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# Accounting Orthodoxy: Standards From The Private Sector

## The Accounting Profession Has Matured Enough To Be Its Own Keeper

By Thomas A. Maddox

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It is not empty patriotic rhetoric to suggest that it is generally preferable to permit citizens and groups of citizens to solve their own problems to the extent they can; to afford them the opportunity to respond to public demands and concerns; and to seek their own solutions with as little governmental intervention as possible. This traditional belief has been repeatedly reinforced and reexpressed in recent times.<sup>1</sup>

Accountants these days may feel like Charlie Brown who, in the song about him as the class clown, laments, "Why is everybody always picking on me?" Truly accountants have been the whipping boys of the Seventies taking the blame for a variety of things from corporate failures to social ills. The reasons for public criticism of accountants are as varied as the motivations of the different groups clamoring for more federal government control over seemingly every aspect of American life. Two explanations offered most often are the fantastic corporate failures of the decade (most notably Penn Central and Equity Funding), and the disclosures of illegal corporate campaign contributions, bribes and

kickbacks. Regardless of their motivation, the critics have hastened the re-appraisal of the role of the accountant, the rules by which s(he) is guided, and the process by which those rules are developed.

The accounting profession has not been blind to this need for re-evaluation, but has been somewhat dilatory in its efforts at completing the job. For instance, the commission organized to study the responsibilities of auditors (the Cohen Commission) issued its final report early in 1978, nearly four years after the commission was formed. Undoubtedly, the report would have been issued even later if the Metcalf Committee's Staff Study, "The Accounting Establishment," had

not speeded up the commission's work.

A current project of the profession is the conceptual framework of accounting standards, or as *Forbes* noted, "sort of an accounting constitution."<sup>2</sup> Unfortunately, this topic has been current for more than one decade and includes the issuance in 1970 of *Accounting Principles Board Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises." The relative infancy of accounting as a profession and the dynamic nature of business are responsible for this seemingly reversed approach to setting standards, i.e., setting standards without broad objectives. Accountants were required by business exigencies to "account" for innovative or unique transactions without time for a study of any economic or social aspects of the transactions. One study commissioned by the profession recognized the inherent dangers of operating without an overall plan. The fear expressed was that the development of standards may be based on the operating needs of certain industries rather than on the needs of those who use the information to make economic decisions.<sup>3</sup>

### Who Shall Set Accounting Principles?

The issue most critical not only to the accounting profession, but to all businessmen as well, is "Who shall set accounting standards: the public or private sectors? Indeed the issue may concern the independent accountant the least. This is the opinion of John Beigler, senior partner of Price Waterhouse. In a speech before The Economic Club of Detroit, he indicated that his opposition to government standard-setting was not due to self-serving reasons. To the contrary, he says that "firms like mine can audit to whatever standards prevail." and he is certain that standards set by government would increase the complexity of auditing to the extent that the demand for accounting and legal services would increase.<sup>4</sup>

### Federal Standards Recommended

The question of standard setting was addressed forcefully by the Metcalf Committee Study previously mentioned. A specific recommendation of the study was that the "Federal Government should directly establish financial accounting standards for publicly-owned corporations."<sup>5</sup> The study severely criticized the Securities and Exchange Commission for

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## A federal standard setting board would not be insulated from pressure by Congress.

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delegating its authorized standard-setting powers to the private sector and urged congress to "exercise stronger oversight of accounting practices promulgated by Federal agencies."<sup>6</sup> The issue of private or public standards has been kicked around for over half a century beginning as early as 1914 when the Federal Trade Commission indicated intent to establish uniform accounting systems.<sup>7</sup> Standard-setting has remained in the private sector, but it is certain that the effort to shift the work to the public sector is gaining momentum.

One basic argument against the promulgation of accounting standards by the public sector is that considerations by those charged with responsibilities to the public are inherently political. A federal board set up to issue standards regardless of its organization, compensation, or selection would not be insulated from the pressure of Congress acting on behalf of some special group. It should be noted that two weaknesses of the present system alleged by the Metcalf Staff Study are 1) The standards are promulgated in response to large corporate interests (as lobbied by the large accounting firms), and 2) current standards provide considerable discretion allowing the manipulation of financial results. The latter point seemingly implies that somewhere the "true" accounting standards exist; diligent and objective research would discover these truths that the accounting profession has obscured due to their own self-interests.

### Politics In Accounting

If the past be prologue then one only has to review the action of Congress to see the results of the "politics" of accounting principles. Two controversies

are available for analysis: accounting for the investment credit and oil and gas exploration costs. In 1971, the Accounting Principles Board (predecessor to the Financial Accounting Standards Board) stated in its opinions that the investment tax credit should be amortized over the life of the asset which gave rise to the credit. This position was based on sound accounting theory. Congress, however, saw that this treatment would lessen the impact the credit would have on corporate earnings. It passed a law prohibiting auditors from prescribing any particular accounting treatment of the credit. Thus, most companies chose to flow the entire credit for a year through earnings all at once. Congress' primary concern in allowing the credit was to stimulate the economy, a concern which spilled over to setting accounting standards.

### Oil And Gas Accounting

The second controversy was officially closed last year when the Securities and Exchange Commission ruled on accounting for oil and gas exploration costs, yet undertones of debate still rumble. The original standard was set by the Financial Accounting Standards Board in December, 1977, with Statement No. 19 which mandated uniform accounting for oil and gas ventures, namely, expensing most unsuccessful exploration costs at once. An alternative method previously available had permitted amortization of unsuccessful costs over the productive life of other successful wells. The difference in the effect of the two methods on earnings is obvious. Suffice it to say that small oil company earnings reported under FASB requirements would rise and fall with the budgeted exploration plans, giving those companies roller coaster earnings records. Large oil companies are not so vulnerable to the roller coaster effect.

Immediately the lobbying of small oil and gas producers impinged upon Congress, who in turn pressured the Securities and Exchange Commission. The argument offered by the small companies centered on the effect the FASB ruling would have on their income statements, with erratic earnings year to year seriously impairing their ability to raise capital for future explorations. Their plea came at a time when energy source exploration was becoming a grave concern to Congress.

On August 31, 1978, the SEC issued

*Accounting Series Release (ASR) No. 253* "Adoption of Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities." which in effect rejected FASB Statement No. 19 by permitting either full cost, or successful efforts, accounting (although endorsing neither) and proposing development of an accounting method based on valuation of proved oil and gas reserves. In December, 1978, the SEC issued *ASR No. 257* and *ASR No. 258*, both related to the problems of oil and gas accounting and both reaffirming its conclusions in the earlier *ASR No. 253*. The FASB then suspended certain requirements of the controversial Statement No. 19. Congress, in its concern over the economic consequences of an accounting policy, had effectively pressured the SEC to overrule what was though by many to be a conscientious effort toward a uniform accounting standard.

Regardless of the merits of the positions taken by the two private bodies, the APB and the FASB, one thing remains clear: the public sector is susceptible to pressure groups and bias. Standards set by the public sector would not assure any great degree of uniformity. Just as the objectives of federal tax policy are shifting from raising revenue to achieving social and economic goals, the objectives of a public body in setting accounting standards may shift from avoiding private interest pressure and providing uniformity to achieving similar economic and social goals.

### Cost Accounting Standards Board

The Metcalf Staff Study mentions the Cost Accounting Standards Board as evidence of an efficiently operating public standard-setting body. This may seem persuasive until one examines the scope of the standards issued by the CASB as compared with the scope of FASB standards. The CASB was established to assure uniform cost accounting for companies working under government contracts, primarily defense contracts. The standards issued by the CASB affect the internal accounting for costs and, while there may be some effect on the company's publicly reported financial position, such effect would probably be minimal. In other words, the effect on earnings of a standard issued by the CASB would not be of sufficient magnitude to influence an investor or potential investor.

Another aspect of CASB standards is the limited number of companies which are required to follow them. When the CASB was first proposed, the accounting profession showed little concern since only government contractors would be affected. Since its formation, however, the CASB's role was broadened. Other government agencies stated that all companies from which services are contracted would also have to comply with the standards. Even with an expanded role, the CASB standards reach an increasing number of companies but have only minimal external effect on financial results. The two bodies, the FASB and the CASB, are not comparable.

An analogy can be drawn from a championship poker game. Some of the decisions to be made before the game begins are the cards and chips to be used, the ante, and the maximum raise to be allowed. Clearly the cards and the chips have little to do with the amount of a gambler's possible winnings or losses or how he will play the game. The ante and the raise, however, determine how long most gamblers stay in the game; decisions as to these amounts affect how the game will be played. The CASB standards have relatively little impact in the financial statements issued. The FASB standards, on the other hand, determine how the game is played.

### Conclusion

The accounting profession is responding to its critics and is setting its house in order. The major areas which have drawn the most criticism are being addressed by special groups or by the FASB, i.e., auditors' responsibilities (including fraud and illegal payments), objectives of financial statements and financial reporting, and the independence and objectivity of the standard-setting body. A recent survey of parties concerned with the preparation and interpretation of issued financial statements shows them to clearly prefer that financial accounting reporting standards be set within the private sector.<sup>9</sup> Harold M. Williams, chairman of the SEC, believes that the private sector should set accounting standards.<sup>10</sup> In spite of the notorious cases of irresponsible financial reporting and disclosure, the present system of private standard-setting has served the financial markets well. The evidence suggests that the public sector may be more susceptible to influence peddling and public interest groups

than the present and recent past standard-setting bodies. The profession has asked for time; time to allow a private citizen group to seek its own solution.

There is always the opportunity for a legislative initiative. Perhaps the ultimate argument for permitting the accounting profession to carry out the changes being adopted and implemented is that if these are insufficient, that will quickly become apparent. Congress can then act in the light of this experience.<sup>11</sup> ■

### NOTES

<sup>1</sup>American Institute of Certified Public Accountants. *Report of Progress. The Institute Acts on Recommendations for Improvements in the Profession.* (New York: American Institute of CPA's, 1978), p. 17.

<sup>2</sup>"Why Everybody's Jumping on the Accountants These Days," *Forbes* March 15, 1977, p. 38.

<sup>3</sup>American Institute of Certified Public Accountants. *Report of the Study Group on the Objectives of Financial Statements.* (New York: American Institute of CPA's, 1973), p. 9.

<sup>4</sup>"Who Shall Set Accounting Standards?" Speech before The Detroit Economic Club, February 22, 1977. (New York: Price Waterhouse and Co., 1977), p. 3.

<sup>5</sup>U.S. Congress, Senate, *The Accounting Establishment*, S. Doc. 95-34, 95th Cong., 1st Session, 1977, pp. 22-24.

<sup>6</sup>Ibid.

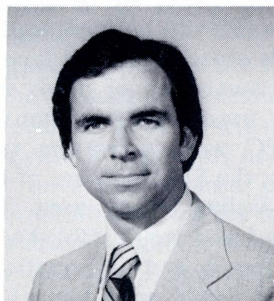
<sup>7</sup>Joshua Ronen and Michael Schiff. "The Setting of Financial and Accounting Standards — Private or Public?" *The Journal of Accountancy* 145 (March 1978): 66.

<sup>8</sup>The SEC has stated that the pronouncements of the FASB constitute "generally accepted accounting principles." This "delegation" of authority is what the Metcalf Study Criticized. The SEC has the power to require other accounting procedures.

<sup>9</sup>Ronen and Schiff, p. 69.

<sup>10</sup>"Williams urges independence at conference of SEC developments." *The Journal of Accountancy* 145 (February 1978): 24.

<sup>11</sup>*Report of progress.* p. 17.



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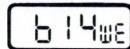
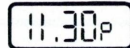


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