or theories that are logical necessities — as such, they will be internally consistent or the logic will not hold. Compromises may be required during implementation, but soundness is certainly a reasonable expectation at the conceptual level. The internal inconsistency of current accounting is that it is internally incomplete. Adjusting entries that update the accounts never get finished. Adjusting entries are conceptually sound but the concept is not consistently applied. Mobley observed that the framework is already present to record holding gains and losses, the effects of inflation, and command over resources — we do not need to resort to single-entry accounting as Wyatt suggests. There is no evidence that single-entry is more conceptually sound than double-entry accounting.

Mobley concluded with the view that the principal change in financial accounting and reporting should be that accountants should provide all relevant information to which they have access; they should no longer be restricted to historical costs. They should be responsive to the economic realities of the day and extend beyond the notions of objective, verifiable evidence.

In reviewing the alternative conceptual frameworks as outlined in the Wyatt paper, Keith W. Lantz, The Pennsylvania State University, agreed with Wyatt that the principal emphasis should be on fundamental issues and not on measurement. Working from an information systems viewpoint, Lantz suggested that the alternative frameworks are really competing information models. The issue, as he sees it, is which information model provides the most relevant information for making decisions related to an individual entity.

Lantz identified three fundamental issues in accounting, stemming from the problem of choosing between two or more alternative sets of information, which he employed as the basis for critically evaluating Wyatt's proposed information model. The first fundamental issue is the purpose of the model. Lantz perceived Wyatt's objective to be to provide more useful information to investors. He considered this objective viable but noted that it is only one of many competing objectives.

The second fundamental issue is whether the proposed information model meets the stated objective. Since Wyatt failed to indicate directly how his information model would be useful to investors, Lantz noted that we must speculate on the relevance of his ideas. As one possible approach Lantz suggested questioning Wyatt's model in the context of modern capital market theory. He argued that if the answer to this question is not available, the only means of obtaining a viable answer is through empirical research, not through theoretical conjecture.

The third fundamental issue is whether the proposed conceptual framework provides a consistent and logical foundation for the development of an information model. Lantz observed that Wyatt's proposed framework suggests measurement of a wealth position, yet Wyatt failed to set forth a justification for the valuation of an entity's wealth position. The proposed conceptual framework does not define the ideal information set for investors, thus is not adequate justification for valuing the entity's wealth position in terms of current values.

In his conclusion, Lantz remarked that he felt Wyatt made some valid points concerning the need for a conceptual framework and in pointing out major weaknesses of alternative frameworks. However, he was of the opinion that Wyatt failed to provide adequate justification for his framework, alleging that the criticisms he made concerning alternative frameworks apply equally well to his own proposal. Lantz warned that there will be no agreement on a conceptual framework until we use the needs of decision makers as a basis of evaluating the relevance of alternative information models.

Current Approach

In his presentation dealing with current efforts to develop a conceptual framework, William G. Shenkir reviewed the FASB's work to date on its ongoing project "A Conceptual Framework for Financial Accounting and Reporting: Objectives, Qualitative Characteristics, and Information." He emphasized that in approaching this project in a series of coordinated steps, the FASB hopes to succeed where previous authoritative bodies have not.

The first phase of this project culminated with the mid-1974 publication of a discussion memorandum that focused exclusively on objectives of financial statements and qualitative characteristics of financial reporting. This memorandum relied principally on the Report of the Study Group on the Objectives of Financial Statements for substantive input and, in so doing, recognized the primacy of objectives in developing a conceptual framework.

The memorandum raised a number of both general and specific questions with respect to the objectives and qualitative characteristics contained in the Report. Additionally, a tentative hierarchical arrangement, demonstrating the way in which the many elements or components of financial accounting and reporting might fit together to form a cohesive and operable whole, was discussed and analyzed. Referring to this arrangement, Shenkir pointed out that the initial phase of the conceptual framework project dealt exclusively with the basic, formative aspects of the framework. Specifically, the framework commences with objectives, which provide a basis for the remainder of the elements. The hierarchy provides for more than one *basic objective*, if necessary, and allows for the existence of supportive *subsidiary objectives*. At the next level are the *qualitative characteristics* which are defined as those attributes of accounting information that tend to enhance its usefulness. At a commensurate level in the hierarchy is the section captioned *information needed*, which involves identifying the nature and extent of financial information needed by users of financial statements.

In analyzing public response to the memorandum on the Report of the Study Group, Shenkir noted that reactions were, not unexpectedly, mixed. This diversity of opinion was manifested in 25 percent of the respondents recommending immediate adoption; whereas 21 percent recommended that the objectives be summarily rejected. Shenkir went on to outline several concerns raised by respondents with respect to Objectives 1 through 6. The level of support for these objectives, which focus on the delineation of financial information to be communicated to users, was substantially greater than that for the remaining objectives. Among the issues raised and discussed briefly were questions of: the user approach versus accounting under the stewardship concept, specifying primary statement users versus responding to multiple users with diverse needs, accrual accounting versus an approach that emphasizes current and prospective cash flows, reporting on past transactions and events versus prediction of future occurences, and questions of interpretation and implementation.

The next phase of the FASB project, underway since the initial public hearing in late 1974, is expected to result in the publication of a second discussion memorandum in the very near future. It is anticipated that this memorandum will begin with the Board's tentative conclusions with respect to the objectives of financial statements based on the Report of the Study Group, the first discussion memorandum, letters of comment, and the public hearing on that memorandum. The memorandum will also emphasize the *fundamental element* of financial statements and accordingly will contain definitions of assets, liabilities, capital, earnings, revenues, and expense. The measurement of these fundamental issues is also contemplated in the memorandum. Five attributes, which relate economic resources and obligations to the unit of measurement, will probably be examined as prospective valuation bases.

Shenkir concluded his presentation with a brief discussion of what he perceived as issues basic to the development of a conceptual framework. The first issue involves the perspective or emphasis around which a framework could be developed. He suggested and outlined two possibilities: an *internal* perspective focusing on the accounting process, and an *external* perspective in which the emphasis is on financial statement users and their information needs. The second basic issue centers on the relative importance of the balance sheet approach (with the emphasis on identifying and measuring assets and liabilities) and the income statement approach (with the emphasis on identifying, measuring, and timing of revenues and expenses). Shenkir observed that these approaches hold several implications for a conceptual framework, namely: a different wording and emphasis in defining fundamentals of accounting, differences in the manner in which specific accounting issues would be resolved, and differences in attitude toward income smoothing. Shenkir maintained that a decision on this matter is critical in establishing a conceptual framework for financial accounting and reporting.

The first discussant, Martin S. Gans, Touche Ross & Co. (San Francisco), argued in his remarks that the course of the FASB as outlined by Shenkir will tend to be overly time-consuming, and consequently it will be difficult to forestall action by the SEC and/or to repel the then existing pronouncements of the FASB. Gans contended that the FASB is proceeding in the standard-setting process without first establishing a framework adequate to substantiate its conclusions. He perceived two objectives that implicitly underlie existing Board pronouncements: (1) The users of financial statements want only "happy surprises" as evidenced, for example, by FASB *Statement No. 2.* (2) The preparers of financial statements would rather be exactly wrong than vaguely right. Gans claimed that the Board is trading between the concepts of relevance and objectivity, usually favoring the latter. He then went on to suggest some simple areas on which reasonable people ought to agree:

1. Valuing the firm is not an objective of financial statements. That is a task better left to the marketplace.

2. Information helpful to one set of users is usually helpful to all users.

3. The crux of whether financial reporting is good or bad can be measured simply: Is the information useful?

4. Usefulness usually means helping people predict the amount, the timing, and the attendant uncertainty of future cash flows.

5. Users of financial statements want to predict the amount, the timing, and the attendant uncertainty of future cash flows.

Throughout his discussion Gans was critical of the FASB's treatment of certain provisions of the Report of the Study Group on the Objectives of Financial Statements, particularly in its rejection of those objectives relating to social measurement and governmental accounting. He cited the issues of "sensitive payments" and municipal bankruptcy as support for his contention that these objectives represent important considerations in a conceptual framework and should not be overlooked by the Board. Gans concluded his remarks by noting that we have a tendency to emphasize certainty, yet almost every problem we face involves uncertainty and risk. Consequently, progress in financial accounting and reporting requires employing the best available solutions that are supported by a rationale or objective. Most importantly, the problems related to the human element must be recognized. The Report of the Study Group can assist greatly in this endeavor.

In discussing the Shenkir paper, Charles A. Neyhart, Jr., focused his attention on the course of action or methodology adopted by the FASB in developing a conceptual framework. He identified and discussed what he perceived to be three major limitations of such a course. First, the approach perpetuates an undue reliance on the ill-defined notion of a "consensus," permitting compromise to prevail over decisive but reasoned action. This reliance may tend to foster indecision, inactivity, and an excessive dependence on others. Second, the approach is likely to be overly time-consuming. Existing standards must necessarily be tentative, awaiting completion of the project before being confirmed as belonging or not belonging to the accounting model. This process can only result in ambiguity, an erosion of credibility in the standard-setting process, and a weakening of the pressures to conform to these interim standards. Third, Neyhart raised the oft-repeated question of whether the private sector will be permitted sufficient time to complete this task before the responsibility is actively preempted by the public sector.

Neyhart argued that the tradeoffs between the above limitations and the benefits expected to be gained from this course of action are unrealistic. He suggested that the time-consuming process by which a conceptual framework is being developed is a manifestation of a much broader policy decision, namely: the decision to proceed in this manner was made to ensure that the power to resolve specific accounting issues will remain in the private sector, at least for the foreseeable future. Under this interpretation, the tradeoffs mentioned earlier are much easier to reconcile.

Neyhart believed that there is an unwillingness on the part of those in authority to progress beyond an incremental approach to developing a conceptual framework. An approach where change is effected in small steps, is heavily dependent on present practice, and is politically feasible. This holds important implications for what kind of conceptual framework will ultimately emerge from the FASB, if indeed one will emerge at all. Neyhart expressed the opinion that the course adopted by the FASB represents an abrogation of responsibility and an incorrect response to the political climate within which accounting standards are set. Neyhart concluded with the judgment that regardless of what results from this process, it is probably unlikely that the framework will perform its intended function of providing explicit guidance in the formulation of accounting standards and the evaluation of accounting practices.

Need for a Definition of Financial Accounting

This section sets forth our interpretation of the two-day Symposium. In addition, we raise questions and present our views regarding the need for a definition of accounting and the data base content of a conceptual framework for financial accounting and reporting. The need for agreement on these issues is urgent. It is fair to state, we believe, that *Statement No. 4* of the Accounting Principles Board is proof enough that financial accounting and reporting is severely limited because of the absence of a conceptual framework.

The presentation by Schrader is notable; he was explicit in pointing out what is realized by few. That is, a large part of the confusion which characterizes the profession is traceable to the fact that *competing definitions of financial accounting* exist. Such confusion will persist until agreement is reached about a definition of accounting. The scope of the field must be delimited. Even the so-called cost-based accounting model is beset by internal inconsistency. For example, in some cases certain items, e.g., inventories and marketable securities, are stated at market values which deviate from cost. Thus, even contemporary financial acccounting does not possess the rigor of consistency in terms of logic.

Failure to be precise in specifying the boundaries of financial accounting is the major problem we perceive to have been highlighted by the Symposium. Resolution of this problem is paramount if any arguments are to be pursued within reason by those who hold opposing views. The purpose(s) for which an accounting is rendered for an entity must, of course, be communicated. We believe that this consideration of objectives is intricately linked with and inseparable from the problem of definition. An *acceptable definition of accounting* should be specific on at least two points: First, it should state precisely what the subject matter of the field happens to be. Second, the definition should provide insight concerning the viewpoint superimposed in relation to the information that the accounting process is intended to generate. Two such viewpoints appear to exist at the present time, that is, the *user approach* and the *accountability approach*. Whether these two approaches are compatible is an empirical question. We believe, tentatively, that they are in the sense that information can be provided in one set of financial statements which will satisfy the conditions of both viewpoints.

Subject Matter Consideration

It is crucial that the profession reach agreement about what financial accounting can and cannot accomplish efficiently and effectively in terms of providing information about the operations, status and prospects of the entity. Stated simply, a definition of accounting should provide insight into the types of information that financial accounting has a comparative advantage in providing. Only then can the data base be clearly specified with respect to what information is admissible to the accounts. Scope delimitation of the type envisioned is absolutely indispensible for specifying the *accounting* information that should be reflected in financial statements.

When agreement is reached concerning a definition of accounting, the profession may then be able to recognize explicitly that different sources exist for providing different types of information about the entity. Information that financial accounting can provide represents at best a subset of the total package of information which may be required. This observation does not diminish the importance of accounting. It may indeed enhance the credibility and professional status of the field. The accounting profession alone has the expertise for determining what should be incontrovertibly designated as accounting data. In addition, accountants have more experience in developing formats for disclosing information in financial statements.

As implied above, it is doubtful whether *any* conceptual framework for financial accounting and reporting can be sufficiently broad such that the output of the accounting process provides *all information* about the entity that *all users* will need. To conclude otherwise would mean that alternative sources of information would not be needed. By implication, the accounting profession may well have to consider the important question of what *non-accounting data* are relevant for inclusion in financial statements. Thus, the need for a definition of accounting in no way suggests that certain nonaccounting information should not be disclosed in financial statements if indeed accounting and nonaccounting information *complement* each other in providing full disclosure about the operations, status and prospects of the entity.

Viewpoint Superimposed

The two different viewpoints superimposed in relation to the types of information which financial accounting should provide have been identified above as the *user approach* and the *accountability approach*. The user approach has more recently been advocated by the Study Group on the Objectives of Financial Statements which concluded that financial statements ought to provide investors with information useful for making economic decisions.[1] The viewpoint that financial accounting should "facilitate the smooth functioning of *accountability* relationships among interested parties" is emphasized by Ijiri[2] who comments as follows:

> By definition, accountability presumes a relationship between two parties, namely someone (an accountor) is accountable to someone else (an accountee) for his activities and their consequences. . . . Detailed records are kept by the accountor not because he expects the information to be useful for his own decisions, but because he is expected to keep the records for the benefit of the accountee.
>
> An accountant joins the accountability relationships between an accountor and an accountee as a third party. . . . The primary role of the accountant is to assist the accountor in accounting for his activities and their consequences and, at the same time, provide information to the accountee. Thus, an accountant has a dual relationship, one with the accountor and the other with the accountee.

Ijiri also contrasts the two approaches by indicating that the decision approach depicts the accountant as a servant of the decision maker whereas the accountability approach deals with the conflict of interests between the accountor and the accountee with respect to the flow of information.

Obviously the viewpoint superimposed acts as a major constraint for specifying the data base of financial accounting. The next section of this article contains an illustration that seeks to reconcile the two viewpoints which some consider to be in opposition. The contemporary financial accounting "model" is employed as a frame of reference in an attempt to reconcile the user approach and the accountability approach to information disclosure.

Components Approach to the Disclosure of Entity Activities

Emphasis on the *periodic* evaluation of entity activities suggests the importance of the income statement as well as the balance sheet. This observation is compatible with the approach of contemporary accounting. The balance sheet is observable only because the activities of the entity are partitioned into segments of time. If the entity is evaluated as a completed venture, for example, a balance sheet would not be relevant. The following discussion reveals how accounting data (outputs of the conventional accounting process) and nonaccounting data (which do not presently meet the criteria for admissibility to the accounts) can be combined in a complementary manner to provide information which may satisfy the user approach and the accountability approach simultaneously. The analysis emphasizes the income statement for illustrative purposes only.

In the context of contemporary financial accounting only two types of income can be identified under the most rigorous analysis:

1. *Operating income* which results from the primary economic operations for which the entity was organized, and

2. *Nonoperating income* which results from certain other activities in which the entity specifically engages.

Each of these is discussed below.

The user approach to accounting places the notion of operating income in imminent danger of being obscured unless efforts are made for the accounting process to preserve the relationship between economic inputs and outputs. It is not objectionable that the user approach emphasizes cash flows. By doing so, however, the approach may result in commingling nonhomogeneous data. Although this approach may facilitate the needs of some users, it may be confusing to others. It is this factor which must be guarded against. For example, disclosure of economic activities which the entity engages in specifically as a provider of goods and services seems necessary if indeed accounting is to facilitate the accumulation of macroeconomic data. This type of data is also necessary for disclosing the degree of progress specifically achieved (performance evaluation) by the entity as a participant in the flow of economic goods and services.

Fluctuations in the general price level have the consequence of making the historical cost of certain economic activities nonadditive. Restatement of the data to reflect the impact of changes in the general price level is warranted. In this way historical cost data would be additive. Thus, evaluations could be effected which reveal income as measured in terms of historical cost *and* the resulting impact of changes in the general price level on the data.

The restatement process also reveals general price-level gains and losses which result from holding monetary items. Such gains and losses do not meet the criteria for classification as either economic or financial income in contemporary accounting. They emerge exclusively as a consequence of changes in the general price level; they reflect neither economic operations of the entity nor do they result from the financial transactions in which the entity engages. General price-level gains and losses affect only the wealth position or status of the entity. They should consequently be treated as capital adjustments inasmuch as they represent redistributions of wealth among entities (including governments). The question of *changes in market values* is pursued later in the analysis.

Three forms of nonoperating income are observable although they have not been adequately contemplated in contemporary financial accounting:

1. Net gains (losses) from transactions involving dispositions of economic assets which are treated as extraordinary items.
2. Net gains (losses) from financial transactions, as distinguished from economic transactions. Financial transactions and events include the phenomena of interest expense and revenue and gains and losses from dispositions or other conversions of financial assets and obligations such as marketable securities owned and bonds payable by the enterprise. These gains (losses) should be disclosed separately since they do not result from primary economic operations.
3. Windfalls and catastrophic events. They can affect both economic and financial balances previously admitted to the accounts.[3]

In accordance with what we term the *component approach* to disclosing periodic financial information about the activities of the entity, it appears that the income statement ought to include the following:

1. Operating income (economic revenue less economic costs)
2. Net gains (losses) from voluntary disposition of economic assets such as machinery used in production
3. a. Net gains (losses) from financial transactions, such as early retirement of debt and voluntary disposition of financial investments
   b. Investment performance, such as dividend and interest income
   c. Other interest expense on debt and interest received on financial balances, such as trade receivables
4. Impact of windfalls and catastrophic events:
   a. Result of involuntary conversion of economic assets, such as through catastrophe
   b. Result of involuntary conversion of investments, such as bankruptcy of a company in which the entity has made an investment
   c. Windfalls

As suggested above, in concept, there should be no objection to expressing the above data in terms of amounts restated for changes in the general price level.

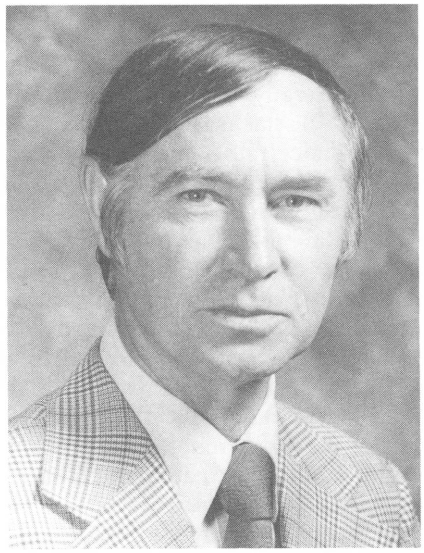
The components approach to the presentation of data in the income statement makes clear the fact that different types of transactions and events may impact differently on the operations (economic *and* financial) and status of the entity. Further, such a disaggregated approach is without bias, except the preceding illustration uses contemporary accounting as a frame of reference. The components approach appears to be compatible with the notion of *accountability* in the sense that it discloses only the results of transactions and events actually experienced by the entity.

Until agreement is reached concerning a definition of financial accounting, it appears reasonable to suggest that certain types of information referred to generally as variations in market values represent nonaccounting data. Disclosure of changes in the values of balance sheet items may indeed represent important information to some who use financial statements. However, it is debatable whether accountants have a comparative advantage in measuring such changes in value. This function is usually reserved for the marketplace, and in some cases appraisals may be necessary. Periodic (unrealized) changes in market values have not been subjected to the transactions test, and their ultimate realization in terms of amount is much more difficult to measure in comparison with the information shown in the above illustration of the components approach to presenting income data.

The point should be emphasized that measurement of current values is an entirely different matter from disclosing such information in annual reports. Whether inclusion of market value data in financial statements will indeed enhance their usefulness is an empirical question. The main emphasis of this discussion is that if such information is included, it should be separately disclosed in terms of components. For example, unrealized

(Continued on p. 20)

The Auditing Profession: Facing Up to Change



Dr. J. Herman Brasseaux, CPA
New Orleans, Louisiana

The author discusses the changing role of the auditor. This article is adapted from a speech given by the author at the Joint Annual Meeting of AWSCPA and ASWA in Houston, Texas in October 1975.

Dr. J. Herman Brasseaux, CPA, is Professor and Chairman of the Department of Accounting at the University of New Orleans. He holds a Ph.D. degree from Louisiana State University in Baton Rouge and a CPA Certificate from the State of Louisiana.

Dr. Brasseaux is co-author of The Auditor's Report *and* Readings in Auditing *and has published several articles on accounting. He is currently a member of the Auditing Standards Executive Committee of the AICPA; however, the views he expresses in this article are his and do not necessarily reflect those of the AICPA Committee.*

Change and the Profession

Change is a way of life and all institutions and professions, like individuals, have some difficulty coping with this phenomenon. The auditing profession finds itself in the midst of change and the challenges which have accompanied this period have been numerous and difficult.

We should not overlook the fact that the auditing profession shares the currents of change with the broad spectrum of service providers in our society. All groups, especially professional groups, which provide service are facing demands for change. The tendencies in the market which are characterized as "consumerism" have affected those who sell a service as well as those who sell a product.

Society's level of expectation for services has and is continuing to rise. Consumers (users) demand not only more services but also better quality services and are more discriminating in regard to services rendered. Additionally, there is a tendency for consumers to seek legal redress for services which are below expected standards.

To get a better perspective it might be advantageous to view the auditing profession as a subset of a larger service group which might be referred to as the "disclosure industry" or "information providers." This larger group has felt a public outcry for more information. This call for more disclosure is partly, but in this writer's opinion only partly, an aftermath of Watergate. Various groups in the disclosure industry are reexamining their roles. This is especially true of the Securities and Exchange Commission (SEC) which is reassessing its role in policing new demands for more disclosure from business to investors and the public. Auditors with their unique role in the disclosure process cannot hope to escape the dialogue and the consequences of change.

The current period of change will undoubtedly alter the boundaries of the profession. In fact it already has. The dimensions of the traditional role of auditing are changing and new types of services and new responsibilities are emerging. When we look back upon this period, i.e., the mid 60's to mid 70's, we will likely conclude that this was the most significant period for the auditing profession since the 30's and the era of McKesson Robbins.

Many leaders within the profession have observed that the expectation level for auditing services and the responsibility level of the auditor have risen at an unreasonable and alarming rate within the last few years. This kind of "future shock" pace, many feel, is on the verge of getting out of hand if it has not already done so.

Response to Change

There is a tendency among groups providing services to resist rapid fundamental change. This bias is generally well founded as society's basic "wants" change in a gradual fashion.

The auditing profession's bias against change — at least rapid basic change — is well anchored. This tendency is perhaps not an unlikely one for a profession whose service is still not widely understood or recognized by the general public. Some critics might suggest that historically the "personality type" atracted to auditing reinforces this tendency to avoid change.

It is abundantly clear, however, that the spirit of the times which has thrust the disclosure industry onto center stage compels a response on the part of the auditing profession. The profession is responding to demands for change — albeit sometimes reluctantly. It is widely recognized that the major catalysts contributing to the profession's response for change are the courts, regulatory agencies (especially the SEC), and the investing community. This has prompted the observation by some that the profession's role has been one of reacting rather than initiating action.

The primary professional body for defining the role of the independent auditor is the Auditing Standards Executive Committee of the American Institute of CPAs. This committee interprets auditing standards, sets guidelines for practice and reacts to calls for a broader scope of service and responsibility. The Committee functions largely as a synthesizer of policies and procedures in use in many major and some of the smaller auditing firms.

The Committee consists of twenty-one part time members, most of whom are auditing practitioners. During 1974-75, there was one member from a federal agency and one from academia. The Auditing Standards Division of the American Institute of CPAs provides the permanent staffing and research support for the Committee.[1] The Committee's official pronouncements are entitled *Statements on Auditing Standards.* These SAS's (twelve to date of this writing) are issued only after they have gone through an exposure period for comment from interested parties and have received at least a two-thirds affirmative vote by the Committee.[2]

Some Current Issues Receiving Attention

The number of SAS's being published belies the numerous issues under consideration in the profession and the volume of work carried on by the Committee and the Auditing Standards Division.

Recent SAS's

The Committee's output and pace of activity have steadily increased in recent years. During 1975 and through January of 1976, the Committee issued the following SAS's:

SAS No. 5
The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report (July, 1975)

SAS No. 6
Related Party Transactions (July, 1975)

SAS No. 7
Communications Between Predecessor and Successor Auditors (October, 1975)

SAS No. 8
Other Information in Documents Containing Audited Financial Statements (December, 1975)

SAS No. 9
The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination (December, 1975)

SAS No. 10
Limited Review of Interim Financial Information (December, 1975)

SAS No. 11
Using the Work of a Specialist (December, 1975)

SAS No. 12
Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments (January, 1976)

SAS No. 5 on "present fairly" was an attempt to deal with the extensive recent controversy regarding the real meaning of the auditor's report. The profession has been most concerned that the view advanced by some, including the courts, that "present fairly" means more than conformity with generally accepted accounting principles would force the CPA into an intolerable position and would impair the utility of the auditor's opinion. The SAS (1) defines "present fairly" within the context of generally accepted accounting principles, (2) establishes the need to consider substance rather than form in the application of accounting principles and (3) directs the auditor to consider whether the accounting principles used are appropriate in the circumstances. At the same time the SAS does not go very far in clarifying the auditor's responsibility for the financial statements and provides little guidance in the selection from among alternative accounting principles.

One of the most troublesome problem areas for auditors is that which is identified as "related party transactions." Financial statements may faithfully reflect transactions; however, if the transactions were "arranged" between parties on a less than arm's length basis, then the financial statements are false and misleading. The tasks of defining, discovering and disclosing related party transactions present the auditor with perhaps insurmountable difficulties. Extensive and heated debate ensued before a consensus was reached to publish some guidelines in the form of an SAS. The SAS puts all auditors on notice to be aware and suggests additional auditing procedures to help uncover manipulated transactions. The auditor's duty is to discover and understand the true nature of such transactions and insist that adequate disclosure be made in the financial statements. The auditor's ingenuity, integrity, and hard-nosed objectivity will be truly tested in applying this new SAS.

The SAS on "other information" breaks some new ground and deals with the auditor's concern with representations made by management in the annual report, other than the financial statements, which may be materially inconsistent with the audited financial statements or which may be material misstatements of fact. The auditors clearly do not audit any part of the annual report other than the financial statements. However, they now are expected to read the other information and take steps to remove significant inconsistencies or misstatements of fact which come to their attention. Thereby they are taking some added responsibility for the protection of investors and others.

One of the most controversial issues facing the profession concerns the need for and the nature of the auditor's involvement with interim financial information. Although the issue has been under consideration by the profession for several years, no one would deny that the SEC's action in this matter brought the issue to a head and precipitated action by the profession.

For some time, the SEC has called for auditor involvement with interim financial information on a less-than-audit basis. The majority of the profession has strongly opposed direct auditor association with interim financial data on a less-than-full audit basis. The profession has argued that the auditor's public association on a limited review type basis would provide an appearance of added credibility without adding substantive credibility. Also, there has been much concern about the increased liability risk which public association with interim financial information would introduce.

In 1975, the SEC issued Accounting Series Release No. 177 which requires the inclusion of interim income data as a "footnote" to the annual audited financial statements of most publicly traded firms. After strong objections were voiced, the Commission agreed to have the footnote marked *unaudited.* The auditor, however, is considered to be associated with such footnote information and is expected to make a limited review of the interim data, at least on a retrospective basis. In addition to requiring the footnote, the SEC Release *permits* (1) the registrant, in connection with filing its interim reports, to report that its auditors have made a timely review of its interim data, and (2) the auditors to file a letter stating that such a review has been made.

The Auditing Committee in December of 1975 issued SAS No. 10 on limited reviews. This SAS is the first of two SAS's expected to be issued on this matter. SAS No. 10 describes the new service, outlines the procedures which constitute a limited review and provides guidance and limits on the reporting. In this SAS the new service is directed to assisting the board of directors and mandates that the auditor's report on the limited review be restricted to the board and management of the client.

At the time of issuance of SAS No. 10 the Committee postponed the issue of public reporting, i.e., reporting to the SEC, stockholders and others. Since the SEC action in ASR No. 177 mandates public association of the auditor with the unaudited footnote data in the annual audited statements and permits association with interim (quarterly) data filed with the

SEC, the Committee is forced to face the question of public reporting and an exposure draft on this matter has been issued. The exposure draft on public reporting does permit the auditor to render a report based upon a limited review and permits this report to go to outside parties. The recommended format of the report uses very guarded language, but neverthelesss, it does represent providing some form of limited assurance on a review which is *less than* an audit.

The SAS on the audit inquiry letter to a client's lawyer (SAS No. 12) is significant in several respects. This issue created a major controversy — in fact, almost a confrontation — between the auditing and legal professions. A compromise was finally reached, but the SAS has brought to the surface a critical and sensitive issue, i.e., the duty to provide full disclosure in financial statements versus a firm's right to self-protection from the revelation of secrets and confidential dealings. The auditor is most concerned with full disclosure; the attorney with confidentiality. Unasserted claims became a pivotal question and the agreement in the SAS calls for the client's management rather than the attorney to provide that information to the auditor. The information provided to the auditor should be based on the client's and the attorney's interpretation of the requirements of generally accepted accounting principles, viz., Financial Accounting Standards Board Statement No. 5.

Other Current Issues

Great public concern has arisen regarding the responsibility for disclosing noncompliance with laws and regulations by business firms. Greater public sensitivity in the wake of Watergate and the disclosure of widespread illegal political contributions, bribes in foreign countries and others have been factors in creating pressure for action. The SEC and other regulatory bodies are reassessing their role and auditors, too, must reexamine basic assumptions and face up to their responsibility, if any, on this sticky issue. For the profession the question is: should the auditor in conducting an examination to determine the conformity of financial statements to generally accepted accounting principles be responsible to look for infractions of laws and regulations? Or, should the auditor report such infractions (only) if they come to his/her attention in the performance of an audit? Further, should the relationship, i.e., the proximity, of the effects of the infractions to the financial statements be the controlling factor? The issues are complex and far-reaching; however, it is likely that auditors will be expected to take some responsibility to deal with infractions which they uncover in the course of their audits.

The auditor's responsibility to detect errors and irregularities (frequently referred to as fraud) is also of widespread current concern although the issue has been around as long as auditing itself. In the aftermath of the wave of litigation against auditors from the mid 60's to the present and sensational scandals such as Equity Funding, loud demands for changes in auditors' responsibility for fraud have emanated from many quarters including the financial press. There are many misconceptions surrounding this issue including what auditors presently do concerning fraud, what the professional literature directs auditors to do, and what they should do and be held responsible for. The profession has been critized for the self-serving negative thrust of professional guidelines on responsibility for fraud in SAS No. 1. The debate in and out of the profession will undoubtedly result in a re-definition of the auditor's responsibility for fraud in more positive terms. The profession's final position on this question is not likely to satisfy all critics, however. Many outsiders feel that the subsequent discovery of undetected fraud is conclusive evidence of negligence by the auditor, whereas auditors maintain that some frauds may be so cleverly concealed, for example, through forgery or collusion, that assurance of detection through a normal audit is not feasible. The profession will likely declare that the discovery of fraud in financial statements is an objective of the audit examination while, at the same time, clearly holding that the audit is not a guarantee of the discovery of all frauds.

A Look at the Future

Many significant issues, in addition to those cited above, are currently being pondered by the profession and the future looks no less challenging. The increasing complexity of business operations along with society's continuing demand for greater accountability suggest that the auditor will be asked to assume a wider role and broader responsibilities. The profession should be prepared to consider a wider scope of service — after, of course, an appropriate weighing of all of the cost-benefit implications for society as well as the profession. Progress, in the form of a more effective audit role and in the form of new areas of service, must be our professional goal.

One significant attempt to be responsive to the current era of change has been the appointment recently of an Auditing Commission by the AICPA. This high-level Commission is examining the nature of auditing and the expectations of users of the audit function, considering the types (or degrees) of assurances which auditors do and should provide, and considering how professional standards might best be established. The Commission has a broad and optimistic agenda and will undoubtedly be a positive force in the profession's response to change.

The changes we now face and will face in the future affect all professional accountants, whether they be in public accounting or industry. The solutions will be more effective if all of us contribute our efforts to the task.

Notes

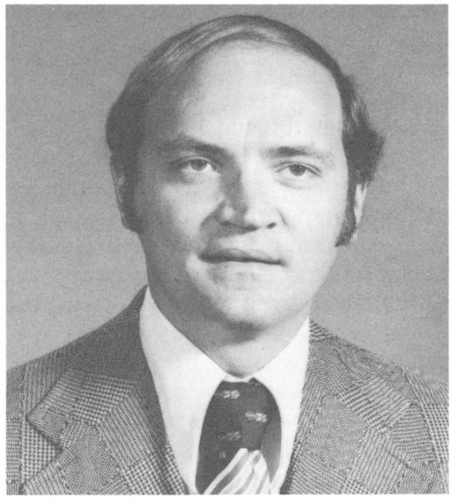
[1]For more information see: Hyman Muller, *Journal of Accountancy,* "The Auditing Standards Division: Responsibilities, Authority and Structure," September 1975, pp. 50-54.

[2]SAS No. 1, issued in 1973, is a codification of previous pronouncements, which were entitled Statements on Auditing Procedures.

[3]The procedures in SAS No. 10 constitute the appropriate procedures for reviewing the "unaudited" footnote as required by SEC regulations.

The Limitation of the Confirmation Process in the Examination of Receivables

Dr. Lary P. Bailey, CPA
Philadelphia, Pennsylvania



The author discusses some reasons why the auditor may not be able to rely on the confirmation process.

Dr. Larry P. Bailey, CPA, is Assistant Professor of Accounting at Temple University in Philadelphia. His prior experience includes teaching at Rutgers University and Virginia Commonwealth University and working as an auditor for Arthur Young and Company.

Dr. Bailey has a B.S.B.A. from Concord College in Athens, West Virginia, a Master of Governmental Administration and a Ph.D. from the Wharton Graduate School of the University of Pennsylvania, and a CPA Certificate from the state of Virginia. His publications include an article in the January 1976 issue of THE WOMAN CPA.

The use of the confirmation procedure in the audit process has been recognized officially by the profession since the 1939 AICPA report on *Extensions of Auditing Procedure* discussed the confirmation of accounts receivables. Although the impact of that report was slightly reduced by SAP No. 43, the confirmation procedure continues to be a fundamental tool employed by the auditor. In fact, this procedure, along with the observation of inventory, is considered to be so critical to the audit that the auditor should "generally disclaim an opinion on the financial statements taken as a whole"[1] if a client restricts the confirmation of receivables.

Such a requirement may imply that the confirmation technique is without limitation and, when applied by the auditor, the results of having used the procedure can be accepted without reservation. The purpose of this paper is to place the confirmation technique in perspective as an audit tool by identifying some of the limitations of this procedure.

Audit Objectives

The third standard of field work of Generally Accepted Auditing Standards requires that evidential matter must be obtained and that this evidence should be the basis for forming an opinion on the financial statements.[2] As an evidence-gathering technique the confirmation procedure is probably second only to evidence obtained through physical inspection. Thus, the confirmation results are normally valued as highly reliable evidence.

In the audit of receivables the auditor must satisfy herself/himself as to the existence and the valuation of the account balance. Combining these audit objectives with the confirmation technique, it can be demonstrated that the auditor must not apply this evidence-gathering procedure in a mechanistic manner. In essence, the auditor must achieve the spirit of the phrase found in the short-form report which reads "included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

Confirmation and Valuation

The confirmation technique does not satisfy the audit objective of determining the valuation of the receivables. One author made the following comment in relation to this problem:

> It should, however, be emphasized that agreement of a balance by the debtor only confirms the accuracy of the recording of transactions by the client and does not confirm the intention or ability of the debtor to pay.[3]

Thus, to achieve the audit objective of valuation, the auditor must refer to other procedures. Typically these would include such procedures as reviewing subsequent cash receipts for a receivable population dominated by relatively large dollar amounts or the aging of accounts receivable balances for a population dominated by small account balances. Therefore, the auditor must extend the audit procedures beyond the circularization of receivables to achieve the valuation objective.

Confirmation and Existence

While it would be generally conceded that the confirmation procedure does not satisfy the valuation objective, it would be equally agreed that the procedure does satisfy the existence objective. However, while the limitations of the confirmation process in the latter objective are more subtle, they are none-the-less important and it is imperative that the auditor recognize and incorporate these limitations into the audit approach.

The validity of the confirmation procedure as an evidence-gathering technique is based on the assumption that the external party will react in a manner consistent with that which the auditor predicts. That is to say, if a confirmation does not agree with the recipient's records, the recipient will react by notifying the auditor. This very fundamental assumption of the confirmation process may, in fact, be invalid.

One researcher using actual accounts of a large bank (personal loans and auto loans) increased the balance due by approximately 10%. Confirmations were mailed out and it was established statistically that less than 70% of the recipients responded to first requests when the accounts were in error.

This type of error is called a non-sampling error and is seldom, if ever, considered by the auditor. The effects of such an error can be illustrated by integrating this non-response with a statistical sampling example. If an auditor is using random attribute sampling in the examination of 2,000 accounts receivable and circularized 200 receivables with the result, based on the returned confirmations, that four balances were said to be in error, a 2% error rate is established. At the 95% confidence level the auditor would expect that the true error rate would fall in the confidence interval between 0.6% and 4.9%. However, this assumes that there is an absence of non-sampling errors. If the non-sampling error rate was 50%, i.e. only half of the errors are being discovered through the confirmation technique, then the revised confidence interval at the 95% confidence level would be 1.9% to 7.5%.[5]

A 50% non-sampling error rate may sound high, but in one phase of the research mentioned earlier only 43% of the recipients responded to the erroneous balances.[6] In a similar study Hubbard and Bullington found the rate to be 48.5%.[7] Thus, the non-sampling error rate may have a significant impact on the evaluation of the returned confirmations. It should also be noted that this problem is as applicable to judgment sampling, or for that matter to 100% circularization, as it is to statistical sampling. Statistical sampling simply affords the opportunity of quantifying the results of the problem.

The appearance of non-sampling errors presents the auditor with a dilemma. The auditor cannot deliberately include incorrect account balances in the confirmation requests mailed. Therefore the question arises as to how the non-sampling error rate can be quantified. Practically speaking, a specific rate cannot be computed. This is not to suggest, however, that the problem should be ignored. In the audit decision process the auditor is, in fact, seldom able to quantify the examination results. For example, the auditor evaluates and tests the internal controls of a firm, but the results are measured in subjective, not in quantitative, terms. Likewise, the auditor must differentiate between factors affecting the level of non-sampling errors even if this level cannot be measured precisely.

Factors Affecting the Level of Non-Sampling Errors

Initially the auditor must evaluate the sophistication of the group to which the confirmation requests are being sent. It stands to reason that an auditor dealing with an audit client who is a wholesaler and whose customers consist totally of medium to large-size business firms could expect a better response than an auditor dealing with non-business debtors. Other recipient segmentations can be made by the auditor.

Another factor influencing the degree of non-sampling errors is the relative size of the individual amounts being circularized. Again, it is reasonable to conclude that the more significant the account balance, the more likely a recipient of a receivable confirmation request is to detect an error. This belief has been confirmed by the research of Davis, Neter and Palmer which was similar in approach to the previously mentioned research projects. They concluded that "the reliability of the confirmation procedures was higher for large accounts than for small accounts."[8]

Based on these factors the auditor must determine whether the possibility of non-sampling errors exists. If it is believed that such errors exist, they must be provided for in the confirmation approach. Based on the research findings mentioned above a 50% rate may not be too conservative. From this starting point the auditor must then tailor the rate to the particular audit client based on some of the factors discussed earlier.

Summary

It should be obvious at this point that the confirmation procedure is, indeed, a useful audit technique, but that it must be used with due professional care. Only by recognizing the limitations of this technique can the auditor apply it in a manner that will meet her/his needs.

Notes

[1]*AICPA Professional Standards*, Vol. 1 (September 1, 1975) AU Sec. 509.12, p. 635.

[2]*Ibid.*, AU Sec. 150.02, p. 81.

[3]P. J. Stilling, "Balance Sheet Verification," *The Accountant (England)*, May 20, 1967, p. 659.

[4]Eugene Sauls, "Nonsampling Errors in Accounts Receivables Confirmation," *The Accounting Review*, January 1972, pp. 109-115.

[5]For an explanation of this approach see *Handbook of Sampling For Auditing and Accounting* by Herbert Arkin (New York: McGraw-Hill, 1963) pp. 120-121.

[6]Sauls, *op. cit.*, p. 112.

[7]Thomas D. Hubbard and Jerry B. Bullington, "Positive and Negative Confirmation Requests — A Test," *The Journal of Accountancy*, March 1972, p. 54.

[8]Gordon B. Davis, John Neter and Roger P. Palmer, "An Experimental Study of Audit Confirmation," *The Journal of Accountancy*, June 1967, p. 42.

Education

Programs and Schools of Professional Accounting

Dr. Loudell O. Ellis, CPA, CMA
University of Alabama in Birmingham
Birmingham, Alabama

Educational needs of the entry-level professional accountant continue to be studied by the accounting profession. One of the most authoritative and far-reaching recent activities is publication of the *Discussion Draft: Standards for Professional Accounting Programs and Schools*[1] of the AICPA Board on Standards for Programs and Schools of Professional Accounting, chaired by Herbert E. Miller. While the Discussion Draft may be revised following the exposure period, it reflects current attitudes toward, and goals for, those university accounting programs educating practitioners of the future. The Draft should be of interest to all practicing accountants — public and private — since accounting graduates soon may be entering the market with more extensive backgrounds than at present.

The AICPA Board was charged "to identify those standards that, when satisfied by a school, would justify its recognition by the profession."[2] The purpose of this article is to summarize the standards recommended in the Discussion Draft and to present the writer's views on programs of professional accounting. To understand the setting and background to the standards, the Board first presented its views on the profession and educational needs and its views on the academic environment.

Discussion Draft

The Profession and Its Educational Needs

Educational programs eligible for accreditation are those training accountants whose career aspirations require the highest degree of expertise. Professional accounting education is not limited to those seeking careers in public accounting, but is intended for those seeking a variety of occupations.

The Board recommends that graduates of professional accounting programs meeting the specified standards should be permitted to sit for the CPA Examination immediately and, upon passing, be awarded the CPA certificate. State Boards of Accountancy may impose additional requirements for a license to practice.

To ensure that standards for educational programs in accounting are responsive to the profession's needs, and to assist schools in attaining the standards, an accreditation process is proposed. While the Board does not elaborate on the accreditation process, it recommends that the AICPA cooperate with other appropriate organizations in formulating such a process.

No specific administrative and organizational structure for housing professional accounting programs is recommended. The program may be offered in separate schools of accounting or within schools of business. The important consideration is the degree to which the administrative structure supports the program and the objective of student preparation for professional accounting careers. Consideration is given to the performance of graduates and to the environmental conditions and standards of quality maintained by the school.

Standards for accreditation apply to five-year programs of study — two years of preprofessional education and at least three years of professional education. A postbaccalaureate degree may be awarded under such conditions. While accreditation would not apply to a four-year curriculum, presumably a student could "bail out" of an accredited five-year program with a Bachelor's Degree at the end of four years of study. Further, a professional program offered entirely at the postbaccalaureate level is encouraged.

The Academic Environment

The Board considers that certain environmental conditions are necessary for the effectiveness of a professional accounting program. The objective of the program should be the graduation of entry-level professional accountants. The program and its academic environment should include appropriate teaching methods whereby the student will acquire the body of knowledge needed in accounting careers, as well as the ability to use such knowledge in the learning process.

Professional accounting programs require a separate identity. According to the Board, identity is a motivating factor for successful completion of the educational process. Identity allows visibility both within and outside the academic setting. It fosters a feeling of esprit de corps among students.

Autonomy also is believed to be a significant factor in the success of the professional accounting program. Administrators of the program should have authority and responsibility for formulating and administering the program including:

> faculty selection, retention, compensation, promotion, and tenure; the development of policies governing curriculum; the selection of methods of instruction: the establishment of academic

standards for admission, retention, advancement, and graduation of students; and all budget matters.[3]

Standards for Professional Accounting Education

To achieve accreditation, certain standards must be met by the accounting school or program (not the university or the school of business):

General Standards[4]

The objective of the school (program) shall be the education of professional accountants.

The school's (program's) parent institution must be accredited by the appropriate regional accrediting organization.

The accounting school (program) should have been established and in operation for such period of time as to make possible an effective evaluation.

Admission and Retention Standards[5]

Students selected for admission should show a high probability of success in the study of accounting.

Students are expected to enter the accounting program following completion of at least two years of preprofessional education. Students are expected to have acceptable grade point averages on prior study and acceptable scores on an Admission Test (presently being developed).

Students should be permitted to continue in the school (program) only by maintaining a satisfactory academic grade level as determined by the accounting faculty.

Curriculum Standards[6]

The curriculum shall provide broad education to prepare students for professional accountancy practice and to develop those qualities which will enable them to achieve success in their professional careers.

The curriculum should include a study of business and government activities relating to accounting. Continuous reexamination of curriculum content should be undertaken, and courses of study within the program should be well correlated.

As a minimum, the curriculum shall consist of at least two years of pre-accountancy preparation and not less than three years of progressively more advanced professional level study.

The preprofessional program should provide for a broad general education including an understanding and knowledge of topics relevant to accounting such as economics, the behavioral sciences, logic, ethics, mathematics, statistics and probability theory, and both written and oral communication.

Such study should provide the student with the *foundation* necessary for the study and practice of accountancy.

The professional course sequence should provide an understanding of the "discipline of accounting" and of the "environment of accounting." Courses in the discipline of accounting cover organization of the profession, ethics and responsibilities, accounting (financial, managerial, governmental), taxation, electronic and nonelectronic recording systems, and auditing. Courses in the environment of accounting cover the institutions and functions of business and public administration, quantitative methods in decision-making, economic analysis, and business law.

The advanced courses in the final year of professional study should cover the concepts and skills required in the several areas of practice: auditing; public, managerial, or governmental accounting; tax advising; and management advisory services, including data processing and the systems area. The advanced professional study should give consideration to the impact of regulatory agencies and professional bodies on current and emerging accounting issues. This broad coverage permits only limited specialization within the five-year program; additional study would be required to achieve substantial specialization.

The content of the individual courses should be designed so that students will be exposed to appropriate technical literature and use of a computer.

Faculty Standards[7]

The academic faculty shall possess the educational qualifications, professional practice experience, professional interests, classroom teaching ability, and scholarly productivity essential for the successful conduct of a professional accounting school or program.

Faculty qualifications considered necessary by the Board, in addition to appropriate education and practice experience, include certification (such as the CPA certificate), involvement in curricular development, research, writing, and publication, continuing professional practice, and continuing education.

In establishing and applying criteria for evaluating faculty performance, teaching should be of primary importance. Faculty involvement in research, significant non-classroom activity in maintaining contact with the practice of the profession, and service to the community are also essential. In evaluating research, equal value should be given to theoretical, applied, and education-oriented studies.

The number of full-time academic faculty shall be adequate to meet the commitments of the school or program, and the full-time faculty shall be distributed among ranks, subject areas, day and evening classes, and locations. In assigning the academic loads of individual faculty, consideration should be given to the total responsibilities borne by each member of the faculty.

In the comments section to this standard the Board states:

At least 50 percent of the required full-time-equivalent faculty should hold an appropriate earned doctorate. At least 60 percent of the required full-time-equivalent faculty teaching accounting subjects should have the CPA certificate. As a further measure of the faculty's professional capability, 60 percent of the full-time faculty teaching accounting subjects should have the CPA certificate.

Not less than 60 percent of the full-time faculty should have relevant professional accounting practice experience to bring to the classroom.

There should be an adequate number of support and service personnel to assist the faculty in meeting the stated objectives of the professional accounting school (program).

Financial Support and Budget Standards[8]

The administration of a school (program) of professional accounting should be able to demonstrate that the continuity of the education program is assured.

The budgetary support for the accounting school (program) should be adequate to meet the standards covered in this document.

Physical Plant and Equipment Standards[9]

The physical plant and equipment should be adequate to meet the requirements stated in the school's (program's) objectives.

Library and Computer Standards[10]

The accounting library, whether established separately or as a section of a combined library, should be well-housed, conveniently located, and open at reasonable hours for students and faculty use. The collection of accounting materials should be adequate to meet the curriculum and research needs of students and faculty.

The library should be administered by a professionally qualified staff and should have an adequate budget for appropriate current accessions.

The computer center or access terminals should be well-housed, conveniently located, and available for student and faculty use on a scheduled basis which provides opportunity to use the computer's capability in both class assignments and research.

Standards of Performance for Graduates

The following standards[11] are not included within those specified to achieve accreditation. Nevertheless, these standards would be used in evaluating the total effectiveness of the program.

Graduates of the professional accounting school (program) should possess the professional attributes and knowledge of a beginning professional accountant.

Graduates should be capable of passing the qualifying entrance examination for the profession.

Graduates of the professional accounting school (program) should be capable of working effectively as beginning professional accountants and should have the capacity for growth to positions of increased responsibility in the accounting profession.

Evaluation of Standards

Accreditation of an accounting program would indicate that the program met at least minimum standards deemed necessary to graduate an entry-level professional accountant. Many accounting faculty will desire such accreditation of their programs if the major universities in the nation set the example. However, certain problems exist and should be considered prior to final adoption of standards and of an accreditation process.

Major universities and others of excellence may not choose to set the example. They may not feel that accreditation is needed or desirable. Or, they may not be able to comply with certain standards such as those requiring autonomy. If the accounting faculty of universities of excellence do not accept the challenge, the accreditation process may fail.

Deans (School of Business) and other university administrators may not feel that accounting education justifies the resources necessary for accreditation. Notice that not only must 50 percent of the required full-time equivalent faculty hold an earned doctorate, but also 60 percent of the full-time faculty must have the CPA certificate and must have relevant professional accounting practice experience. (The CMA is not mentioned in the Discussion Draft, but it may appear after the exposure period.) With the existing shortage of professors with the earned doctorate, the added qualifications of experience and certification probably will result in rising faculty salaries for those with such qualifications. Coupled with rising salaries is the possible need for additional faculty due to an increased number of classes (5 years of study) and a limitation on students taught by faculty (not less than one full-time equivalent academic staff for each 350 student credit hours per term). Other drains on total university funds may result from the need for adequate support personnel, adequate physical plant and equipment, and adequate library and computer facilities. In other words, university administrators and possibly state legislators must recognize a need for the proposed change in accounting education or the funds may not be available.

Others who must recognize a need for the proposed change in accounting education are employers and students. Employers must be willing to support a five-year program of study by a differentiation in employment offers to those graduating from a five-year program as opposed to those graduating from a four-year program. Students must be willing to invest an additional year in academic study, and to do so they must understand the merits of proposed changes. Professional accounting organizations must be willing to help educate their members.

The position of the American Assembly of Collegiate Schools of Business (AACSB) on separate accounting accreditation is not clear. However, certain officers have expressed an interest in cooperating with an accreditation committee. Also, the Board of Directors of the National Association of Accountants (NAA) has expressed a willingness to help finance an accreditation program. Organizations other than the AICPA and NAA have not taken official positions, but several are responding to the Discussion Draft.

The question arises of future eligibility to sit for the CPA examination. Graduates of accredited programs would be eligible to sit for the exam immediately. What about graduates of four year programs? Would State Boards of Accountancy continue to control requirements for sitting for the exam for such graduates? Or, in the future would only those graduating from an accredited program be eligible to sit for the CPA examination? (And what changes may be made for sitting for the CMA examination?)

On the positive side, graduates of accounting programs (schools) are expected to be better prepared for accounting careers due to additional exposure to both technical aspects of accounting and practical applications. The student is expected to study current pronouncements of all authoritative bodies, to learn how to research a problem, to explore current topics, and to develop an inquisitive mind and a professional attitude. Future graduates are expected to perform well on entry-level examinations, such as the CPA exam. There is no reason why the future pass-rate on such examinations should be relatively low compared to examinations in comparable professions.

Quite possibly the demand on financial and faculty resources may result in relatively few accounting programs across the nation achieving accreditation. Accredited schools soon may exist in a few selected areas in each state, producing the majority of accounting graduates. Such a trend could result in economies of operation and continuous improvements in curricula and teaching methods. Smaller schools without adequate resources to operate accounting programs may become feeder schools. They may offer only basic accounting courses, or they may limit their educational services to students electing four years of study for less challenging careers in accounting.

The writer believes the AICPA intends to pursue its present course of action in implementing an accreditation process. The extent to which universities, employers, students, and professional organizations support such a movement will determine its success. The concept has been "talked" for a relatively long period. Today is the time for action.

Notes

[1]*Discussion Draft: Board on Standards for Programs and Schools of Professional Accounting* (New York: American Institute of Certified Public Accountants, 1976).

[2]*Ibid.*, p. 1.
[3]*Ibid.*, p. 4.
[4]*Ibid.*, pp. 4-5.
[5]*Ibid.*, pp. 5-6.
[6]*Ibid.*, pp. 6-9.
[7]*Ibid.*, pp. 9-11.
[8]*Ibid.*, pp. 11-12.
[9]*Ibid.*, p. 12.
[10]*Ibid.*, pp. 12-13.
[11]*Ibid.*, p. 13.

Financial Statements

Other Information — The Auditor's Lost Weekend

Dr. Clara C. Lelievre, CPA
University of Cincinnati
Cincinnati, Ohio

On her way home from the office on Friday, June 25th, Bea picked up the printer's proof of the Tardy Company's Annual Report. Shortly before 5 P.M., one of her partners had requested that she review the report over the weekend to fulfill the auditor's responsibility under Statement on Auditing Standards (SAS) No. 8. (The Tardy Co.'s stockholders' meeting was set for July 15, thus the report must be mailed during the week of June 30.) Another partner, other than the partner-in-charge of the engagement, had already reviewed the financial statements. However, he was on vacation and would not return until July 6 so he could not review the annual report for compliance with SAS No. 8. The nearness of the meeting dictated the weekend review.

Before leaving the office Bea made a Xerox copy of the client information card for the Tardy Co. Her firm had performed audits for the fiscal years ending April 30, 1976 and 1975. Previous audits had been performed by another reputable firm. The Tardy Co. ranks among the top 100 in the Fortune 500. Bea's firm also aids the client in the preparation of the 10K form.

At 8 P.M. on Friday Bea took SAS No. 8, "Other Information in Documents Containing Audited Financial Statements" from her briefcase. Its four pages with only approximately 600 words in the actual text looked innocent enough. She felt that it would probably not take a great deal of time to verify the report's compliance. But first, she thought, "When will the Statement become effective or has it already taken effect? Since SAS No. 8 is dated December, 1975, maybe it has not become applicable yet." SAS's often have a 6 to 12 month lead time before they become effective. Bea searched for the effective date. Alas, no effective date is given, so she must assume that it is effective for all reports issued after 1975 and would thus apply to that of the Tardy Co.

Another thought, "Maybe it still does not apply to the Tardy Co." Another bit of wishful thinking! Paragraph 1 of the Statement provides guidelines for the auditor's consideration of published documents, "that contain information in addition to audited financial statements and the independent auditor's report thereon." Paragraph 2 further declares that the Statement is applicable to *other information* contained in "annual reports to holders of securities."

Having established its applicability and effectiveness, Bea rereads the Statement to determine the extent of the auditor's responsibility imposed by it. Paragraph 4 provides the answer. It explains that "other information in a document may be relevant to an independent auditor's examination or to the continuing propriety of his (sic) report." Bea muttered that the auditor's examination had already been completed and wondered why this review had not been made before the report went to the printer. She read further, "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his (sic) report, and that the auditor has no obligation to corroborate other information contained in the document." However, the auditor should read the *other* information and consider whether such information, or the manner of its presentation, *is materially inconsistent* with information, or its manner of presentation, appearing in the financial statements." (Underscoring added by Bea.) Bea read on, "If the auditor concludes that there is material inconsistency, he should determine whether the financial statements, his report, or both require revision." She found another gem in paragraph 5, ". . . if while reading the other information . . . the auditor becomes aware of information that he believes is a material misstatement of fact. . ." Bea decided that in reading the report she would search for information that was *inconsistent* with that contained in the financial statements, or data that appeared to be a *material misstatement* of fact.

Bea's hoped-for free evening rapidly vanished. Not only must she consider the "other information" and its manner of presentation, but she must also pass judgment on the materiality of the inconsistencies. On the problem of materiality Bea was as confused as are the majority of her colleagues. (Why can't FASB speed up its project on materiality? The discussion memorandum merely served to point out the magnitude of the problem.)

Having assured herself of an atmosphere conducive to concentration by loading her stereo with tapes of soft music and turning the ringer off on her telephone, Bea spread the report proofs on her desk, determined to complete the review that night. A quick glance revealed that the report covered sixty pages. However, the financial statements, notes, and auditors' report took 20 of these pages, so she would only have 40 pages of *other information* to review. She set as her first ground rule that as an auditor she should probably consider as relevant (1) all of the other information that was expressed in quantitative terms and, (2) all direct or indirect references to the financial statements. Since the financial statements had previously been reviewed by one of her partners, she would examine them only as they related to the *other information* included in the annual report. However, as a competent auditor she knew that she must satisfy herself on any question that might arise from her review of the data. Since the average statement user would read the report without the benefit of any prior knowledge of other available data, Bea decided that she would read it without reference to the auditor's working papers. With these basic "rules" established, she turned to page one.

Revenues and Earnings By Quarters

Bea made quick work of page one since it was the table of contents. Turning to page 2 she found the heading, "Revenues and Earnings by Quarters." Since SAS No. 10 required that this information be included in a footnote to the Statement of Earnings, Bea immediately attempted to verify it through a footnote. However, there was no footnote that related to revenues or earnings by quarters. A reading of SAS No. 10 revealed that it became effective for interim annual periods beginning after December 25, 1975. However, must the information be included in the annual financial statements for periods that began before that date if only *one* of the four interim periods began after that date? Apparently the partner-in-charge of the engagement and the independent reviewer decided that the current statements did not have to include interim information, but Bea started a list with the heading, "Items to be discussed with partners," and entered as Item No. 1: Check the Applicability of SAS No. 10 when fiscal year begins before December 25, 1975.

Since the page of interim data was clearly other information, Bea started reading it. Cumulative totals for the eight quarters should tally with amounts shown in the annual financial statements for 1975 and 1976. Bea compared the figures for Sales, Revenues, Net Earnings, and Earnings Per Share to the Statement of Earnings and found the data to be consistent both in amount and method of reporting. She turned to the footnotes and realized that she must decide what the Committee meant by the word read. The Statement speaks of conclusions that the auditor may draw as a result of the reading. In order to draw conclusions, one must have a degree of understanding, and the perusal must be made with the *intention of understanding the information*.

As Bea read the three footnotes to the interim statements another problem came into focus. Should the "other information" conform to Generally Accepted Accounting Principles (GAAP)? Footnote 2 reported the sale of assets (marine vessels) that were previously leased to an unaffiliated company. Accounting Principlies Board Opinion (APB) No. 30 requires that a discontinued segment that represents a major line of business or the loss of a customer be reported separately. The footnote reported that this sale was included in the third quarter's operating results. Forty-eight percent of the profits for the quarter came from this sale, and 12% of the annual profits were a result of this sale. Were these amounts material enough to warrant separate reporting? The old nemesis of materiality strikes again! Since neither the interim statements nor the annual statement included an item about discontinued operations, Bea added Item 2 to her list: Check to determine if the chartered vessels qualify as a major line of business.

Stockholder's Letter

Pages 3 and 4 of the report consisted of a ten paragraph stockholders' letter. Eight of the ten paragraphs reported quantitative information, or referred to the operating results of the four major operating divisions of the company. The two non-quantitative paragraphs referred to unresolved contractual issues between the company and the U. S. Navy; the issues were being appealed to the Armed Forces Board of Contract Appeals. These issues being legal problems, Bea decided that the auditor's responsibility was fulfilled by the footnote to the financial statement, which outlined the measurement and realization problems arising from them.

Quantitative amounts corresponding to items in the financial statements were traced to those statements. However, they comprised only a minor part of the "other information" in the eight paragraphs. Since the majority of the information related to the operating results of the various divisions and the next section was the Operations Review, Bea transferred her attention to that section, but 'noted' that her "reading" of the stockholders' letter was deferred and not complete.

A quick glance at the "Operations Review" section revealed that it was twenty pages long, or a third of the total annual report. At that discovery, Bea decided to wait until the following day to examine it. However, her dreams that night were not peaceful — a myriad of confusing images vaguely relating to APBs, SASs, and FASBs. In her sleep she was searching for guidelines for the proper treatment of the growing spectre of "other information" that was lurking in the background.

Operations Review

By noon on Saturday Bea had resigned herself to the task of reading the "Operations Review" section. She was haunted by the terms "material misstatement" and "material inconsistency." Some inconsistencies can be easily dealt with since they can be discovered by a direct tracing to the financial statements. But material misstatement is another matter. For instance, Bea added the sales for the four major divisions and traced the total to the total in the income statement, but how could she be sure that the breakdowns by divisions are not distorted to the extent that there is a misstatement of fact? She remembered reading a recent Wall Street Journal article where a company had done just that to conceal the fact that one of the divisions was operating at a substantial loss.

The recap of sales by the four major divisions tallied to within .6 of one percent of the sales shown on the Statement of Earnings. The difference was accounted for by interdivisional sales. However, a recap of the earnings exceeded those reported on the Statement of Earnings by 450%. Hoping that this difference would be explained later in the review, Bea began another list entitled, "items to be cleared later" and entered as No. 1: Inconsistencies between combined divisional incomes and that reported on the earnings statement.

The next several hours were spent searching the cohesive ideas in the extensive divisional reviews. Bea finally organized the material in several basic categories: amounts and reasons for changes in sales and profit margins; product changes — additions and withdrawals; operational changes; changes in marketing strategies; reports on litigations; R and D leading to new technologies; and settlements of labor disputes. Extensive quantitative data was reported throughout the section, some of an unverifiable nature. How would one verify the statement, "The project is the largest venture of its type ever launched in the United States?" Bea decided that it would be impossible to conclude anything about this section; she had no basis for concluding whether the data was or was not inconsistent or incorrect. She started yet another list labeled, "inadequate information for a conclusion", and entered as Item No. 1: Operations Review section.

Product Group Results — Continuing Operations

Bea skipped several pages in order to read the product group results next. It seemed to logically follow "operations review." She made a mental note to suggest its repositioning for a more logical information flow. Many of the amounts shown for fiscal year 1976 could be compared with her recap of major totals taken from the operations review section. The accuracy of the percentages of changes and totals was verified. Her previous question concerning why the total net incomes from the four major divisions exceeded the net for the year was answered by the deduction for interest and other unallocated expenses. She found no problems with the 1976 fiscal year results.

But the product group results covered a five-year period. Is the auditor responsible for the "other information" for the previous years? Bea acknowledged her firm's responsibility for the fiscal year 1975 since she should be able to verify the amounts from the working papers for 1975. However, what should her position be on the years prior to her firm's acceptance of the engagement? Should she ask the client to delete those years from the annual report? Or, should she ask the previous auditors to examine the data for the years of their audit? Does the firm have the permission of the previous auditors to use this information in the current 10K? If so, then this data should be compared with that in the 10K. Bea added another item to those to be cleared with her partners: Do we have prior auditors' assurances about the information included for the 1972, 73, and 74 fiscal years?

Product Market — Area Review

The two pages labeled "Product Market-Area Review" offered some fascinating "other information," none of which could be traced to the current financial statements. Each of the four major operating divisions was divided into major product groups, and the product groups then divided into product types. For instance, the Business System and Equipment division was divided into product groups of: Business machines and retail information systems; Typewriters and office copiers; Specialty paper, printing and forms; and Office products, furniture and fixtures. Each of these product groups was then divided into product types. There were 49 product types scattered over the major divisions. Sales data was reported for the 49 product types. Other estimated data was given for the total world market for each product type, and sales were allocated to each major consumer group. *All of this estimated data "blew" Bea's mind. How can* an auditor reach any conclusions about possible inconsistencies and misstatements of estimated data. The Product Market-Area Review section was added to the "inadequate information" worksheet.

With the hour growing late, Bea gave up for the evening. That night she dreamed of an accounting fantasyland, completely void of SASs, FASBs, APBs and SEC regulations.

Five-Year Summary of Operations

Sunday P.M. found Bea again at her desk determined to complete the "reading" of the Tardy Co.'s annual report. She began with the Five-Year Summary of Operations. Again, she had no problems with the current year and the 1975 fiscal years, but again she was forced to decide what to do about the data that was included for the three years that were audited by the other auditors. She decided to search for this data in the 10Ks.

The summary also contained information relative to Stockholder's Investment, Capital Expenditures, Common Stock Dividends, and Number of Employees. Bea compared the capital expenditures with those shown on the Statement of Changes in Financial Position. The latter statements reported capital expenditures of 91 million for F. Y. 1976, while the Five-Year Summary reported 104 million. The difference of 13 million or 14% appeared to be material and called for further information. There was an 18% difference in the amounts on the two statements for F. Y. 1975. Bea would again have to rely on the previous auditors for confirmation of the prior years amounts. She had no way to verify the information given about the number of employees.

Management's Discussion and Analysis of the Summary of Operations

Bea could satisfy herself on very little of the information included in management's analysis of operations. A few statements such as "interest expense increased by 45%" could be verified, but the majority of the discussion was devoted to various operational changes and other events of the period. This section was added to the "inadequate information" worksheet.

Financial Statements

Bea did not make an independent review of the financial statements and the auditor's report. However, she did make a notation to discuss the feasibility of printing the statements and the auditor's report on tinted paper so that users could easily distinguish the two from the remainder of the annual report. She also made a note to ask the partner-in-charge of the engagement if there was a special reason for placing the auditor's report at the beginning of the financial statements rather than its usual positioning at the end. Did the fact that it was a qualified opinion influence this decision? (The report was qualified due to the uncertainity of outstanding litigation on cost-plus contracts.)

Other Information about the Company

This section began with the corporate file which closely followed the information contained in the master file of clients. Bea had no way to determine if there were inconsistencies or misstatements in the data describing the worldwide sales and marketing organization and the business backlogs. The description of capital expenditures was again inconsistent with that shown in the Statement of Changes in Financial Position. Bea was further frustrated by her inability to reach a conclusion on the data shown for: patents and trademarks, employment figures by major divisions and by geographic areas, square footage of plant facilities, and research and development expenditures.

The last page of this section contained quantitative data related to outstanding securities. The high and low selling prices of each class of security was given for the last two fiscal years. This data could be checked from security guides in the office. The last pages of the annual report were devoted to a listing of the products (by their trade names) produced by each of the major operating divisions, a list of the Board of Directors with their business affiliations, and a list of the Company Officers.

Having read the complete report, Bea took another look at the Stockholders' Letter. She did not feel any more comfortable now with the material that it contained then she had when she first read it two nights ago. She decided to add another entry to the growing list of items where additional information was needed. The list was now frightening. What course should her firm follow as to the compliance of the Tardy Co.'s annual report with SAS No. 8? How long would it take to just clear up the list of inconsistencies?

Bea's Recommendation

Suddenly a solution to the dilemma emerged! Why not recommend that the financial statements and the auditor's report be bound separately from the "other information"? If the auditor's report, together with the financial statements covered by the report were issued as a separate document, then no responsibility for the "other information" would accrue to the auditor. With that "gleam of inspiration" Bea folded the proofs, placed them in her briefcase, and went to bed. That night her dreams were filled with visions of two separate documents where the auditor was responsible only for his/her report and the financial statements covered by that report.

* * *

Note: Only the auditor in this account is fictional. An actual annual report was used to analyze what might happen when an attempt is made to satisfy the requirements of SAS No. 8. This editor does not imply that the problems met by Bea are typical. The particular report was chosen because of its presence in the files of the editor. A "reading" of the report to satisfy the requirements of SAS No. 8 reinforces this writer's opinion that the short Statement may indeed prove to open a Pandora's box.

Conceptual Framework
(Continued from p. 8)

holding gains and losses may be influenced by changes in the general price level as well as changes in specific price levels in which case the impact of each should be separately disclosed. Disclosure should also be made of the fact that this information differs from that which has been subjected to the transactions test. Prospective data, such as changes in market values, can be accommodated by the components approach outlined above irrespective of whether an income statement or balance sheet is prepared. If users require information that reveals variations in market values, disclosure of it in financial statements may result in meeting the conditions of the user approach. Disclosure of this type of information, which probably should be considered nonaccounting data at the present time, in combination with accounting data may well help to resolve alleged conflicts between the two viewpoints discussed above.

Concluding Observations

In conclusion, it appears that in the absence of an agreed upon definition of accounting, the debate over a conceptual framework will continue, and little progress will be made to resolve this important issue. It may well be that the debate over the two viewpoints superimposed in financial accounting — that is, the *user approach* and the *accountability approach* — will continue indefinitely unless accountants realize that data yielded by the accounting process alone are insufficient for reconciling the differences suggested by the two approaches. What may be needed is acceptance of the possibility that no matter how the field of financial accounting may ultimately be defined, the need for disclosing nonaccounting data will still exist in order to satisfy the diverse information needs of users of financial statements. Indeed, even the present accounting "model" needs to be extended and improved to satisfy the conditions of the accountability approach. Consider, for example, the present ban against recording executory contracts. It is doubtful whether the information needs of all users can ever be satisfied without disclosing *both* accounting data and relevant nonaccounting data in financial statements.

Notes

[1]A comparison of the Study Group's conceptual framework with contemporary financial accounting is contained in Joe J. Cramer, Jr., "An Eclectic Approach to Financial Reporting," *Business Horizons* (August, 1975), pp. 65-76.

[2]Yuji Ijiri, *Studies in Accounting Research, No. 10,* "Theory of Accounting Measurement," American Accounting Association, 1975, pp. ix-x and 32-33.

[3]Cramer, p. 72.

Theory & Practice

Questionable Corporate Payments

Are Independent Auditors To Become Super Sleuths?

Marilyn J. Nemec, CPA
Partner, Alexander Grant & Company
Chicago, Illinois

Stories in the news media about questionable payments by U. S. corporations to officials of foreign governments began appearing in early 1975. These followed revelations in prior years about use of corporate funds for illegal domestic political contributions. While the Securities and Exchange Commission was not involved in the investigation of these political contributions, which were discovered during the Watergate hearings, it did issue a statement expressing the view of the Division of Corporation Finance that disclosure of legal action against a registrant or its officials must be disclosed in filings with the SEC since such information was of possible significance to investors. The later questionable foreign payments were the subject of SEC investigations followed by injunctive action in many cases.

While the SEC contended that it had not expanded its view of what constitutes material information that must be disclosed, registrants and others felt it had, since by any previous SEC standard the amounts involved, in many cases, were immaterial to the registrant's net earnings. But the individual commissioners in various speeches and interviews stated that the SEC believed these cases were significant to investors primarily because they raised questions of the quality of management, the quality of earnings, and the integrity of financial accounts and reporting. Also, stockholders have a right to know that the company in which they have invested finds it necessary to make payoffs in a foreign country and what the risk of stopping the payoffs might be.

The Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices submitted to the Senate Banking, Housing and Urban Affairs Committee on May 12, 1976 included the following comments:

Regarding corporate management and inaccurate books and records

"Millions of dollars of funds have been inaccurately reported in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.

"The accumulation of funds outside the normal channels of financial accountability, placed at the discretion of one or a very small number of corporate executives not required to account for expenditures from the fund; the use of non-functional subsidiaries and secret bank accounts; and the laundering of funds or other methods of disguising their source of disbursement quite often has been observed."

Regarding effect upon corporate business and earnings

"The fact that a company has engaged in a pattern of payments over an extended period of time suggests that the company's product or service could not be successfully marketed in the absence of the payments involved, and that failure to continue to make such payments could endanger the business operations. If other companies in the same line of business are not making, or would not make, such payments, a question arises regarding the salability of the company's product or service.

"Where such a pattern of conduct exists with respect to a significant line of business, or conversely, if termination of the payments might be expected to change significantly the economic success of a significant line of business, disclosure is appropriate."

Regarding the independent auditor

"The independent accountants' responsibility is to certify that the financial statements of a corporation are fairly presented in accordance with generally accepted accounting principles. Accountants are not free to close their eyes to facts that come to their attention, and in order to properly satisfy their obligations, they must be reasonably sure that corporate books and records are free from defects that might compromise the validity of these statements.

"The Auditing Standards Executive Committee of the American Institute of Certified Public Accountants prepared an exposure draft of a proposed Statement on Auditing Standards regarding 'Illegal Acts by Clients.' The draft statement discusses how accountants may become aware of illegal conduct and the inquiries that should be made if such conduct is suspected.

"Moreover, the programs outlined above demonstrate that the initiative and professional competence in the accounting profession are a significant resource in our continuing program relating to questionable or illegal foreign and domestic payments."

The Internal Revenue Service has also become involved. The IRS Commissioner announced that the Internal Revenue Code and related regulations prohibit allowance of any deduction for moneys paid to a foreign official if a similar payment would have been unlawful under U.S. federal statutes. The IRS's concern was not with protection of the investor, but with how many tax dollars were not being collected. To obtain the information about questionable payments, either foreign or domestic, the IRS developed eleven questions. Responses are to be obtained by Revenue Agents who audit the 1,200 corporations with gross assets of over $250,000,000. Answers are made under penalties of perjury. While the official announcement mentioned only the 1,200 corporations, the IRS simultaneously sent a telegram to its agents permitting them to use the questionnaire in any audit regardless of size and type, so long as the agent's group manager approved. Initially, the questions were to be asked of selected corporate officials, key employees and the managing partner of the corporation's accounting firm who determines the scope of the audit and the type of opinion to be rendered. After discussions were held between the AICPA and the IRS, the independent auditor's participation was changed from directly responding to the questions. Now, a written attestation (addressed to the IRS and made under penalties of perjury) to the responses of the corporate officials based on the auditor's best knowledge, belief and recollection is required.

The investigations of questionable payments by various governmental committees culminated in proposed legislation which was slated to be considered by the Senate in August. The bill includes provisions that bribery of foreign officials would be made a crime for U. S. corporations, making false or misleading statements to independent auditors would be prohibited and companies would be required to keep accurate books and records and maintain adequate accounting controls. Neither the SEC or the AICPA are pleased about all aspects of the legislation as proposed. The Chairman of the SEC has stated that questionable and illegal foreign corporate payments can be effectively controlled under present federal securities laws and do not require major new federal securities legislation. Amendment of Section 13(b) of the Securities Exchange Act of 1934 as proposed by the SEC (which relates to accurate books and records, adequate systems of internal control and not misleading the auditor) should be adequate. The Chairman feels that there may be no reason not to make it a crime for officials of public and private companies to use bribes to divert business or to change laws, if such legislation can avoid the confusion of payments that are questionable and foreign laws that are vague. However, the SEC should not be required to enforce such legislation as the SEC's role in such matters is one of disclosure. Furthermore, it would be difficult for the SEC to judge whether foreign payments actually represented bribes and it should not be put in the position of determining whether the law has been violated or not.

The AICPA's Technical Services Director has expressed concern that the provisions of the bill which would make it illegal for anyone to make false or misleading statements or omit to state material facts to independent auditors in connection with the examination of the financial statements of a registrant could have undesirable consequences. The bill makes "any person" liable for lying and both oral and written information fall within its provisions. An auditor must talk to many people in the course of gathering information for the examination. Bankers, attorneys, and other corporate outsiders from whom auditors seek information may not want to respond in the face of criminal penalties that could attach to mistakes. The AICPA has urged that these provisions apply only to intentional misrepresentations and that such a limitation be included in the proposed legislation.

As noted in the SEC's report to the Senate Committee, the AICPA has issued an exposure draft of a proposed Statement on Auditing Standards entitled "Illegal Acts by Clients." An exposure draft of a companion proposal entitled "The Independent Auditors' Responsibility for the Dectection of Errors or Irregularities" was issued at the same time. The comment period for each ended July 30.

The statement on Illegal Acts provides guidance when acts that appear to be illegal come to the attention of the auditor during an examination of financial statements. Although an examination in accordance with generally accepted auditing standards does not ordinarily include procedures specifically designed to detect illegal acts and cannot be expected to provide assurance that illegal acts will be detected, particularly those removed from the events and transactions ordinarily reflected in financial statements with respect to which the auditors' training and experience cannot be expected to make them aware of the act or to recognize its possible illegality. If the auditor believes that illegal acts may have occurred, additional procedures should be performed to obtain an understanding of the nature of the acts and their possible effects on the financial statements. The proposed statement distinguishes between possible illegal acts which have a direct monetary effect on the financial statements, an understanding of which is within the expertise of the auditor (such as tax laws), and those which are outside the professional competence of the auditor (such as anti-trust and environmental protection laws). Upon becoming aware of a possible illegal act, the auditor should consider the circumstances promptly and consider seeking the advice of legal counsel or other specialists. The impact of the possible illegal act on the degree of reliance to be placed upon internal control and the representations of management should also be considered. If it is determined that an illegal act has occurred, the auditor should report the circumstances to a high enough level of authority in the client's organization so that action can be taken by the client with respect to adjustments, disclosures, and appropriate remedial action. In some circumstances, the only appropriate persons of a sufficiently high level of authority to take necessary action may be the Audit Committee or the Board of Directors. An auditor is under no obligation to notify outside parties of an illegal act. If the illegal act is sufficiently serious to warrant withdrawing from the engagement, however, the auditor should consult legal counsel as to further action. Also discussed are audit procedures which might identify illegal acts, evaluation of the materiality of the illegal acts, and effects on the type of opinion to be issued.

Guidance on the independent auditor's responsibility for detecting errors or irregularities when making an examination of financial statements in accordance with generally accepted auditing standards is discussed in the second proposed statement. An audit cannot be expected to provide absolute assurance that the financial statements are not materially affected by errors or irregularities. The professional responsibility of the auditor has been fulfilled by making an examination in accordance with generally accepted auditing standards, even though errors or irregularities are subsequently discovered. Errors as opposed to irregularities are defined. Errors are unintentional mistakes such as clerical inaccuracy or misinterpretation of existing facts or erroneous application of accounting principles. Irregularities are intentional distortions which might include deliberate management misrepresentations or misappropriation of assets. The independent auditor's approach, when making an examination in accordance with generally accepted auditing standards, is influenced

(Continued on p. 24)

Legal Developments

SOCIAL SECURITY: The Promises, Problems and Possibilities — Part I

Dr. Patrica C. Elliott, CPA
University of Washington
Seattle, Washington

If Diogenes were around today he would have more difficulty finding a person satisfied with the present Social Security system than he had finding the honest man (sic). Working wives are unhappy because their husbands are not routinely covered as are the wives of working husbands; poor people and liberals are unhappy because the tax is regressive in nature; the conservatives are unhappy because the benefit structure is geared more toward need than based on contributions the way private annuities are; retired people are unhappy because their pensions are not keeping pace with the cost-of-living index; employers and employees are unhappy because the rate is a whopping 5.85% on the first $15,300 of gross salary per year and both the rate and the base are scheduled to rise in the future; economists are unhappy because (unless something is done soon) the current tax rate will have to be tripled in the next 75 years to cover the widening deficit; taxpayers are unhappy because over one-half of them paid more in Social Security taxes than they did in income taxes last year; politicians are unhappy because all of their constituents are unhappy (and unhappy voters tend to vote the old rascals out and the new rascals in); and the Social Security Administration is unhappy because everybody is blaming them and they do not like the situation any better than anybody else. The most tragic fact of all is that all these people are absolutely right — the present Social Security system does do all these things to all these people.

How could a system with such a socially desirable and benevolent purpose be so positively messed up? One way to answer this question is to examine the evolution of the Social Security laws and perhaps sort through how the original goals changed because of changing social and political mores. There may or may not be a way to appease everyone but it might be useful to examine some suggested alternatives.

The Promises

The Social Security Act of 1935 was signed into law by President Roosevelt amidst many misgivings by the population of Depression-era America. The Depression had clearly shown that some type of financial security was desperately needed by older people, yet the majority of the population was afraid that such a system would undermine the Puritan-ethic based ideas of thrift and hard work. The original law was not intended to provide an adequate pension for comfortable living in the worker's old age; it was intended to be a supplement to personal savings and a bare minimum or "floor of protection" for retirees.

Prior to this law it was assumed that the worker would work until death or be supported by family members and savings in cases of illness or disability. The assumption was not too unreasonable for several reasons. First, the population was predominantly rural, where three generations in a family dwelling was not uncommon. In a rural setting, workers were still valuable even if the tasks assumed in old age were different from those performed during one's youth. It simply took all hands to keep a family farm operating. Even in the cities it was more usual for older people to live with grown children than to maintain a separate household[1] and to continue working into their old age.

The life expectancy for all Americans was substantially shorter than it is now. The life expectancy for a man in 1910 was 46.3 years; by 1970 it had risen to 67.1. A female's life expectancy rose during that period from 48.3 years to 74.6 years.[2]

After the passage of the Social Security Act of 1935 (but before any payments to retirees were made), two major changes in emphasis occurred: first, the funding of benefits was put on a pay-as-you-go basis. It was quickly recognized that no meaningful benefits could be paid for several years if benefits were to be based on the retiree's contributions. The second shift was to emphasize the social and financial need of the recipients and the benefits were heavily weighted in favor of low income workers and workers with dependent wives. Thus, before the first payments were made in 1940, the function of Social Security had been split into two (sometimes incompatible) functions: The welfare function and the insurance (annuity) function.

With World War II industrialization and urbanization flowered along with the breaking up of extended families. With the movement of women into the labor force during the war and the subsequent postwar baby boom, it became more attractive to retire older workers in order to make room for younger ones.

Dr. Alicia Munnell, an economist recognized as an expert on Social Security, maintains that Social Security has historically had a dual impact on retirement and savings.[3] First, an employee was less reluctant to require an employee who had a pension (Social Security) to retire than one who did not. Since Social Secuirty coverage is mandatory (with a few exceptions), almost all employees were covered and the trend toward forced retirement at the arbitrary age of 65 (the age at which benefits were originally paid) was begun. Since people then began to expect to retire at 65 and had a longer life expectancy, they began to save more to supplement their modest Social Security benefits. This was in contrast to the opposite impact of having less to save because of the Social Security tax one had to pay. The dual effects tended to negate each other with the tendency being toward more total savings.

Since 1945 the system has been radically expanded. Because increasing the benefits and coverage was a politically "good" thing to do, the coverage and benefits were raised astronomically. The maximum benefits for a retiree and dependent spouse have risen from about $150 per month in 1955 to almost $600 per month in 1976.[4] Benefits for survivors, disability and hospital insurance were added to the original pension. Any time benefits were raised, they were extended to cover not only current retirees but present workers when they did retire in the future. As the benefits expanded, the maximum taxes to support the expenditures have risen from about $200 per year in 1955 to $1,800 per year in 1976. (Half is withheld from the employee and half is paid by the employer.)[5]

With Congress constantly raising benefits (a politically expedient thing to do) and tying benefits to the inflation rate, they are spending nonexistent funds and are promising workers huge benefits for which funding has not yet been arranged.

The Problems

With the rapidly rising benefits workers have begun to view Social Security not as a "floor" to be supplemented by private savings, but as their total retirement savings. As rates of taxation rise, workers expect their future benefits to rise when in actuality the increased taxes are going to pay off present retirees' increased benefits. Still, people cling to the idea that their taxes are funding their future benefits. Some[6] feel the Social Security Administration encourages this belief by talking about the "huge reserves" (which will, in fact, be totally exhausted by 1980) in such a way as to make the public believe that their pensions are, in fact, funded. John A. Brittain, a Brookings Institute economist, does not worry about the "bankruptcy" of the system because Social Security is "backed by the most solid source of funds known, the federal taxing power. The bankruptcy charge is a senseless generator of fear."[7]

If the bankruptcy scare is senseless, certain other facts are not. All predicted taxes are based on population estimates which have been radically altered by the falling birth rate. While life expectancies have risen very little in 20 years, the birth rate has declined dramatically. A major population shift is occurring: One in seven Americans is now receiving Social Security and by 2005 there may be only two workers to support each pensioner.[8]

Since benefits are tied to inflation, the expenditures in the past few years of double-digit inflation have exceeded all projections. Furthermore, there is a built-in double inflation raise. No one objects too much to raising retirees' benefits, but under the 1972 formula (which tied benefits to inflation), an oversight occurred. Not only are retirees' pensions raised for inflation, future retirees' pensions are raised. Those who are not yet retired presumably receive inflation-keyed raises which automatically give them higher scheduled benefits by putting them in higher maximum benefit brackets. This, coupled with the additional inflation raise, gives present workers a double adjustment upwards for inflation. If rapid inflation continued over a long period, it would be possible for today's workers to receive larger pensions than their former salaries!

Another problem is that personal savings for retirement are now declining. Dr. Munnell believes there will be a serious decline in personal savings in the future.[9] If this does happen, it will mean that Social Security benefits will probably rise to fill the need which will result in higher taxes and even less personal savings. This, together with the lower worker-retiree ratio, could have drastic effects on the tax rates.

Another set of serious problems (and of particular interest to women) are centered around the concepts of "fair" and personal "rights." These problems will be covered, along with some possible solutions, in Part II in the next issue.

Notes

[1]Alicia Haydock Munnell, *The Effect of Social Security on Personal Savings,* Cambridge, Mass.: Ballinger Publishing Company, 1974, Chapter 2.

[2]*Statistical Abstract of the United States:* 1972 (93rd Edition) Washington, D. C., 1970, Table 74, p. 55.

[3]*Op. cit.,* Chapter 1.

[4]"Propping up Social Security," *Businessweek,* July 19, 1976, p. 34.

[5]*Ibid.,* p. 37.

[6]Warren Shore, *Social Security: The Fraud in Your Future.* New York: Macmillan Publishing Co., Inc., 1975.

[7]*Businessweek,* op. cit., p. 36.

[8]*Ibid.*

[9]*Op. cit.,* p. 99.

Theory & Practice
(Continued from p. 22)

by the possibility of errors or irregularities in the circumstances, the auditor's judgment concerning the integrity of management, and the relationship between internal control and the potential for errors or irregularities. In the absence of evidence to the contrary, however, the auditor's reliance on the truthfulness of a representation or the validity of a record is reasonable. The auditor cannot be expected to detect unrecorded transactions in the absence of finding evidence of their existence. In determining the extent to which corroboration of management representations is necessary, the auditor should be aware of and consider those circumstances that might predispose management to misstate financial statements, for example, adverse financial developments. However, the auditor is not expected to obtain more than reasonable satisfaction that management has not made material misrepresentations or overridden control procedures. There are inherent limitations on the effectiveness of internal controls which prevent the auditor from placing complete reliance on them. The auditor's examination normally includes procedures to test the existence of errors or irregularities that could have a material effect on the financial statements even in the absence of material weaknesses in the system of internal control. Additional procedures should be performed if the auditor believes errors or irregularities may exist and, depending upon the circumstances, the auditor's opinion should be qualified or disclaimed or the auditor may determine that the only course is to withdraw from the engagement.

The auditor's role in IRS investigations of questionable payments is apparently settled. Now we must wait for the proposed Congressional bill to be enacted, amended or dropped. However, it is highly improbable that legislation will not be forthcoming, even if substantially amended. The proposals of the AICPA in the two exposure drafts need, also, to be finalized and may be changed before issuance as Statements of Auditing Standards. In the meantime, the auditor should maintain an attitude of professional skepticism in planning and conducting examinations of financial statements. Any questionable payments noted or suspected might appropriately be handled at the highest level both in the auditor's firm and in the client's organization complying with the procedures in the exposure draft on illegal acts.

Reviews

Writings in Accounting

Dr. Carole Cheatham, CPA
Mississippi State University
Mississippi State, Mississippi

INFLATION ACCOUNTING, A Guide for the Accountant and the Financial Analyst, Sidney Davidson, Clyde P. Stickney, Roman L. Weil; McGraw-Hill Book Company, New York, N. Y., 1976; 242 pages, $12.50 (cloth-cover).

Inflation Accounting is an authoritative guide which takes the reader step by step through every significant aspect of the general price-level-adjusted accounting procedure. How the adjustments are made, how pro-forma general price level adjusted financial statements are prepared, and how the adjusted statements are interpreted and analyzed are included in this book. Cases and situations using actual data portray realism which enhances the understanding of the reader. In the book the results of applying the procedure to financial statements of over 100 actual firms are provided. The effects of the restatement in firms in a variety of industries using various accounting methods and having different assets and equity structures increases the validity and understanding of the methods depicted. Such comprehension is especially useful if general price-level-adjusted financial statements of a client are being audited, and some criteria are necessary to judge the reliability of such statements.

The first six chapters of this book explain the accounting procedures for preparing general price-level-adjusted financial statements and, therefore, would be especially useful to the accountant who must deal with technical details of preparation. Chapters 7-10 seek to help those interested in financial analysis and in the interpretation of general price-level-adjusted financial statements. They also provide estimates of such statements for particular corporations as examples. Material in this section would be especially useful to auditors in checking general price-level-adjusted financial statements prepared by clients. Chapters 11-12 explain more fully the alternative methods of accounting for price changes along with the advantages and disadvantages of each. These chapters would be useful to both the accountant and the financial analyst.

This book is understandable and well-written and is probably the most comprehensive, compact reference on the subject of general price-level-adjusted accounting statements. The primary disadvantage of this subject is that current accounting thinking seems to be in the direction of current value accounting instead of inflation accounting to solve the problems addressed by this book; if this trend continues, detailed knowledge of inflation accounting will be obsolete.

Dr. Dora R. Herring, CPA
Mississippi State University

SUCCESSFUL SMALL BUSINESS MANAGEMENT, Curtis E. Tate, Jr., Leon C. Meggison, Charles R. Scott, Jr., and Lyle R. Trueblood; Business Publications, Inc., Dallas, Texas, 1975, 563 pages, $13.50 (cloth-covered).

Aspiring members of the small business community are basically aggressive, identity seeking, and achievement oriented. Since these enterpreneurs appear to accept challenges, they should perhaps be told that a 93% attrition rate exists among small businesses. The authors make every effort to detect the many problems and pitfalls which beset small business operations and then set forth tools and techniques to prevent such disasters.

The book is logical and well conceived in terms of framework and orientation. The perception of the authors is exhibited by their recognition and in-depth treatment of the small business as a multifaceted entity whose management requires integrative multidisciplinary knowledge and skills. The legal, financial, accounting, economic, and marketing ramifications are all given thorough treatment in portraying their respective roles in the scheme of successful small business management. The format introduced by the authors closely approximates a schematic for the total management concept of applied interdisciplinary achievement. Each functional area is clearly presented and closely synthesized.

The authors provide excellent treatment of the underlying theoretical constructs covered in preparation for follow-up cases designed to provide the practical application. The book is characterized by a basic tenet deemed essential to all successful "learning and doing" presentations — theory must be combined with practical application. A general consensus exists among the business populace that theory without practical application is virtually devoid of value.

Part one contains an overview of small businesses, their characteristics, and the fundamental attributes of the owner-manager. Part two constitutes an analysis of integral concepts (e.g. economic, legal, financial) which are essential considerations antecedent to any commitment in a small business. Part three contains an excellent reinforcement of the basic management functions. Special attention is devoted to the individual's decision of whether to be only an owner or an owner and manager. The authors assert that, in the dual role, the owner must evolve through adaptation and adjustment to become a generalist manager. The generalist must possess conceptual skills in order to perceive and analyze total situations. Such persons must become conversant with areas and disciplines peripheral to their own area of interest and competence. Part four contains an overview of the interrelationship between marketing and small business management. Consumer orientation and the marketing concept are related well to the fundamental ideas of product, price, place, and promotion.

Part five focuses upon the many and diverse internal considerations related to the production of the product or service to be sold by the firm. In part six the authors concentrate on the personnel aspects of small business management. Personnel is viewed as a pervasive function for both small businesses in the formative or embryonic stages as well as for established, going concerns. One of the strong points of the book is part seven — the maintenance of the firm's financial strength. Strong emphasis is accorded to ensuring the firm's financial viability, evaluating the financial structure, safeguarding assets, planning profits, and structuring a useful accounting system. Part eight deals with the two problems most distinctive and unique to small business. These are: (1) working in a small business, and (2) providing for a successor. Each separate part is succeeded by a battery of cases.

In the opinion of this reviewer this book is an excellent reference on the management of small businesses. The authors have fulfilled their stated objectives because the reader's opportunity for successfully "doing her/his own thing" has been enhanced through continuity and comprehensive topical coverage. The book is recommended to anyone interested in this area. For those unfamiliar with the subject it is easily understood and very readable. For those already familiar with the subject area it can serve as a valuable informational source.

Dr. Carroll D. Aby, Jr.
Mississippi State University

"TO STAY PUT OR PIONEER: ARE YOU CAPABLE OF BECOMING A MANAGER?," Janet Schumer, NATIONAL BUSINESS WOMAN, April 1976.

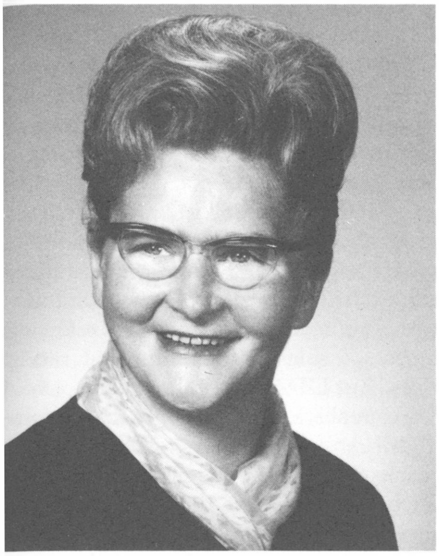
This thought-provoking article discusses a study make by Lois Ann Koff, President of Lois Ann Koff & Associates, a management consulting firm. The study provided information that 30% of the women in business are moving upward and are about evenly divided into categories of "pioneers," "climate sensitives," and "support seekers." The remaining 70% of the women are "stay-puts."

The "pioneers" show patterns of success, willingness to change employers often, and willingness to take on challenges. These are the women at the top of the management ladder. The "climate sensitives" tend to stay with the same employer and are willing to sacrifice better salaries with risky futures for lower-paying jobs with promises of advancement within the company. These women depend on the "pioneers" to pave their way. The "support seekers" accept promotions but need constant reassurance from both family and employers. They are easily discouraged, but with support do tackle positions of importance.

The reason that 70% of working women fall into the category of "stay-puts" is attributed to an emotional need. The needs vary from a desire not to conflict with strong traditional patterns of a man-woman relationship to a fear of failure.

The author concludes that the working woman should reconsider Alexander Pope's advice to "Know thyself." It would be well if all of us who are serious in our careers not only find out which type we are but consider whether we intend to stay in that category.

Helen Shepherd
Touche Ross & Co.
Los Angeles, California



Small Business

Rediscovering the Balance Sheet

Barbara I. Rausch, CPA
Marysville, Ohio

The June 7, 1976 issue of *Business Week* is must reading for every owner and manager of a small business. Even though the article, "Focus on Balance Sheet Reform," deals primarily with the problems of big corporations, the comments and conclusions apply to small businesses to the same, if not greater, degree. Lenders have always been more thorough in their review of the financial statements of closely-held entities than those of large publicly-held corporations — and all the points raised in the article will be brought to the fore by every banker in reviewing credit applications and renewal negotiations of small businesses.

The Need for Capital

Unlike publicly-held corporations which can raise needed cash by offering equity issues for sale to the public, small businesses usually have only two sources to which to look when money is needed for working capital or expansion — the owners of the company and the banker. In most cases, it will be the latter who supplies the necessary funds.

With the renewed interest in the balance sheet the owner or manager of a small business must be well prepared to answer questions that have not been asked for a while. There was a time when the income statement was considered more important — despite the fact that the effects of inflation were, in many cases, responsible for the nice increases in earnings. Most bankers still insisted on scrutinizing repayment ability, but even that consideration was tainted by the psychological effect of comparative income statements which showed progressively increasing earnings.

"Leverage" became a laudable attribute until interest rates climbed to the point where the debt became a millstone around the neck. Even though reasonable leverage is still a most desirable position for the company, it can get a lender into a lot of trouble very fast. Therefore, bankers are getting back to basics and looking very closely at ratios on the balance sheet. And they are going a few steps further into the new direction — asking questions that help bring certain balance sheet items into line with economic reality.

Some Joy — Some Grief

Adjusting the balance sheet for the effects of inflation is bound to have some pleasant results in some areas, but also to cause some real grief in other areas. Since the underlying idea is REFORM, any changes made in balance sheet accounts have to find their way into the income statement, and it will be there that most of the grief comes about.

In going over the various accounts on the balance sheet it is apparent why cash is usually listed first. It is probably the only item that will always be expressed in current-value dollars at the balance sheet date. Besides being the "anchor" of just about any transaction, it is immune to adjustments regardless of whether the current-value, replacement-value or purchasing-power approach is used.

Accounts receivable, so long as they are truly "current," are so close to being converted into cash that any adjustments for inflationary changes would probably be immaterial. However, more and more sophisticated lenders will be asking for detailed and aged lists of accounts receivable to help them decide whether this account should be accepted at face value — other than making customary allowances for bad debt losses.

Long-term notes receivable, on the other hand, will have to be discounted for the loss in purchasing power.

Marketable securities have traditionally been stated at acquisition cost, possibly with a footnote disclosure of current market value. Naturally, the purchase price may be completely unrealistic — depending on when the securities were acquired. Needless to say, if they were purchased before the last recession their restatement can cause a lot of grief, while if they were acquired at the "bottom" of the market, there will be pleasant effects on the income statement. Investments in unconsolidated subsidiaries, as well as purchases of 5% or 10% of the stock of totally unrelated companies will be considered to be a proportionate share of the equity of the other company, rather than the amount of the reporting company's original investment. Since presumably the other company is also on a "current-value" basis, the investment would thus be stated at a realistic value.

Inventories are probably first-rate candidates for adjustments, since they are stated at totally misleading figures. The first in, first out method probably comes closer to a realistic figure, but the traditionally conservative pricing at the *lower* of cost or market works to defeat the concept of current values. The last in, first out method, which has been adopted for tax saving considerations by many companies, is so far removed from replacement values that the adjustment will probably be quite sizable. Whatever method is used by the business, to translate the balance sheet into current values will require stating inventories at the amount it would cost today (the balance sheet date) to replace the items.

Plant and equipment are invariably stated at original acquisition cost less accumulated depreciation. Adjusting these figures to current values presents a whole new set of problems. It would be unrealistic and wrong under the concept current or replacement values to simply substitute the current cost of replacing machinery, equipment, and buildings for the historical cost. The emphasis should be on productive capacity, substituting the type of equipment currently available that would produce the same output. Some very surprising results could happen when manufacturing equipment is (for purposes of restating balance sheet values) replaced by more modern and technologically advanced machines that could match the production of the currently used, possibly outmoded, machinery. Naturally, accumulated depreciation as well as current changes for depreciation expense must be adjusted along with the plant and equipment account, and useful lives must be reviewed with an eye towards future technological advances rather than the physical usefulness of the asset.

Land and income-producing real estate fall into the same troublesome category as plant and equipment. Land and natural resources are unique, since they cannot be reproduced or increased. Most lenders will look at land from the standpoint of realizable value, provided there is a reasonable expectation that the land will be sold. Raw land may be valued at its ultimate realizable value less the cost of developing it for its intended purpose. Natural resources lend themselves to valuation on the basis of expected return and future cash flow. Rental properties are subject to established appraisal procedures, and most lenders will automatically substitute their own valuation estimate for whatever appears on the financial statements. Accountants have, with proper disclosure, substituted appraised values for historical costs in this area for a while. The dilemma has been the disposition of the appraisal surplus and its amortization.

The "Fuzzy" Intangibles

Undoubtedly the most controversial area is that of intangibles which occupy a permanent place on the balance sheet. Goodwill, or the excess of the total purchase price given for a going business over the values assigned to specific assets, is not eligible for amortization under the tax laws. Therefore, most small businesses keep this capitalized investment on the balance sheet forever — long after the actual value of any goodwill has passed. Despite the fact that it is not a tax-deductible expense, the value of goodwill should be written off over a realistic period of time and charged to the cost of doing business. No matter how well established the acquired business was, unless the acquiring business can earn the confidence and continued patronage of the customers of the predecessor, they will not remain customers and there will be no beneficial effect of goodwill. To a lesser degree this would apply even to a "captive" market (where the acquired company had an exclusive process, product or license) since nothing seems to be irreplaceable any more in today's world of rapid technological advances.

The Debt Structure

Moving over onto the liability side of the balance sheet, current accounts payable and accrued expenses will be viewed much like current accounts receivable — they require the use of cash within such a short period of time that any reevaluation appears unnecessary and an exercise in futility.

Long-term debt, on the other hand, is a hotly debated item. There is true leverage in a mortgage that has 40 or 50 years to run. If inflationary trends continue even at a modest pace, the last payment due in the year 2016 or 2026 may be peanuts in the cash flow statements of those years. Accountants are not ready to do anything about long-term debt, but lenders tend to ignore it except for taking annual payments into account for their evaluation of the repayment ability of the applicant. A possibility for adjusting long-term debt to current values is to discount a debt at current interest rates and show the gain or loss as if the company were to retire the debt now. However, barring very unusual circumstances, few businesses would be inclined to accelerate the repayment of a long-term debt obligation, and thus the adjustment appears futile. Nevertheless, in due time businesses, regulatory agencies and the accounting profession will have to come to grips with this problem if reform is to apply to the total balance sheet rather than just the asset side.

The use of reserves, particularly valuation reserves and deferred tax items, on the balance sheet is not wide-spread in small businesses and it may suffice to say that most reserves will probably disappear altogether under the concept of current value restatements.

The Effect on Income

That leaves the question of the disposition of these adjustments necessary to bring the balance sheet in line with economic reality. Since reserves are a taboo, all adjustments will have to be shown on the income statement — for better or worse.

What is a true measure of income — or for that matter, management performance? Disregarding for the moment the concept of replacement values, it is the best possible match of operating income with the related costs attributable to the same period. But does a FIFO inventory priced at the lower of cost or market really reflect the cost of doing business? The LIFO method produces a much more realistic cost picture, since the purchases and manufacturing expenditures reflected in cost of sales are at the most recent prices. But LIFO leaves the balance sheet with unrealistically low values that require an adjustment to replacement costs. Clearly that adjustment is a period cost which could greatly distort the cost of sales for the current year, unless the opening inventory is restated under the same criteria — an adjustment below the bottom line. Depreciation is another significant cost figure and if plant, equipment, land, natural resources and rental properties are restated on the balance sheet depreciation charges must reflect these adjustments.

There may be quite a few "below-the-bottom-line" adjustments, and there should be a distinction between current-period gains and losses resulting from restatements of balance sheet accounts and "holding" gains and losses, where the effect on the income statement is not yet realized through sale or other disposition.

An Invitation to Defraud?

The pressures that are bringing about these changes in accounting concepts and procedures come from financial analysts, investment advisors and big banks. They have long contended that they are the ultimate and only true users of financial information and that they have never been given the information they really needed to make decisions on investment recommendations and the granting of credit. They have long substituted their judgment for the historical cost figures that appeared in the financial statements.

Now management and their accountants are asked to furnish data which are largely based on assumptions. Accountants will be facing a very difficult role. The public has always been entitled to rely on the opinion expressed by CPA firms that the financial position of the company is fairly presented. Audit procedures and generally accepted accounting principles are designed to protect the public against management fraud — preventing management from "window-dressing" its financial statements. And in a number of law suits the public has left no question about the fact that it means to take the matter of reliance at face value. It remains to be seen whether the current trend towards substituted values will prove to be a haven for those who aim to make their companies look a few shades better than what the situation really is. It appears that the responsibility for the "fair presentation" of financial data will have to be shared by those who contribute input to the revamped composition of the balance sheet. It is one thing to restate inventories at current market values if all items are purchased but quite another thing when the stock is composed mostly of manufactured goods and an entirely new ballgame when it comes to substituting a completely new set of manufacturing equipment and plant for the existing facilities if such a substitution is to be measured by productive capacity rather than merely recalculating the plant investment on the basis of replacement costs.

With the new emphasis on the balance sheet, with adjustments in the income statement going both ways, and with all effects of restatements finding their final resting place in stockholders' equity, the temptation to manipulate may be greater than ever and much harder to control.

Bankers are in a much better position than financial analysts because they are closer and can ask specific questions and require detailed analyses that go beyond the financial position at a fixed date. They can find out about transactions consummated just before the balance sheet date for the sole and specific purpose of improving the company's current ratio. They make it their business to find out how fast inventories turn over and what and WHO makes up the list of current receivables. Repayment ability is still the overriding consideration for the extension of credit, even if the revamped balance sheet shows a greatly improved debt-equity ration.

What It Means to the Small Business

Businesses, as well as the accounting profession, will be forced into making some rather radical changes to accommodate the true users of the financial statements — creditors, potential lenders and investment advisors. For the owner or manager of a small business, these changes may be much less dramatic and probably some time in coming. But it will be good to realize that the banker downtown is looking at the balance sheet with a much different eye — through a pair of glasses that make automatic adjustments to current values.

Not-for-Profit Accounting

A Brief History of Hospital Accounting and Auditing

Wilma Loichinger
University of Alaska
Fairbanks, Alaska

GUEST WRITER: This column was written by Dr. Dale L. Flesher, CPA, CMA.

Dr. Flesher is Assistant Professor of Accounting at Appalachian State University in Boone, North Carolina, and the author of a new book, Operations Auditing in Hospitals.

For most industries the development of accounting procedures and auditing methodologies has been the function of the American Institute of CPAs. Hospitals, however, have not followed this trend. The development of their accounting and auditing has, instead, been influenced by the American Hospital Association (AHA), the Hospital Financial Management Association (formerly the American Association of Hospital Accountants), the Blue Cross plans, and government Medicare.

The 1922 Committee Report

The great majority of American hospitals belong to the AHA which was founded in 1898. In 1918 the AHA formed a committee to examine the problems of hospital accounting and to further the voluntary establishment of uniform accounting practices throughout the country. In 1922 that committee issued its first accounting manual.[1]

The 1922 report recommended the segregation of hospital accounts into two funds: the corporation accounts and the operating accounts. The reason for the two categories of accounts was the exclusion from normal operations of expenses which varied from one hospital to another.

The corporation accounts included land, buildings, equipment, endowment and trust funds, building funds, and investments. Also, the long-lived assets should include "an item of appreciation and depreciation, if in the judgment of the administrative board this should be considered in the corporation balance sheet." The expenses charged against the corporation accounts included interest expense, fund raising campaign expenses, and salaries of hospital officers.

The committee recommended that the operating accounts of hospitals provide for the segregation of items by hospital function. This was particularly emphasized for expense accounts. It also saw fit to remind hospital administrators that just having a good accounting system was not enough, that to be of any value the financial data had to be analyzed daily.

The committee recognized that country-wide uniformity of accounting practices would aid in measuring and comparing the efficiency of hospital managements. At that time such comparisons were impossible due to a lack in uniformity.

The 1922 report also recommended that only highly qualified individuals be hired for the accounting department because accounting was no longer a process of recording historical events. Instead, accountants had to prepare up-to-date statistics to be used in planning the day-to-day operations of the hospital. The report also suggested the preparation of monthly financial statements.

Apparently few changes in hospital accounting resulted from the 1922 recommendations, especially regarding the use of accounting information to control the daily operations of the hospital. A 1930 article by an authority in hospital accounting noted that

> there is a feeling at present among hospital administrators which is not unlike that expressed by managers of industrial enterprises 30 years ago, namely that a cost accounting system is a luxury and a nuisance, rather than a tool of control.[2]

The article also noted the difficulties inherent in comparisons among hospitals caused by different definitions. The ratio of cost per patient-day could, for instance, not be used because some hospitals included depreciation and other overhead as costs while others did not, and some hospitals counted new-born infants as patients, while others did not.

The 1933 Committee Report

The major turning point in the development of hospital accounting came with the creation in 1933 of the AHA Advisory Committee on Accounting. Its published report made four major recommendations.[3]

1. Regular preparation of balance sheets. Prior to 1933 few hospital balance sheets were prepared although hospitals owned millions of dollars worth of assets. The report recommended dividing the balance sheet into three types of funds: current, investments, and plant. Most hospitals kept adequate records of their current activities and investments, but plant assets were often ignored altogether because they were usually replaced by contributions or taxation and not from patient revenues.

2. Classification of revenues. The report recommended that revenues from patients be separated from income generated from the general community in the form of taxes or contributions. Allowances, such as charity cases and bad debts, were to be deducted from gross revenues

to arrive at net revenues.

3. Recognition of depreciation as an expense. Many hospitals did not deduct depreciation expense since the fixed assets had been initially donated and were presumed to be replaced by future contributions. Therefore the need to provide for depreciation from patient revenues was not seen. Some hospitals, however, did charge prices high enough to allow for future replacement of fixed assets and did, therefore, deduct depreciation expense. The result was no uniformity in financial statements or statistical data. The committee therefore recommended the recognition of such expenses as interest, depreciation, taxes, and rent and their classification as non-operating expenses.

4. Preparation of periodic cost analyses. Although the recognition of depreciation expense is the most important of the committee's recommendations for external reporting purposes, the preparation of periodic cost analyses proved to be of major importance for internal control purposes. It made it possible for hospital administrators to compare and improve managerial efficiency in a manner similar to that in manufacturing industries.

The two decades following the issuance of the 1933 report saw few innovations in hospital accounting. Many hospitals implemented the committee recommendations, at least in regard to the preparation of financial statements and of periodic cost analyses. The recording of depreciation expense, however, was accepted only slowly according to a 1954 article.[4]

Cost Reimbursement

In the 1950s a new influence on hospital financial management made itself felt: the increase in individuals covered by Blue Cross plans and other types of hospitalization insurance. In 1954 an estimated 50% of hospital patients' bills were paid by one of these plans.[5]

At first Blue Cross established the rates it would pay. Although it tried to match hospital costs, that was often difficult due to the variations among hospitals.[6] During the late 1950s Blue Cross began to change to a system of cost reimbursement. This was not a new concept, since it had been used previously by various governmental units, but the increasing popularity of Blue Cross made it a topic affecting all hospitals. The idea of charging for patient care at cost (or cost plus a small percentage) contributed greatly to improved hospital accounting because hospitals had to design systems for gathering cost data.

Cost reimbursement plans resulted in increased acceptance of depreciation as a normal hospital expense because the Blue Cross plans considered depreciation a reimbursable cost. Depreciation expense for hospitals differs, however, from that for other industries since it is considered an expense requiring a cash outlay because "cash in an amount equivalent to the total depreciation charge should be transferred from the General Fund to the plant, building or some other similar fund."[7]

It is interesting to note that the non-profit hospitals reacted to depreciation accounting in the same way as did profit-oriented industries. Despite all the theoretical arguments supporting the recognition of depreciation expense, it was seldom done until it became economically beneficial. For profit-making businesses the corporate income tax law provided the financial incentive, for tax-exempt hospitals the cost reimbusement plans did.

The Health Insurance for the Aged Act (Medicare) was passed by Congress in 1965. It is administered by the Social Security Administration, but the seventy-six Blue Cross Associations in the various states act as agents between hospitals and the Social Security Administration.[8] The Medicare Act improved cost finding and accounting procedures in hospitals which had not implemented sound procedures for Blue Cross purposes.[9]

The most recent accounting recommendations from the AHA are in the 1966 publication *Chart of Accounts for Hospitals.* It contains two changes from previous AHA recommendations: long-term security investments are to be reported at current market values and property, plant, and equipment are to be reported at current replacement costs.[10] Other assets are still to be carried at historical cost.

Hospital Auditing

The development of hospital auditing lagged behind the development of auditing in general because hospital financial statements were not used by outside investors. Auditing for fraud purposes continued much longer, and early audits of hospitals were performed by state auditors and committees of the board of trustees.[11]

By the 1930s outside auditors occasionally audited hospitals for Blue Cross or banks who loaned money to hospitals. The major purpose of audits was, however, still to make sure that monies were spent in accordance with state laws and clauses in trust fund agreements.

The AICPA did not contribute much to the literature of hospital auditing until after World War II. Even then the only contributions were a few articles in the *Journal of Accountancy.* The first major publication concerning hospital auditing was Case Studies in Auditing Procedures No. 11, *A Hospital,* published in 1956. Other articles in the *Journal of Accountancy* followed.

The next major publications are two recent audit guides, *Medicare Audit Guide* and *Hospital Audit Guide.* The latter is perhaps more significant in that, for the first time, it recognizes that hospital audits may be for other than specialized or compliance purposes. It emphasizes that hospital financial statements are "being used by credit grantors, government agencies, and the community."[12] As a result hospital financial statements should be prepared in accordance with generally accepted accounting principles contained in APB Opinions and FASB Statements. The *Hospital Audit Guide* sees a general compatibility between GAAPs and the recommendations of the AHA *Chart of Accounts for Hospitals* with two exceptions: the use of current replacement cost for property, plant, and equipment and the use of current market values for long-term security investments.[13]

The passage of the Medicare Act also influenced hospital auditing. Blue Cross plans always had the option of auditing hospital records, but these audits are now formalized for Medicare purposes. The intermediary may use its own auditors or may contract out audits to independent public accounting firms. In addition, the Medicare Act provides that hospital records may also be audited by the General Accounting Office, the Department of Health, Education and Welfare, and the Social Security Administration.

Summary

Hospital accounting has been influenced primarily by the American Hospital Association, the Hospital Financial Management Association, the Blue Cross plans, and Medicare. Hospital auditing has been most influenced by the Blue Cross plans, Medicare and, most recently, by the AICPA.

Non-profit hospital financial statements differ from those of profit-oriented industries primarily because they are prepared on a fund basis rather than on an owners' equity basis. Depreciation accounting has been slow to develop, but the deductibility of depreciation expense in cost reimbursement contracts has recently led to uniformity among hospitals in this area.

Hospital audits have traditionally been for compliance purposes because government agencies and other third-party payers required an independent check on cost computations and uses of funds. Hospitals have recently begun to publish audited annual reports for financial purposes similar to businesses operated for profit.

Although the hospital industry was slow to develop sophisticated accounting systems and techniques, the advances made in the past four decades have put hospitals on a par with other industries. Hospital accountants must, however, not rest on their recent laurels. New methodologies and information systems await implementation. With a little effort the hospital industry can be a leader in accounting development, rather than a follower.

Notes

[1]A. C. Bachmeyer, F. E. Chapman, and John Bresnahan, "Hospital Accounting," *Modern Hospital,* XIX (August 1922), pp. 130-131.

[2]C. Rufus Rorem, "Cost Analysis for Hospitals," *Accounting Review,* V (June 1930), p. 159.

[3]C. Rufus Rorem, "Uniform Hospital Accounting," *Accounting Review,* XI (June 1936), pp. 158-161.

[4]Frederick Grubel, "Practical Aspects of Accounting and Auditing in Hospitals," *New York Certified Public Accountant,* XXIV (June 1954), p. 382.

[5]*Ibid.,* p. 380.

[6]Robert M. Sloane and Beverly LeBov Sloane, *A Guide to Health Facilities Personnel and Management* (St. Louis: C. V. Mosby Co., 1971), p. 84.

[7]Philip Taylor and Benjamin O. Nelson, *Management Accounting for Hospitals* (Philadelphia: W. B. Saunders Company, 1964), p. 45.

[8]Albert L. Craven, "Impact of Cost Finding Requirements of Medicare Legislation on Hospital Accounting and Cost Control" (Unpublished Ph.D. dissertation, Department of Accounting, University of Alabama), p. 57.

[9]*Ibid.,* p. 128.

[10]*Chart of Accounts for Hospitals* (Chicago: American Hospital Association, 1966), p. 14.

[11]Robert H. Montgomery, *Dicksee's Auditing* (New York: Ronald Press Company, 1909), p. 159.

[12]*Hospital Audit Guide* (New York: American Institute of Certified Public Accountants, Inc., 1972), p. 3.

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

Editor's Notes

A Look at the Woman CPA

Whenever the editorship the THE WOMAN CPA changes, the incoming Editor does not receive a beautifully engraved certificate to confirm her new status, nor does she receive an executive-size desk. In fact, she doesn't even get a blue pencil to help her in her editing work. What she does receive are boxes and boxes and more boxes of files. Since this is our last issue and since we are in the process of packing all these files into more boxes than we received when we took over four years ago, our thoughts turned naturally to the past and our predecessors and to the future and our successor.

A Look At The Past

Among all the boxes which travel across the country whenever the editorship changes is the box containing the complete file of all the issues of THE WOMAN CPA published since the beginning. If anything can be viewed as the Editor's sign of office, this is it. And before we were ready to pack this box off to Cincinnati, we took one last look through all the previous issues to see how THE WOMAN CPA became what she is today.

Volume I, No. 1 is dated December 1937 and carries the sub-heading "Bi-Monthly Bulletin — American Woman's Society of Certified Public Accountants." It consists of a few typed pages and does not identify the Editor. Unfortunately it is also silent about the number of copies produced. The news in it is mostly of an organizational nature, similar to the present AWSCPA Newsletter and ASWA Coordinator.

The practice of starting a volume in the fall continued through 1968; Volume 31 finally changes to the present practice of making the volume year coincide with the calendar year.

A year later Volume II, No. 1, dated October 1938, reports on the formation of ASWA. But the name of the Editor still remains a secret. Two issues later, in February 1939, we finally meet the Editor: Anna G. Francis, CPA, one of the founders and the first President of AWSCPA.

The third volume introduces several changes: the volume number is expressed in Arabic numbers from then on; the sub-heading is altered to "Joint Bi-Monthly Bulletin — AWSCPA and ASWA"; issues tend to be divided into two parts, one for AWSCPA news and one for ASWA news; and Evelyn Vick is added to the staff as ASWA Editor.

Anna Francis remains as Editor until Volume 4, No. 3, dated December 1940, when Helen C. Weil, CPA, is listed as Editor, Julia G. Norse, CPA, as Associate Editor, and Evelyn Vick as ASWA Editor.

In Volume 5, No. 1, for October 1941, Julia Norse as Editor starts "The President's Column" which is written by Mary C. Gildea, CPA, for ASWA and Ida S. Broo, CPA, for AWSCPA. These columns, however, last only for a little over a year.

Volume 6, edited by Ethleen Lasseter, CPA, again makes several changes: the sub-heading becomes "Official Publication;" four associates are appointed with responsibility for Technical Articles, Income Tax, Current Literature, and Coast-to-Coast News; articles are accompanied by a picture of the author; and a new column, "Editorially Speaking," is started which continues more or less regularly and finally evolves into the present "Editor's Notes."

Mary C. Gildea, CPA, who edits Volume 7, continues the columns, but when Phyllis O'Hara, CPA, takes over as Editor with Volume 8, she drops the Technical Articles Department in favor of an Ideas Exchange Department.

Early in 1947 a crisis must have occurred because in Volume 9, No. 2, dated February 1947, Jennie M. Palen, CPA, the President of AWSCPA, takes over as temporary Editor. After a few issues she either gives up looking for another Editor or develops a liking for the job, because she drops the "temporary" and stays on as Editor through Volume 11.

The next two Editors, Helen F. McGillicuddy, CPA, (Volumes 12 and 13) and Alice H. Aubert, CPA, (Volumes 14 and 15) continue the four columns and are able to staff them. Bur Margaret W. Tuma, CPA, who becomes Editor with Volume 16 in December 1953 runs into some tough luck. In April 1954 she loses her Tax and

Literary Editors and is unable to replace them, and in June 1954 the Coast-to-Coast News moves to the National Bulletin of ASWA. She struggles on with only the Ideas Exchange Editor until February 1955 when she finally finds another Tax Editor. She apparently learned from that experience because in April 1956 she spreads the work load by forming a 3-member Editorial Board. A year later the Editorial Board is expanded to six members, and over ten years later it finally reaches its present size of nine members.

By the time Margaret Tuma is replaced as Editor she holds the record for longevity with twenty-two issues. However, her record is broken by her successor, Marguerite Reimers, CPA, who edits thirty-six issues, a record which still stands.

The list of Marguerite Reimers' accomplishments is long: She discovers Mary F. Hall, CPA, who becomes Idea Exchange Editor in October 1959 and serves in that capacity through August 1960, when she takes a temporary leave from THE WOMAN CPA to serve as Vice President and President of AWSCPA, returning in December 1965 as Associate Editor. Reimers also finds Dr. Catherine Miles who becomes Literary Editor in October 1957, and she changes the Tax News into the Tax Forum, a name still used for the Tax Department. To improve the looks of the journal she adds color to the cover and changes the color with every volume.

But the work load seems to have become too much for Marguerite Reimers because she is forced to discontinue the Editor's column. She also has trouble finding a replacement for herself, because her Associate Editors disappear after a year or two until she finally finds Corinne Childs, CPA, in October 1960.

When Corinne Childs becomes Editor in August 1963 she revives the Editor's column and calls it "In This Issue." She places it on the last page, obviously so she can use it to fill in the space left over whenever manuscripts turn out to be shorter than expected.

She is followed by her Associate Editor, Mary J. McCann, CPA, in December 1965, who leaves the Editor's column on the last page but re-names it "Editor's Page." She is apparently unable to find a Literary Editor because her Associate Editor, Mary F. Hall, CPA, does double duty by editing the "Tips for Busy Readers" which evolves into the Reviews Department when Mary Hall becomes the Editor in December 1967. But she, too, seems to have trouble finding an editor for that department, because she asks her Associate Editor, Phyllis E. Peters, CPA, to do double duty for a while by editing the Reviews.

With Volume 30, No. 2, dated February 1968, Mary Hall changes the cover to dark green and white, a look which THE WOMAN CPA retained through July 1973. She also adds the Theory and Practice Department in January 1969 and publishes the first article by Constance T. Barcelona, entitled "The Census — Quantitative Interpreter for the Republic," in September 1969, thereby launching another Editor for the Woman CPA.

In January 1970 Phyllis E. Peters, CPA, becomes Editor and remains for three years, Volumes 32 through 34. Before she leaves the editorship she assures herself of the gratitude of all her successors when she gets the publication dates of THE WOMAN CPA changed from bi-monthly to quarterly. Under the bi-monthly publication schedule the Editor was always working on two issues simultaneously, since each issue had a lead time of three months from the day when the Editor first started to work on it until the day it was published. With the quarterly publication schedule the Editor now has time between issues to clean up her desk periodically.

A Look At the Present

During the four years while we served as Editor we made one major change when, starting with the October 1973 issue, we increased the size from 7" by 9" to the present 8-½" by 11" and expanded the number of pages to thirty-two plus the cover. When we realized what we had done, we got frightened by all the blank space and quickly took out insurance against empty pages by introducing several new departments. Our search for qualified editors for the new and the old departments was greatly helped by the tremendous increase in the membership of both AWSCPA and ASWA during the past three years. This increase in membership of our two sponsoring organizations is vividly shown by the circulation figures of THE WOMAN CPA: of the October 1973 issue only about 5,000 copies were printed; with the July 1976 issue we went above 8,000 copies.

A Look At the Future

With this issue we complete our term as Editor and turn THE WOMAN CPA over to our successor, Constance T. Barcelona, who has served a longer apprenticeship on THE WOMAN CPA than any of her predecessors. She became a member of the Editorial Board in January 1969, was re-appointed when her term expired three years later, and has served as our Associate Editor since January 1973.

Constance Barcelona is a member and past president of the Cincinnati Chapter of ASWA and was Program Chairperson for an All Ohio Day and for the 1975 Spring Conference in Cincinnati. She is the Accountant for The Camargo Club and teaches accounting principles and theory in the Evening College of the University of Cincinnati.

She has an undergraduate degree in economics from Iowa State University and an M.B.A. with a concentration in accounting from the University of Cincinnati. Since her first article appeared in the September 1969 issue of THE WOMAN CPA, she has been published in trade journals and the *Journal of Accountancy* besides making repeat appearances in our journal. She is presently collaborating on an accounting textbook with Dr. Clara C. Lelievre, who edits our Financial Statements Department, and with Dr. Thomas W. Lelievre.

We are confident that Constance Barcelona will be an outstanding Editor of THE WOMAN CPA. We thank her for serving as our Associate Editor and making our life as Editor much easier. We also thank all of our contributors who made it possible for us to publish Volumes 35 through 38. And now we happily join the ranks of the Ex-Editors of THE WOMAN CPA.

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