RESEARCH IN ACCOUNTING REGULATION

Editor: GARY JOHN PREVITS

Associate Editors: LARRY M. PARKER
ORACE JOHNSON
SHYAM SUNDER

Volume 4 • 1990

RESEARCH IN ACCOUNTING REGULATION

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A Research Annual

Editor: GARY JOHN PREVITS
Weatherhead School of Management
Department of Accountancy
Case Western Reserve University

Associate Editors: LARRY M. PARKER
Weatherhead School of Management
Department of Accountancy
Case Western Reserve University

ORACE JOHNSON
Department of Accounting
University of Illinois at
Champaign-Urbana

SHYAM SUNDER
Richard M. Cyert Professor
Carnegie-Mellon University

VOLUME 4 • 1990

JAI PRESS INC.

Greenwich, Connecticut *London, England*

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55 Old Post Road, No. 2
Greenwich, Connecticut 06836

JAI PRESS LTD.
118 Pentonville Road
London N1 9JN
England

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ISBN: 1-55938-084-5

Manufactured in the United States of America

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LIST OF CONTRIBUTORS

Paul R. Bahnson	Division of Accounting and Business Law University of Colorado at Boulder
Edward N. Coffman	Department of Accounting Virginia Commonwealth University
Denis Cormier	Accounting Faculty Universite du Quebec a Montreal
Billie M. Cunningham	Department of Accounting Colin County Community College
Fara M. Elikai	Department of Accountancy University of North Carolina at Wilmington
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Rasoul Tondkar — Department of Accounting, Virginia Commonwealth University

Michael J. Tucker — Department of Accounting, George Mason University

John R. Williams — School of Accountancy, Southwest Missouri State University

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Weatherhead School of Management
Department of Accountancy
Case Western Reserve University

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PREFACE

This volume presents a variety of research based upon empirical, legal, and field studies. Additional descriptive papers consider subjects of continuing interest including recent case law, the activities of Emerging Issues Task Force, fee structure regulation and the Financial Accounting Standards Board's (FASB) conceptual framework. The editorial addresses the issue of the financial standard setting process and the multiple processes which have emerged since 1973.

The perennial debate over auditor independence continues within the context of a discussion of prime contractor relationships as recently written about in the *Journal of Accountancy* by Robert Mednick, a senior partner in the firm of Arthur Andersen & Co. The FASB and the GASB have, perhaps definitely, concluded upon a basis of their relationship after a series of contests this past year. Those who opposed the increased authority of the FASB over governmental matters have, with singular resolve, noted that the prerogatives of state government and the accounting thereof require the distinctiveness of authority which is founded upon the rights of states under the constitution. The FASB, they assert, does not have the authority to extend its domain into this area, and therefore the governmental standards board must remain differentiated. One must of course ask by what constitutional authority the GASB itself exists, and thereafter by what consent it decides accounting principles for state government?

The rush of events in the Eastern Europe block countries since the days of autumn raises as many political questions for world progress and alliances as the changes that have occured in the microcosm of the world represented by the accountancy profession. The latter range from the reduction of major first-tier public accounting firms from eight in number to six, and the disclosure of the income and fee structure that developed about the mergers, to the overwhelming vote of the AICPA membership approving the final of seven Anderson Committee proposals for the structure of the Excellence program.

Perhaps what stands out most in my thinking about the events of this past year is the difficulty the FASB faces in addressing the issues raised by the adoption of, and then on two separate occasions, the postponement of *FASB 96* ["Accounting for Income Taxes," 1987]. This matter and the anticipated difficulty in resolving the issues related to accounting for other postemployment benefits promise to test the strength of the seven good men who currently are charged with this responsibility. The promotion of the FASB as a solution to the APB crisis reflected the thinking of the 1960s. It was created in the 1970s and has worked undaunted through the 1980s. It is not unexpected that the 1990s will find it sovereignly straining to adapt its actions to a more global role while at the same time meeting the concerns of both governmental constituents and corporate practicing CPAs who are vehemently critical of its standard setting orientation. To characterize this orientation dilemma in clearer terms will require more than quick statements about balance sheet versus income statement or rhetoric about the inappropriate slant of the conceptual framework. Despite the concerns, the individuals who comprise the organized accountancy profession have today what precedding generations did not—a substantial body of literature, a community of highly trained academics to assist in research issues, and a professional organization endowed with the self-regulatory authority to insure that the public interest is protected. It is unlikely that a century ago even the greatest minds of the early profession—Sprague, Haskins, Mongomery—would have hoped for what has been achieved. The question remains, are we today capable of generating a vision about the future of the profession that will lead us together through the changes and controversy of the coming decade?

We cannot accept anything but a positive answer to this question if we are to continue in a distinctive role as the profession which claims to provide information for decision making in an objective manner with competence and integrity.

Gary John Previts
Series Editor

WHO DECIDES?

Larry M. Parker and Gary John Previts

The essence of effective self-determination in professional governance, just as in governance overall, is the existence of an informed constituency. Since the establishment of the Financial Accounting Standards Board (in 1973) a nexus of entities has evolved which produce FASs, SOPs, SABs, FRRs, or consensus positions affecting the content and timing of financial reports. Determining who sets the agenda for an issue is unclear. The hierarchy of financial accounting standard entities has become extended, and perhaps more complicated than anticipated.

In 1938, *Accounting Series Release No. 4* (*ASR 4*) of the Securities and Exchange Commission (SEC) formally established the concept of "substantial authoritative support" as a fundamental concept in deciding which accounting principle was acceptable for public company filings with the Commission. Carman G. Blough, first Chief Accountant of the SEC, later wrote his successor that this concept " . . . meant authority of substantial weight rather than the predominance of authority. . . . Thus two contrary procedures might each have 'substantial authoritative support' . . . " [*Journal of Accountancy,* January 1982, p. 95]. In 1973, *ASR 150* established the Financial Accounting Standards Board (FASB) as the primary source of authoritative support (though maintaining the SEC's overall authority for financial statements of publicly

traded companies) by stating " . . . the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."

However, the concept of substantial authoritative support still has to be applied to emerging problems upon which the FASB has not taken a position. As the increasing number of such new, unresolved issues arose, the Commission, in 1984 [*Staff Accounting Bulletin No. 57* (*SAB 57*)], " . . . approved . . . the creation of an advisory group. . . . It is intended that this group assist the FASB in identifying, and in some cases resolving, emerging issues." The Emerging Issues Task Force (EITF) was to "interpret" these standards for specific situations. The EIFT requires assent (11 of the 13 voting members) to achieve "consensus." The SEC's chief accountant, or a representative, participates in EITF discussion. Though the SEC representative does not vote, it would be difficult to achieve consensus if the Commission opposed a position. The SEC by its action has given notice that the statements of this group, the EITF, constitute substantial authoritative support for specific public company accounting issues.

Further, when the FASB was established in 1973, the American Institute of Certified Public Accountants (AICPA) retained the role of setting specific industry standards by way of Statements of Position (SOPs) issued by the AICPA's Accounting Standards Executive Committee (AcSEC). In a recent letter the SEC affirmed that it also supports this role of the AICPA " . . . subject to FASB review, and . . . subject to SEC oversight" [Letter from Edmund Coulson, Chief Accountant of the SEC, to Jack Kreischer, Chairman of AcSEC, December 20, 1989].

Therefore, the FASB, its EITF, AcSEC and the SEC itself now set financial accounting "standards." (The IRS, of course, and many regulatory agencies also affect or set standards for certain types of businesses such as utilities, insurance companies, and so forth.)

The SEC has no formal authority over the accounting principles set for private companies (those companies that do not have "publicly traded" securities), nor does it or the FASB have ultimate authority over financial accounting in state and local governments. For private companies, a traditional authority has been the AICPA, whose authority is derived from its broad membership and relationships with groups that interact with private companies, such as lending institutions. The FASB has recently re-asserted its role over non-federal governmental accounting.

From the view of the general public it is difficult to be certain if an institution is public, private, or governmental, and, therefore, which group ultimately has authority for financial standards.

In the face of new and often complex types of business transactions and business practices, often designed specifically to circumvent existing standards,

management of standard setting entities and their agenda have become increasingly frustrating. In order to find out how to treat a "problem" transaction, pracitioners research many layers of standards, statements, bulletins, reports, positions, releases, and letters. A brief overview of the most prominent documents offering substantial authoritative support, not including pronouncements of the Government Accounting Standards Board and other federal agencies, includes:

- *FASB.* Statements of Financial Accounting Standards (SFASs) and any predecessor opinions in effect. The FASB also issues Technical Bulletins, Financial Interpretations, and Research Reports of the FASB staff. The FASB establishes generalized standards, those having a generic effect, and its authority derives largely from *ASR 150* of the SEC (for publicly held companies), and the AICPA's Code of Professional Conduct (for publicly held and private companies).
- *EITF.* Consensus Positions. It is less clear to the general observer where these positions reside in the hierarchy, but they do represent an authoritative source as interpretations of standards applied to a growing variety of emerging issues. The EITF derives its authority from the FASB and the SEC's *SAB 57.*
- *AcSEC.* Statements of Position. AcSEC via the AICPA establishes positions and informal reports. These standards often address specific industry needs. AcSEC derives its authority from the AICPA Code of Conduct and the support of the FASB and SEC.
- *SEC.* 1. ASRs (now FRRs and Accounting and Auditing Enforcement Releases (AAERs);
  2. Staff Accounting Bulletins (SABs); and
  3. Informal opinion letters of the SEC staff.

The Securities Acts, other legislation, and case law have given the SEC power over financial accounting presentations for all publicly traded companies [Miller and Robertson, *Research in Accounting Regulation*, 1989, pp. 239-248].

Even if an accountant effectively intepprets all the extant pronouncements relevant to an accounting issue, discussion with the SEC staff over, for example, an offering of a new security may find the SEC staff taking a position that is different due to "facts and circumstances" of the case. The SEC has the authority to rule in every specific situation of financial accounting, even if all existing authority permits the specific accounting. In the existing circumstances, if a problem occurs in, for example, savings and loan accounting, even sophisticated practitioners can have difficulty determining which standard-setting body to approach for guidance.

As can be expected there have been differences among the standard-setting bodies. Recently an EITF interpretation, established with the approval of the

non-voting SEC staff member sitting in on EITF meetings, was challenged by AcSEC. The interpretation, in AcSEC's view, essentially established an industry standard, which is within the purview of AcSEC, not the EITF. The interpretation was rescinded. The "turf" conflict between the FASB and the GASB has been resolved for the present by the Financial Accounting Foundation (FAF), but the underlying problems of overlap of authority persist.

The constant direct involvement of the SEC with the EITF has raised a concern that the EITF is, de facto, setting standards. Since consensus of the EITF is unlikely if the SEC staff participant argues against a position, the EITF may be incapable of acting other than in concert with the SEC. Does this circumvent the due process that exists within the FASB and AcSEC? Traditional SEC deliberations, often case by case, are less likely to involve due process. On the other hand, the FASB and AcSEC processes are not geared to rapid issue resolution. Therefore, the cost of an SEC presence on the EITF is worth the benefit of resolving problems quickly given the enhancement of SEC acceptance of the interpretations. Also, SEC "participation" in the EITF is the commission's way of working within the structure of the standard setting process while retaining its agency prerogatives.

The greatest controversy, however, will continue to be about the FASB. The issuance of *SFASs 94, 95,* and *96,* and the exposure draft on postemployment benefits all have created "constituent" opposition. *SFAS 94* (consolidated financial statements) was overdue and has been attacked as vague in certain format issues, largely because the FASB has been unable to complete even the first of three phases of the related consolidation project begun in 1982. *SFAS 95*, cash flows statements, has been modified twice since it was issued late in 1987. Implementation of *SFAS 96* on deferred taxes has been deferred twice. The initial issuance was a year later than expected. The postemployment benefit exposure draft requiring the accrual of health benefits due employees at retirement has created strong protests because of the potential for very large balance sheet liabilities and the possibility of companies reducing postretirement health benefits to such related liabilities.

The Financial Executives Institute (FEI) and the Business Roundtable (a powerful organization of chief executive officers) have been particularly critical of the FASB. These organizations argue that the FASB is unrealistic and impractical, is too concerned with concepts and current values, and has a balance sheet, rather than an income statement, emphasis. A recommendation for changing the required FASB vote for standard acceptance from 4-3 to 5-2 has been made. Some have even suggested that the SEC should directly set all standards, and the FASB should be eliminated. In response, the AICPA and FAF commissioned studies of the FASB. The 1989 AICPA study, chaired by former AICPA Chairman Ray Groves, determined that the FASB had done well, but recommended changes in FAF oversight and assessment of the FASB. An FAF study group, chaired by Charles Horngren, also reported in 1989,

and recommended a change in the FASB voting requirement to establish standards be increased from 4-3 to 5-2.

On January 23, 1990, Congressman Dingell, Chairman of the House Subcommittee on Oversight and Investigation, sent a letter to Richard Breeden, Chairman of the SEC, expressing concern " . . . that the FASB is a target of an external political pressure campaign by certain elements of the business community." Dingell has requested the SEC to provide him with all correspondence criticizing the FASB, and seems concerned about "undue interference."

The purpose of this essay has been to set forth a view about the status of the process of financial accounting standard setting. The recent FAF decision to require a "super" majority FASB vote of 5-2 to establish accounting standards is a signal that the influence over the process of standard setting will continue to be a point of focus. The SEC, AICPA, AcSEC, FAF, FASB, EITF, and GASB all are involved and have come under some pressure from Congress, the FEI, and the Business Roundtable. The FASB may be again at a watershed. Its difficulties are related to its role which is *legislative.* Yet its popular sovereignty is not derived by a direct accountability to its constituents—as in an election. The presumption by other pseudopopular bodies—the FAF and FASAC—that the manner by which the FASB is supported and constituted is fairly representative of the professional practice community is defensible but not convincing. While it is not being proposed that FASB members stand for popular elections, a further broadening of the public representation of the FAF and Financial Accounting Standards Advisory Council (FASAC) (thereby broadening the base of credibility) may be worth considering. Soon the issues of international accounting standards and the role of the International Accounting Standards Committee (IASC) also will be a factor in this setting. A revised FAF and FASAC structure, at least at an international level, will be needed to provide an international "umbrella" of authority. It is again time to make clear *who decides* accounting principles. For if we cannot agree upon standard setting in the national arena, how can we expect to establish standard setting in an international one?

MAIN PAPERS

AUDITOR CHANGES AND INFORMATION SUPPRESSION

Michael C. Knapp and Fara M. Elikai

ABSTRACT

The increasing rate of auditor turnover in recent years has spurred analytical and empirical research to identify the factors primarily responsible for this trend. One plausible explanation, the information suppression hypothesis, suggests that auditor changes are often motivated by client management's need or desire to suppress "sensitive" financial information. This study is designed to provide insight on the validity of that hypothesis as well as to yield more general insights on the nature of predecessor-successor auditor communications. Data for this study were collected from a sample of 94 audit partners drawn from the roster of Texas CPAs compiled annually by the Texas State Board of Public Accountancy. The results suggest that approximately one of every five auditor changes is motivated by an information suppression objective on the part of client management. Empirical data further imply that the present structure regulating auditor switching may not deter corporate managers from successfully concealing problematic information from financial statement users by changing auditors.

Research in Accounting Regulation, Volume 4, pages 3-20.
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ISBN: 1-55938-084-5

Public confidence in the integrity of corporate financial reports is shaken whenever cases of abusive financial reporting are publicized [National Commission on Fraudulent Financial Reporting (NCFFR), 1987; Cowherd, 1988]. These events, such as the recent scandals in the savings and loan industry, reduce, at least in perception, the integrity and credibility of all participants in the financial reporting process, including independent auditors. Congress and the Securities and Exchange Commission (SEC) monitor these events since they dampen public confidence in financial reports and may affect the costs of raising capital for public and private entities [Ingersoll, 1985; NCFFR, 1987].

One of the concerns expressed about the financial reporting system is the rapid increase in the rate of auditor dismissals by public firms over the past decade [*Public Accounting Report*, 1988]. The SEC is particularly sensitive to allegations that auditor switches are motivated by a desire on the part of corporate managers to suppress negative or problematic financial information [Schwartz and Menon, 1985; Knapp and Elikai, 1988]. Even in the absence of ulterior motives for auditor changes, a high rate of switching activity diminishes the overall credibility of audited financial data because of the higher degree of "information risk" associated with post-switch financial statements.[1,2]

The principal purpose of this study is to provide insight on the validity of the "information suppression hypothesis" which posits that the disproportionate number of "audit failures" following auditor changes [St. Pierre and Anderson, 1984] is a consequence of switching firms successfully concealing audit-relevant information from successor auditors [Mangold, 1984; Schwartz and Menon, 1985]. This problem is explored from the perspective of audit partners since these individuals are in a strategic position to observe and comment on the motives underlying auditor changes.

The objective of this research is to develop a base of information to evaluate existing and proposed policies intended to assist in ensuring that critical audit-relevant information will not be lost when auditor changes occur. By ensuring that "audit sensitive" information is communicated to successor auditors, such measures should assist in decreasing the risk of audit failures subsequent to auditor changes and promote the credibility of the corporate financial reporting system as well as the independent audit function.

REGULATORY RESPONSES TO INCREASING RATE OF AUDITOR CHANGES

In response to the increasing rate of auditor turnover and consequent allegations that audit clients are abusing their prerogative to choose an independent auditor [Smith, 1986], regulatory authorities have adopted several measures to discourage and/or prevent firms from attempting to suppress negative financial information by changing auditors. Since 1971, the SEC has

issued a series of regulations requiring public firms to disclose certain information following an auditor change. Most importantly, these regulations mandate that switching firms disclose in an 8-K filing all major auditor-client disagreements that occurred in the two years preceding the auditor change. Additionally, former auditors of switching firms are required to file an exhibit letter to the 8-K which comments on the accuracy and completeness of the former client's disagreement disclosures. Empirical research, however, strongly implies that switching firms and their former auditors have circumvented the 8-K disclosure rules in the past [McConnell, 1984]. In 1986, only 5 percent of the more than 700 8-K auditor change filings disclosed prior audit disputes [*Public Accounting Report*, 1987], although the SEC's disclosure rules at the time broadly defined a "reportable disagreement."[3]

The SEC's dissatisfaction with registrants' and auditors' perfunctory compliance with the 8-K disclosure rules resulted in the adoption of more rigorous disclosure requirements for switching firms [SEC, 1987; Ricks and Berton, 1988; AICPA, 1989a, 1989b] . The tightening of these rules can be traced directly to congressional hearings into the sudden collapse of ZZZZBest Company in the summer of 1987 [Berton and Ankst, 1988; Ricks, 1988]. In that case, the auditors of ZZZZBest resigned after they uncovered evidence suggesting that their client's financial statements contained fraudulent misrepresentations [Berton and Ankst, 1988]. In the 8-K statement disclosing the change in auditors, ZZZZBest reported that there had been no disagreements with their former audit firm, an assertion that apparently was not true [Ricks, 1988]. Thirty days subsequent to the 8-K filing, the firm's former auditors filed an exhibit letter to ZZZZBest's 8-K in which they contested the assertion that there had been no major disagreements with their former client. By this time, however, ZZZZBest had already filed for protection under Chapter 11 of the federal bankruptcy laws [Berton and Ankst, 1988].[4]

Auditing standards have also been adopted to inhibit the ability of audit clients to conceal problematic information by changing auditors, most notably *Statement on Auditing Standards No. 7* (*SAS 7*), Communications Between Predecessor and Successor Auditors [AICPA, 1975].[5] Issued in 1975, *SAS 7* requires communications between predecessor and successor auditors both before and after a client acceptance decision is made. Unlike 8-K disagreement disclosures, *SAS 7* reports are confidential, consequently, it is difficult to determine whether information that audit clients may have hoped to conceal by changing auditors is communicated to successor auditors by predecessor auditors. However, anecdotal evidence [Hall and Renner, 1988] and the results of one survey study [Hull and Mitchem, 1987] imply that the degree of compliance with *SAS 7* may be less than satisfactory. Because of fear of litigation and/or overt pressure exerted on them by former clients [McConnell, 1984], predecessor auditors may be reluctant to respond candidly to successors' *SAS 7* information requests. Such reluctance on the part of predecessor

auditors may be a contributing factor to the relatively high rate of "audit failures" following auditor changes. A study by St. Pierre and Anderson [1984] of several hundred lawsuits brought against audit firms found that auditor errors or oversights are more common on audits performed in the first few years following an auditor change than on engagements involving fairly lengthy auditor-client relationships. Similar findings also were reported by the Treadway Commission [NCFFR, 1987].

RESEARCH QUESTIONS

When auditor changes abet concealment of important information from financial reports, the societal objective of the financial reporting process and the independent audit function are subverted. This issue has been addressed by a limited number of empirical research efforts, nearly all of which have focused on the SEC's 8-K disclosure rules for auditor changes [Fried and Schiff, 1981; Nichols and Smith, 1983; McConnell, 1984]. This study investigates the nature and apparent effectiveness of predecessor-successor communications and the implications thereof to the information suppression hypothesis. The following research questions are addressed.

1. What methods may audit clients employ to inhibit or to diminish the effectiveness of predecessor-successor auditor communications?
2. Do audit practitioners perceive that these methods are employed by clients in connection with auditor changes?
3. Do predecessor auditors (engagement audit partners) typically disclose to prospective successor auditors the information required to be disclosed by *SAS 7*? Do predecessor auditors from different-size classes of audit firms and with varying levels of experience differ in their propensity to provide candid responses to *SAS 7* information requests?
4. From the standpoint of audit practitioners, what are the key contextual variables which influence the effectiveness of predecessor-successor communications?

The next section addresses the first research question by analyzing the context in which predecessor-successor communications occur; the subsequent section provides an overview of the research method used to provide empirical data addressing the second through fourth research questions. Finally, the remaining two sections of the paper summarize the empirical results and identify future research needs in this area.

PREDECESSOR-SUCCESSOR COMMUNICATIONS AND INFORMATION SUPPRESSION BY AUDIT CLIENTS

SAS 7 requires both pre-acceptance communications between each prospective successor auditor and the predecessor auditor as well as post-acceptance communications between the actual successor and the predecessor. The primary purpose of the pre-acceptance communications is to provide information that will assist a prospective successor in determining whether a given firm should be accepted as a client. Alternatively, post-acceptance communications are intended to facilitate the efficiency and effectiveness of the successor auditor's examination. An analysis of the structure and nature of predecessor-successor communications, as defined by *SAS 7*, suggests four methods that a switching firm may potentially use to conceal information from a prospective or actual successor auditor.

1. *Blatant information suppression* — This occurs when an audit client dismisses their auditor and then refuses to authorize either pre-acceptance or post-acceptance *SAS 7* communications. This approach to subverting the intent of *SAS 7* is most likely used by a firm when the former auditor is aware of the information that management wishes to conceal and when the latter has identified a successor auditor which has agreed not to insist on communicating with the predecessor.
2. *Coercive information suppression* — This method involves a former auditor who is aware of information that the switching firm wants to conceal. In this case, however, the former client authorizes *SAS 7* communications and then pressures the predecessor auditor to withhold the problematic information from prospective successors or the actual successor.
3. *Manipulative information suppression* — This technique is used as a means to conceal a material error or irregularity that has yet to be discovered by a firm's present auditor. This form of information suppression is predicated on the existence of a perceived learning curve effect in auditing [DeAngelo, 1981a; St. Pierre and Anderson, 1984; Knapp, 1988].[6] That is, client management may perceive that their present auditor is more likely to discover certain problematic information than a replacement auditor which would be unfamiliar with the firm's operations and accounting systems. When this method of information suppression is used, client management will not be forced to interfere in *SAS 7* communications since the predecessor auditor would be unaware of the information management hopes to conceal.
4. *Systemic information suppression* — This method also does not require client management to interfere in *SAS 7* communications. As McConnell [1984] notes, predecessor auditors may be reluctant to disclose negative information concerning a former client to a successor. Such reluctance may

stem from a predecessor's desire to avoid being labeled as a "poor loser" which could damage its ability to attract new clients. Given this alleged tendency on the part of predecessor auditors, switching firms may dismiss an auditor that is aware of problematic information, authorize *SAS 7* communications, and then expect the predecessor to withhold that information from the successor.[7]

Prior empirical research has not explored the feasibility of or the frequency with which the above methods are used by switching firms to accomplish information suppression objectives. As noted earlier, only a limited amount of empirical research has investigated the more general question of whether auditor changes are often a consequence of information suppression motives on the part of switching firms [Mangold, 1984; Schwartz and Menon, 1985]. One key finding of the extant research in this area is that a disproportionate number of audit failures or breakdowns occur following auditor changes [St. Pierre and Anderson, 1984]. A plausible explanation for this finding is that failing firms attempt to "buy time" by changing auditors [Mangold, 1984]. That is, financially distressed firms change auditors with the hope of concealing the severity of their financial problems from a successor auditor.

Kluger and Shields [1987] performed a study which provided a more direct test of the information suppression hypothesis. These researchers identified a set of firms that had changed auditors a few years prior to becoming insolvent and a matched sample of firms that had not changed their auditors prior to insolvency. Bankruptcy prediction models developed for each set of firms demonstrated that the quality of the switching firms' financial data, vis-à-vis that of the control sample, decreased significantly following the change in auditors. This result indicates that the switching firms may have concealed information from their successor auditors, information which likely would have provided the latter with a more accurate view of their new clients' true financial condition.[8]

The higher rate of audit failures following auditor changes and the empirical evidence which suggests that information suppression may be an underlying motive for many auditor changes point to a need for a better understanding of the specific methods that audit clients may use to conceal sensitive information in connection with a change in auditors. In the following section, the research method used to study this issue and the related issues raised by the remaining research questions are discussed.

RESEARCH METHOD

A three-part questionnaire was developed and administered to a sample of audit partners to collect data for this study. The first section of the instrument contained a series of questions intended to provide insight on how frequently

Table 1. Biographical Information for Subjects

Number of respondents	94.0
Percentage of respondents employed by Big Eight firms	56.3
Mean number of years of public accounting experience	18.2
Mean number of years of experience as an audit partner	8.7
Median number of years of experience as an audit partner	8.0
Mean percentage of subjects' work time spent with non-SEC clients	65.9
Mean percentage of subjects' work time spent with SEC clients	20.3
Mean number of times subjects have been involved in auditor changes as a predecessor auditor	6.3
Mean number of times subject have been involved in auditor changes as a successor auditor	13.4

the different methods of information suppression defined earlier are used by switching firms. In the following section, subjects were asked to respond to three scenarios describing problematic information regarding a former client. The subjects were instructed to assume the role of the audit engagement partner for this former client and then asked to report the likelihood that they would disclose the given information to a prospective successor auditor. The objective of this section of the instrument was to investigate whether predecessor auditors may facilitate the information suppression efforts of their former clients by failing to respond fully to prospective successors' information requests. A related objective was to determine whether, as suggested by prior research,[9] the size class of the predecessor audit firm and/or the length of experience of the predecessor audit engagement partner affect the likelihood that the latter individual will respond candidly to *SAS 7* requests. In the final section of the instrument, the subjects provided Likert-scale responses to a set of statements concerning auditor changes. The intent of this section was to identify factors which audit partners believe significantly influence the effectiveness of predecessor-successor communications and to elicit the subjects' views on important policy issues regarding these communications.[10]

The subjects for this study were selected from the roster of Texas CPAs compiled annually by the Texas State Board of Public Accountancy. From a sample of 247 audit partners, 94 usable responses were obtained (38% response rate). Biographical information provided by the respondents is summarized in Table 1. Most important, the data reported in Table 1 indicate that the subjects had been involved in a significant number of auditor changes and, consequently, should have important insight on the issues addressed by this study.

RESULTS AND DISCUSSION

Auditor Changes and Methods of Information Suppression

Table 2 summarizes the subjects' responses to the series of questions included in the first section of the research instrument. The subjects' responses to Question 1 demonstrate they believe that approximately one of every five auditor changes is a consequence of an information suppression motive. The intent of Questions 2 through 6 was to assess how frequently switching firms use either blatant or coercive information suppression in connection with an auditor change. The mean responses to this set of questions suggest that neither of these methods is commonly used by switching firms. For instance, the mean response to Question 2 demonstrates that management typically does not inquire of the predecessor auditor regarding the specific information that the latter intends to disclose to the successor auditor. Intuitively, such an inquiry would precede management's decision to employ either the blatant or coercive information suppression methods. Similarly, the mean responses to Questions 3 and 4 indicate that client management seldom interferes in either pre- or post-acceptance *SAS 7* communications, a necessary condition for the use of blatant information suppression. Finally, the means for Questions 5 and 6 provide corroborating evidence that coercive information suppression is apparently infrequently used by switching firms. The subjects' responses to these two questions confirm that former clients seldom attempt to persuade predecessors to withhold negative information from a successor or prospective successor and are even less likely to threaten reprisals against a predecessor if such disclosures are made.

The intent of the final question in Table 2 was to determine whether audit practitioners perceive that a successor auditor is less likely to discover existing material errors than a predecessor auditor with five years experience auditing a given client. A necessary condition for the use of manipulative information suppression by audit clients is a perception that a learning curve effect is present in auditing. Given the mean response reported in Table 2 for Question 7, audit partners perceive that a successsor auditor is much less likely to discover a material error than the predecessor auditor. If this perception is valid and is shared by audit clients, manipulative information suppression is a viable method for firms to use in concealing problematic information from their auditors.[11]

In summary, the data reported in Table 2 demonstrate that the subjects perceived that a need or desire on the part of client management to suppress sensitive information is a major factor in a substantial proportion of auditor changes. Apparently, however, in such cases switching firms typically do not conceal information from a successor auditor by refusing to authorize *SAS 7*

Table 2. Summary of Subjects' Responses To Questions Regarding The Underlying Motives for Auditor Changes

Question	*Mean Subject Response* (%)
1. In what percentage of auditor changes do you believe management's *principal* reason for changing auditors is to suppress negative information concerning its firm?	20.2*
2. In what percentage of auditor changes does the former client attempt to determine, prior to authorizing *SAS 7* communications, the information that the predecessor auditor intends to communicate to the sucessor auditor?	9.8
3. In what percentage of auditor changes does the former client impose restrictions on communications between the predecessor and prospective successor?	4.1
4. In what percentage of auditor changes does the former client authorize the predecessor to provide the successor with unrestricted access to prior year working papers?	91.8
5. In what percentage of auditor changes does the former client authorize SAS 7 communications but then attempt to persuage the predecessor to refrain from disclosing certain negative information to the successor?	3.4
6. In what percentage of auditor changes does the former client threaten reprisals if the predecessor auditor discloses certain (negative) information regarding the former client to the successor auditor?	2.1
7. Assume that in a given set of facts you believe there is an 80% likelihood that an auditor with five years experience auditing a given client would discover a material error that exists in the client's financial statements. In your opinion, what is the likelihood that a new auditor (with no prior knowledge of the client's accounting systems or operations) would discover that same error?	60.9**

* Significantly different from 0% (p =.05).
**Significantly different from 80% (p = .05).

communications, nor do former clients typically attempt to persuade the predecessor to withhold problematic information from the successor. These findings imply that audit clients which change auditors for the purpose of concealing sensitive information are most likely to use one of the two "passive" information suppression methods, either manipulative or systemic information suppression.[12] The data supplied by the subjects suggest that manipulative information suppression may be a feasible method for switching firms to use to conceal problematic information from a successor auditor. That is, the subjects generally believed that a learning curve effect adversely influences the quality of an audit performed subsequent to an auditor change.

SAS 7 Disclosures by Predecessor Auditors

The second section of the research instrument was intended to provide insight on the feasibility and existence of systemic information suppression, the second of the two passive information suppression methods defined earlier. In this part of the questionnaire, subjects were asked to assume that until recently they had served as the engagement audit partner for a given firm. Subjects then were instructed to indicate the likelihood that they would disclose to a prospective successor auditor certain information regarding the former client. *SAS 7* requires a prospective successor auditor to inquire of the predecessor regarding three specific items of information: (1) any major auditor-client disagreements preceding the auditor change, (2) matters that might provide insight on the integrity of client management, and (3) the predecessor's understanding of the reason for the auditor change. Each of the information items that the subjects were asked to consider disclosing to a prospective successor addressed factual circumstances relevant to the subject matter of one of these inquiries.

Prior analytical and empirical research posits that certain biographical variables may be influential factors in auditors' decisions of whether or not to comply with explicit professional standards, such as those included in *SAS 7*. In this vein, DeAngelo [1981b] asserts that Big Eight auditors are less likely to make significant concessions to clients than non-Big Eight auditors, an assertion that is consistent with McConnell's [1984] empirical data regarding 8-K disagreement disclosures. Likewise, Sack and Tangreti [1987] maintain that the ability of an audit engagement partner to resist management pressure to approve questionable accounting treatments is positively correlated with the individual's length of experience as an audit partner, a contention weakly supported by the behavioral study of Farmer, Rittenberg, and Trompeter [1987]. Given these prior findings, the size class of each subject's employing firm and each subject's length of experience as an audit partner were identified to determine whether either of these factors influenced the likelihood that the subjects would disclose sensitive information to successor auditors.

The mean reported likelihoods for the information items included in the second section of the questionnaire are shown in Table 3. The data reported in Table 3 demonstrate that the subjects, as a group, were more likely than not to provide each of the items of information to prospective successors. Nevertheless, for each scenario, a substantial minority of the subjects reported that they would most likely not disclose the given information to a prospective successor. Regarding the two dichotomous biographical variables, only the Big Eight/non-Big Eight factor yielded distinct differences in the mean likelihoods of disclosure reported by the subjects. Big Eight audit partners were more likely to disclose the information items to successors in each case, although the difference between the mean responses of the two groups was statistically

Table 3. Mean Reported Likelihoods That Subjects Would Disclose Given Problematic Information to a Successor Auditor

	Mean Subject Response (%)			
	Type of Audit Firm		Length of Experience*	
Scenario	Big Eight	Non-Big Eight	High	Low
A. During the last audit of this firm, the search for unrecorded liabilities disclosed a material amount of unrecorded liabilities/expenses. The client contended that the amount was immaterial but you disagreed. After two meetings with the client's senior executives, they agreed to record the adjustment.	58.7	52.8	55.6	56.8
B. During the last audit of this firm, which owns and operates a chain of retail stores, you found evidence that certain store managers were holding the sales books open several days past year-end. The client made the proper adjustment for these sales but did not reprimand the individuals involved.	63.8**	47.2	55.1	58.2
C. You believe that your firm was dismissed because the thorough nature of your firm's annual audit interfered with management's ability to manipulate reported earnings.	72.7	61.7	69.5	66.0

Notes: The grand means for the three scenarios were: 56.1% (A), 56.5% (B), and 67.9% (C). The following percentages of subjects reported a likelihood of less than 50% of disclosing the given items of information to a prospective successor: 39.3% (A), 37.2% (B), and 21.3% (C).

* The median length of experience as an audit partner (8 years) was used to form these two subgroups of the subject sample.

** Significant difference in treatment level means ($p = .05$).

significant for only one of the items. As Table 3 shows, there were no significant differences in the likelihood measures when the subjects were divided into groups above and below the median number of years of experience as an audit partner for the total sample.

As noted earlier, McConnell [1984] maintains that an auditor may choose not to disclose information concerning disputes with former clients (in exhibit letters filed with 8-K auditor change announcements) because of the potentially negative economic consequences of such disclosures for the auditor.[13] Such perceived consequences also may account for the greater reluctance of non-Big Eight auditors, as demonstrated by the data shown in Table 3, to disclose sensitive information regarding a former client to a successor auditor. Unfortunately, this predisposition on the part of certain auditors may

encourage firms to switch auditors to conceal critical information from third party financial statement users. This form of information suppression, earlier defined as systemic information suppression, has particularly negative connotations for the auditing profession since it requires the implicit cooperation of auditors.

The Nature of *SAS 7* Communications: Contextual Factors and Policy Issues

The two objectives of the final section of the research instrument were: (1) to provide insight on whether certain contextual variables in the audit environment influence predecessor auditors' willingness to respond candidly to SAS 7 information requests, and (2) to obtain the views of audit partners on important policy questions concerning predecessor-successor communications. Regarding the first of these objectives, McConnell [1984], Farmer, Rittenberg, and Trompeter [1987], and Kluger and Shields [1987] maintain that two key contextual variables in the audit environment, the degree of competition among audit firms and the level of audit-related litigation, impact the economic consequences of auditors' decisions and, consequently, often significantly influence the nature of those decisions. As reported in Table 4, the majority of the subjects believed that the increasingly competitive nature of the audit market is adversely affecting the degree of cooperation between predecessor and successor auditors. Conversely, there was much less agreement with the assertion that the current litigation "crisis" facing audit firms [Palmrose, 1987] is significantly impacting the willingness of predecessor auditors to communicate with successors.

Investigations of the accounting profession by a U.S. House subcommittee [Schroeder , Solomon, and Vickery, 1986] and the Treadway Commission [NCFFR, 1987] have resulted in recommendations that firms establish audit committees and assign them important responsibilities in the corporate monitoring configuration [Bull and Sharp, 1989; Marsh and Powell, 1989]. As shown in Table 4, the audit partners in this study expressed moderate agreement with the statement that firms with audit committees are less likely to change auditors to accomplish an information suppression objective. This finding, when coupled with empirical evidence that audit committees are increasingly becoming more active participants in the audit context [SEC, 1982; Schroeder, Solomon, and Vickery, 1986], suggests that audit clients in the future may find it more difficult to change auditors for illicit reasons.

Statements 4 and 5 in Table 4 focused subjects' attention on two policy measures which would potentially diminish the ability of audit clients to conceal critical information from financial statement users by changing auditors. The subjects clearly supported the proposal that would prohibit audit firms from accepting clients which refuse to authorize *SAS 7* communications but strongly

Table 4. Mean Subject Responses to Statements Focusing on Factors Which May Influence Predecessor-Successor Communications and on Proposed Policy Mesures Regarding Such Communications

	Statement	*Mean Subject Response*	
1.	The recent increase in competition among audit firm has adversely affected the degree of cooperation between successor and predecessor auditors.	5.21*	(70.2)**
2.	The recent increase in litiigation against auditors discourages predecessor auditors from freely communicating with successor auditors even when authorized to do so by the former client.	4.06	(44.7)
3.	Audit clients that have audit committees are less likely to attempt to dismiss their auditors to accomplish an information suppression objective.	5.63*	(88.3)
4.	The profession should adopt a rule that prohibits audit firms from accepting a prospective client if the latter refuses to authorize unrestricted communications between the predecessor and successor auditor.	5.31**	(73.4)
5.	The profession should adopt a rule that requires predecessor auditors to provide successor auditors with unrestricted access to prior year working papers (if the client approves).	2.02*	(6.4)
6.	As presently structured, *SAS 7* ("Communications Between Predecessor and Successor Auditors") neither prevents nor inhibits information suppression by audit clients in connection with auditor changes.	4.48	(50.0)

Scale used by subjects in responding to statements listed above:

Strongly Disagree	1	2	3	4	5	6	7	Strongly Agree

* Significantly different from midpoint of dependent variable scale, 4.0 ($p = .05$).
** The percentages in parentheses represent the proportion of subjects that expressed at least moderate agreement (5 or greater on the scale) with the given statement.

rejected the measure which would require predecessor auditors to provide successor auditors with unrestricted access to prior year working papers. Finally, exactly half of the respondents expressed at least mild agreement with the assertion of Statement 6 that *SAS 7* neither prevents nor inhibits information suppression by audit clients in connection with auditor changes.

SUMMARY AND FURTHER RESEARCH

The principal purpose of the independent audit function is to facilitate the efficient operation of the capital markets by lending credibility to published

financial data [AICPA, 1978]. Over the past two decades the ability of the auditing profession to provide that service is alleged to have been impaired by a dramatic increase in auditor switching activity and a parallel increase in the number of highly publicized "audit failures." Empirical research confirms that problem audits occur more frequently following auditor changes, however, the causal factors underlying this relationship have not been the subject of extensive research. This study was designed to provide information about the validity of the information suppression hypothesis which posits that the disproportionate number of problem audits following auditor changes is a consequence of switching firms successfully concealing audit-relevant information from successor auditors. A key finding of this study is that the reluctance of predecessor auditors to cooperate fully with successor auditors may facilitate the efforts of switching firms to conceal problematic information from third party financial statement users.

The findings of this study are subject to several limitations. The fact that all participants in this study were from the state of Texas limits the generalizability of the results. Since a disproportionate number of the recent financial reporting scandals, particularly those in the savings and loan industry, occurred in Texas, audit practitioners in that state may be more sensitized to the issues addressed in this study than practitioners from other regions of the country. The limited amount of data provided to the subjects when asked to disclose whether they would report certain client-relevant information to a successor auditor also constrains the external validity of the results. Finally, the modest response rate and the possibility that the sensitive nature of the issues addressed may have influenced the responses provided by the subjects impose restrictions on the extent to which this study's results can be generalized.

The limitations of this study and the complexity of the issues addressed require that considerable additional research be performed before firm conclusions can be drawn concerning the nature of predecessor-successor communications and the measures, if any, which should be taken to facilitate the accuracy and completeness of these communications. In particular, there is a need for additional research of two matters. First, there is a need for intensive descriptive research of predecessor-successor communications. Detailed descriptive data documenting the timing of these communications, the quantity and quality of information communicated by predecessors, and the manner in which such information is used by successors should provide critical insights useful to regulatory authorities and audit practitioners alike.

A related issue meriting empirical research is the extent to which a learning curve effect influences the quality of audit services. If such an effect influences audit quality, audit clients may successfully conceal critical information and thus subvert the purpose of the independent audit simply by changing auditors. Importantly, empirical evidence documenting the existence of a significant learning curve effect in auditing practice would motivate a search for methods

to "shorten" the learning curve when an auditor change occurs, including methods to facilitate predecessor-successor communications.

NOTES

1. This higher degree of information risk is a consequence of a replacement auditor's relative unfamiliarity with the client's operations and internal control structure [Williams, 1988]. Exacerbating this problem, from the standpoint of regulatory authorities, is that auditors who discover management fraud may resign the audit engagement and then be prohibited from disclosing the information to other parties by the profession's confidentiality rule. Recently, U.S. Representative John D. Dingell, chairman of the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee, inquired whether the former auditors of ZZZZBest resigned the engagement having concerns about management integrity and then failed to disclose that information to others, particularly regulatory authorities [AICPA, 1988]. For an overview of the new disclosure rules for switching firms and their former auditors, see AICPA [1989a, 1989b].

2. Prior research demonstrates that a desire to reduce the audit fee is likely the most common motive for a change in auditors [Bedingfield and Loeb, 1974; Eichenseher and Shields, 1983]. This study does not dispute that finding. Nevertheless, a number of studies indicate that information suppression may have been a significant contributing factor in several financial reporting scandals of the past decade [Knapp and Elikai, 1988]. The pervasive and negative implications that successful information suppression by switching firms has for financial reporting, in general, and the independent audit function, in particular, suggest that additional study of this phenomenon is merited.

3. In this same vein, Shaw and Francis [1987] found that *The Wall Street Journal* often reports prior auditor-client disagreements that SEC registrants should have disclosed in their 8-K auditor change announcements. See McConnell [1984] for a discussion of the economic disincentives that may discourage switching firms and their former auditors from disclosing prior audit disputes.

4. The new disclosure rules for auditor switches significantly shorten the maximum length of time that can pass before auditors publicly report information regarding disagreements that may have led to the auditor change [AICPA, 1989a, 1989b]. Nevertheless, these disclosures are still *ex post*. Consequently, financial statement users must be aware that the resignation of the auditor is the most timely signal available that something may be amiss in a given firm's financial statements.

5. *SAS 50*, "Reports on the Application of Accounting Principles" [AICPA, 1986], also was motivated by the increase in auditor switching activity over the past decade. *SAS 50* specifies the professional responsibilities of an auditor who has been requested by a nonclient to provide an opinion on the application of an accounting principle. Typically, these requests involve an accounting principle which the nonclient's present auditor believes is unacceptable.

6. In fact, each of the information suppression methods is predicated, to some degree, on the greater difficulty that a successor auditor should have in discovering problematic information vis-à-vis an incumbent auditor. However, when using this method the client is relying solely on the learning curve effect to accomplish its intended objective of concealing sensitive information from a client.

7. A related problem not addressed by this study is that successor auditors may choose to ignore audit-relevant information communicated to them by the predecessor. Simon and Francis [1988] maintain that a new auditor, particularly one that has obtained the client by offering a discounted audit fee, is more likely to ignore problematic client information than an incumbent auditor with considerable tenure. However, empirical data collected by Raghunathan, Lewis, and

Evans [1987] regarding the frequency with which audited financial statements contain material misrepresentations do not support Simon and Francis' contention.

8. An alternative explanation for Kluger and Shields' results is that the successor auditors were more "flexible" or "compliant" than their predecessors. That is, the successor auditors uncovered abusive accounting and/or reporting tactics (either on their own or via *SAS 7* communications) but failed to persuade management to refrain from using such tactics and also failed to disclose these abuses in their audit report.

9. This research is reviewed in the following section.

10. An earlier version of the research instrument was pilot tested on a sample of audit practitioners (five audit managers and four audit partners of Big Eight firms). The comments and suggestions provided by these individuals were considered in developing the final version of the instrument.

Where appropriate, *t*-tests were used to determine whether mean responses for predefined subject groups were significantly different and whether there were statistically significant differences between mean subject responses and a discrete point (such as, the midpoint) of the given dependent variable scale. The results of these tests are reported in the appropriate data tables.

11. Although the existence of a learning curve effect in auditing is one plausible explanation for the finding of St. Pierre and Anderson [1984] that audit failures occur more frequently following auditor changes, extant empirical research has not investigated whether such an effect actually influences the quality of audit service provided. Nevertheless, Mangold [1984] and Schwartz and Menon [1985], among others, suggest that client management perceives that a learning curve effect influences the likelihood that material errors will be discovered in the course of an audit engagement and acts accordingly.

12. Of course, the choice of which "passive" method to employ will be determined by whether the predecessor auditor is aware of the problematic information. If the predecessor auditor is not aware of the given information, then the manipulative information suppression method would be used. Otherwise, the client would change auditors and assume that the predecessor would not disclose the information to the successor (systemic information suppression).

13. McConnell's study did not yield data demonstrating that auditors, in fact, had failed to disclose prior audit disputes with former clients. However, a recent study by Shaw and Francis [1987] documents numerous cases in which auditors failed to disclose such disputes, disputes that were subsequently disclosed by *The Wall Street Journal.*

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THE EVOLUTION OF INFLATION ACCOUNTING IN FRANCE SINCE 1960

Denis Cormier, Helen McDonough,
and Bernard Raffournier

ABSTRACT

This paper describes how the French legislature affected the development of inflation accounting in France from 1960 to the present. The first part of the paper gives a brief historical overview of inflation in France. Next, the organization of the accounting profession is described, illustrating the influence of the State on the profession and on accounting thought. This is followed by a description of the legislation adopted by the French government to respond to inflation, including a discussion of optional and legal revaluation of financial statements. Finally, the latest Exposure Draft of public accountants concerning price-adjusted data is given. A brief discussion and critique conclude the paper.

Research in Accounting Regulation, Volume 4, pages 21-42.
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ISBN: 1-55938-084-5

In the field of accounting, the inflation phenomenon of the past 25 years resulted in many studies aimed at incorporating into accounts, or into the notes accompanying them, the effects of changing prices on the evaluation of net worth and on business performance. The United States and Great Britain made important research efforts in this respect. After much controversy and many developments, the research finally resulted in the adoption of U.S. Statement of Financial Accounting Standards 33 (FAS) in 1979 and Statement of Standard Accounting Practice 16 (SSAP) in 1980 in Britain.

France was not exempt from the effects of inflation. On the contrary, as the Appendix indicates, price increases were greater in France than in most other Western countries. However, studies comparable to those done in the United States and Great Britain were undertaken only later in France. Among these, Lecointre [1977], Burlaud [1979], Seneterre [1980], Boussard [1983], and Gensse [1985] are well-known examples. However, the Conseil National de la Comptabilité (CNC), the governing national accounting board in France, remained silent; it was not until 1981 that the Ordre des Experts Comptables et des Comptables Agréés (OECCA), the major professional accounting body in France, presented the results of a study in the form of an *avis* (exposure draft) of an experimental nature.

The delay of French research on an overall procedure to adapt accounting information to inflation does not imply that accounts omitted the effects of changing prices. In fact, many corrective measures were taken at an early date to compensate for certain specific effects.

The purpose of this paper is to describe the manner in which inflation was incorporated into the accounts of French businesses since 1960. We will show that the State played an important role through tax and other legislative measures. To fully understand the importance of this, it is necessary to understand the organization of accounting in France.

THE ORGANIZATION OF ACCOUNTING IN FRANCE

This section will briefly review the differences in the national economies, the goals for accounting, the structure in which standards are set, and the major factors which had an influence on the standards relating to inflation accounting.

French accounting differs from its Anglo-Saxon counterparts in the involvement of the State in all stages of development and control of accounting procedures.

The State first becomes involved through the CNC, the main standard-setting body. The purpose of this institution, which was created by the State and is governed by the minister of economic affairs, is to coordinate and synthesize accounting research. Its members come from three equal categories: accountants (public accountants and accounting executives); corporate

directors and labor and trade organization representatives; civil servants and magistrates. As a consulting organization, the CNC must give advice before any accounting regulation is imposed by the State [AICPA, 1988, p. 1-3]. The CNC can also propose "... any measures relative to the rational use of accounts, either in the interest of business and professional business groups, or to establish national statistics or national budgets and economic accounts" [*Journal officiel de la République française,* Decret (Decree) 57-129 (February 7, 1957), modified by Decret (Decree) 64-266 (March 20, 1964)].

This quotation, which sets both public and business interests on the same level, shows the importance the State grants to accounting as a source of economic information. The State demands data that is reliable and easily aggregated, which can only be obtained by standardizing the presentation and valuation of the accounts (for an in-depth analysis of the objectives sought by the French national accounting system, see Miller [1986]). This led the CNC to develop the Plan Comptable Général (Uniform Chart of Accounts), which includes all accounting standards and rules applicable in France. It is not only a coded chart of accounts, but also contains precise rules for each account, and for the valuation of transactions and the presentation of financial statements. This extremely detailed plan leaves firms few options for the preparation and presentation of their financial statements. A first Plan was published in 1942, but the war postponed its implementation; it became effective in 1947 in a slightly modified form. The Plan was revised in 1957 and extensively revised in 1982. It is compulsory for industrial and commercial firms, but all French businesses use the Plan, with the exception of those which must use specific procedures, such as banks and insurance companies.

The dominant role of the State in the introduction and control of accounting procedures reflects the importance of the State in French economic life. Since the end of World War II, every government has endeavored to plan and control economic activities. Indicative planning was introduced in 1946. It coincided with the creation of the Commission de Normalisation des Comptabilités (Accounting Standardization Commission), a forerunner of the CNC. In addition to these activities, the State controls entire segments of the national economy, for example, banking, insurance companies, and energy. In 1954, the State-owned firms accounted for 28 percent of the revenues of industrial and commercial firms in France [Eck, 1988, p. 50]. By the end of 1986, the State controlled, either directly or indirectly, 15 percent of the largest industrial firms [*Science et Vie Economie,* 1988, p. 46].

The influence of capital markets has always been weak, due to the particular structure of capitalism in France, which for the most part has been made up of small, privately-financed firms. Morin [1974] showed that, as late as 1971, 50 percent of the largest 200 French firms were still family-controlled. Since then, an increase in individual share ownership and the creation of a secondary market for small firms have helped decrease this percentage, but the stock

exchange in France has remained nonetheless smaller than its European or American counterparts. The financial market's lack of influence is intensified by the fact that the Commission des Opérations de Bourse (COB), an organization that controls the operation of the stock market and the information published by listed corporations, cannot rely on sanctions to enforce its decisions [Durand, 1983].

The accounting profession plays but a minor role in the development of accounting procedures. The main reason for this is the State's dominant role, but besides this, standardization projects are not, as in Anglo-Saxon countries, the object of exposure drafts. Businesses therefore are unable to express their opinions except through their representatives on the CNC, yet because these representatives are supposed to act on behalf of business as a whole, they can only defend common interests. Member associations of the OECCA may issue recommendations; these are not compulsory and sometimes clash with the Plan Comptable Général, which has force of law. Finally, it is important to note that the existence of two rival organizations (the OECCA and the statutory auditors) does not strengthen the role of professionals.

The distinction between *experts-comptables* (members of the OECCA) and *commissaires aux comptes* (statutory auditors) lies in the source of their mandate. The former are named by company directors, with whom they have contractual obligations. The latter are named by the shareholders at their annual meeting and their duties are defined by law. In practice, an individual can belong to both organizations since, though it is forbidden to act simultaneously as expert-comptable and commissaire aux comptes within the same firm, one can be expert-comptable for one firm and commissaire aux comptes for another.

The influence of academics in the development of accounting is even weaker. The inflexibility of accounting regulations has for many years discouraged researchers from a subject which had been reduced to the prescribed methods of recording economic operations. As stated by Scheid and Standish [1988], major theoretical research in accounting has not taken place in France since the promulgation of the Plan Comptable Général in 1947; most articles and texts published since then have been limited to interpreting and commenting on the provisions of the Plan.

Using its regulatory authority, the State has led accounting in a direction consistent with the State's interests. It has been asserted that the high level of standardization that the Plan Comptable Général has generated serves to produce information useful for the preparation of economic policies. Another factor influences the State in its accounting actions: to limit the divergence between accounting and tax procedures in determining profit. Similarity of these rules facilitates fiscal control and reduces processing costs engendered by going from accounting income to taxable income. It is thus not surprising that taxation, for the most part, has been assimilated into commercial accounting

in France. In a 1987 study comparing the relationship between taxation and accounting, the Organization for Economic Cooperation and Development (OECD), classified France among "uniform reporting countries" as opposed to Anglo-Saxon countries which are part of "separate reporting countries."

This tax conformity results in the following principle: an expense cannot be deducted from fiscal income until it has been accounted for. Thus, in order to benefit from accelerated depreciation for tax purposes, the firm must enter this amount of depreciation into its accounts, even if it exceeds the normal depreciation of the asset. In certain cases, this procedure may even lead to accounting entries that are purely fiscal. For example, to benefit from an option offered to businesses that create foreign subsidiaries, the firm must enter as a liability a *provision pour implantation commerciale à l'étranger* (a provision for the expense of foreign investment) for which the calculation terms are established by tax legislation [Castagnède and Toledano, 1987, p. 184]. It is obvious that the impact of tax rules on accounting alters the image that financial statements present of the economic situation of the firm. The deterioration of the quality of accounting information is the price the firm must pay in order to minimize its tax liability.

We have shown that accounting in France is characterized by two phenomena: the undeniable power of the State to establish accounting procedures and the relative conformity of these procedures with tax accounting. These characteristics are most noticeable in the methods by which the effects of inflation were incorporated into the accounts of French businesses, specifically:

1. The law decides when and how balance sheets must be revalued.
2. Any adjustment for the effects of inflation on income statements are essentially made through the income tax laws.

THE ADJUSTMENT OF PROFIT: THE EFFECTS OF TAX LAWS

The high inflation rates beginning in the late 1930s resulted in the government modifying certain tax rules to avoid taxing so-called fictitious profits. The basic rules for revaluation were contained in the *ordonnance* (law) of August 15, 1945. This gave firms the option to revalue their assets. Sole proprietorships, partnerships and corporations were eligible, but not obliged, to use the proposed revaluation methods. The choice of balance sheet accounts that would be revalued was left to the discretion of the individual firms, with the exception of organization expenses and goodwill which were not allowed to be revalued. The main elements to be revalued were inventory and fixed assets [Ordonnance no. 45-1820, 1946].

As for fixed assets, an index of goods of which most fixed assets were composed was used. Hence the method sought to eliminate the effects of changing prices on specific goods rather than to reflect changes in the general price level. The use of *specific indices* for revaluation purposes, such as the index for a sophisticated machine or for a building, is appropriate for measuring changes in the physical substance of the invested capital, whereas a *general index* provides a common basis for measuring changes in the invested monetary capital of a firm. Hence, the latter is more consistent with the objectives of general price level accounting. The French approach is thus "middle of the road"; that is, a compromise between the use of a specific index and a general index. Such an approach is difficult to justify and the resulting statements are difficult to interpret. Furthermore, the revaluation was optional and left to the discretion of firms, thus destroying the comparability of financial statements and making manipulation of results possible [Holzer and Schönfeld, 1963, p. 387].

In the case of inventory, a specific wholesale price index was used. The implied intent was to exclude general as well as specific price changes. At the time, several authors indicated that the use of last-in, first-out (LIFO) for inventory valuation could more easily achieve this objective given the lack of accuracy of the indices used [see, for example, McKeown, 1979, p. 65].

Since 1959, the State has observed closely the effects of inflation on business income and has taken measures to enable firms to maintain their productive capacity despite price increases. It instituted a series of tax procedures aimed at avoiding taxation of the fictitious portion of profits and enabling the firms to maintain the level of fixed assets and inventories. Taxing only real profits generates higher cash flows to firms, due to the lower taxes paid, and leads to a more efficient rational resource allocation since the true value of the firm is better reflected. However, this practice also diminishes State revenues, reduces the possibilities of the State to intervene in the economy, is complicated to administer, and can in fact fuel inflation in the long run.

Adjustment of Depreciation

Tax authorities do not establish depreciable life; rather, firms determine their own estimates by taking into account such factors as professional standards and the particular circumstances and uses of the asset in question. However, the State has published for indicative purposes a list of depreciation rates most commonly used [Ministère de l' économie et des finances, Documentation administrative, 4D-142]. These rates correspond to depreciable lives of 20 to 50 years for buildings and four to ten years for equipment.

The published rates closely reflect the actual measures of asset life determined by statistical surveys. According to one study done by Mairesse [1972] the average depreciable life of fixed assets is about 30 to 40 years for buildings

and 12 to 20 years for equipment. Another study conducted by Lecointre [1977] evaluates a depreciable life of 34 years for buildings, and between 12 and 17 years for other fixed assets. These estimates show that, as far as buildings are concerned, there is a consistent correspondence between fiscal depreciation and actual life of buildings. In addition, they reveal that equipment is depreciated, for tax purposes, much more rapidly than its economic depreciation. This is intensified by the reducing balance method of depreciation.

The reducing balance method of depreciation is an accelerated depreciation of fixed assets. By law, it can be used only for new equipment bought by the firm [Goré and Jadaud, 1980, p. 801]. The amount of depreciation is obtained by applying a rate to the net value of the asset at the beginning of the fiscal year. This rate is obtained by multiplying the depreciable life of the asset by a coefficient that is itself a function of this depreciable life and is established by tax authorities. These coefficients have varied according to the government's desire to either increase or decrease business investment. The most frequently used coefficients are 1.5 for a depreciable life of three or four years, 2 for a life of five or six years, and 2.5 for a life greater than six years. The relative importance of this depreciation method can be judged through a recent study [Groupe d'étude sur les durées d'amortissement, 1987, p. 118] which estimated that 33 percent of all depreciation claimed was calculated by means of the reducing balance method.

Adjustment for Increases in the Cost of Inventory

To enable firms to maintain inventory levels despite inflation, tax authorities allow firms to deduct from their taxable income part of the nominal increase of their inventory cost between the beginning and the end of the fiscal year through the use of a *provision pour hausse de prix* (price increase provision). When the price of a product has undergone an increase of more than 10 percent within two years, the firm may deduct the fraction of the increase above 10 percent. This provision is calculated separately for each inventory account. The maximum amount of the provision at the end of the fiscal year is equal to the product of the quantity of inventory at that time and 110 percent of the unit cost at the end of one of the last two fiscal years. This maximum is reduced by the provision established during the last fiscal year. Whatever the previous increase in cost may have been, the provision must be transferred to the income statement within six years [Goré and Jadaud, 1980, pp. 810-812].

The Accounting Consequences of these Tax Procedures.

Because of the procedure requiring an expense to be entered in the accounts in order to be deducted from taxable income, firms that wish to take advantage of these tax measures must conform their accounting to these procedures:

- use the reducing balance method of depreciation with unusually short depreciable life;
- enter the price increase provision for inventory as an expense.

It is in this manner that, for the past 30 years, French businesses have adjusted their income statement for the effects of inflation. The efficiency of these adjustments is questionable.

The use of excessively short depreciation periods and of the reducing balance method certainly reduce the gap between fiscal depreciation and the depreciation that would be obtained through revaluation. However, these measures are frequently insufficient to permit the replacement of productive capacity during periods of inflation.

It is clear that the reducing balance method of depreciation alone is incapable of accomplishing this. Gensse [1985], when simulating the effects of the reducing balance method of depreciation for different lengths of use and different inflation rates, has shown that the sum of the depreciation expenses does not reconstitute the replacement value of the fixed asset. Moreover, the results indicate that for low inflation rates and short depreciation periods the straight-line method of depreciation is more efficient than the reducing balance method.

Furthermore, it has been asserted that even the use of both measures combined (reducing balance depreciation and short depreciation life) is insufficient to compensate for changing prices, at least during periods of high inflation. A recent study conducted by the Institut National de la Statistique et des Études Economiques (INSEE), the body responsible for statistical and economic studies, reveals that between 1975 and 1983, fiscal depreciation expenses remained below economic depreciation calculated using the actual life of fixed assets and using bases revalued each year according to the consumer price index [Groupe d'étude sur les durées d'amortissement, 1987, pp. 24-25].

As for the price increase provision, the part of the increase of inventory value below 10 percent is not taken into account. Burlaud and Illien [1977] estimate that as a result, only 50 percent of the total nominal increase in the cost of inventory is adjusted for.

It is equally important to note that the effect of these measures is temporary, since the price increase provision must be transferred to the income statement within six years. The State is not eliminating taxes on the strictly nominal increase of inventory cost; it is simply postponing its assessment. Similarly, if the reducing balance method or the use of short depreciation lives increases the amount of depreciation during the early years, it does so to the detriment of future amounts. The firms that wish to maintain constant self-financing have no option but to renew their fixed assets more and more rapidly, thus reducing their available capital and overextending their productive capacity. This process in itself increases inflation significantly.

The main problem with this adjustment system is that it is fiscal in nature. Most businesses support the use of accelerated depreciation, or the use of a price increase provision, because of the resulting reduction of taxes. It is evident that profitable firms are more apt to use the reducing balance method of depreciation, to use shorter depreciation periods, and to establish a provision for price increases, than are firms experiencing a loss. A study conducted by the Crédit National verifies this. The study reveals that between 1981 and 1984, the average length of accounting life of fixed assets was established at 19 years for firms experiencing a loss and at ten years for profitable firms. Similarly, among firms experiencing a loss, the amount of depreciation calculated under the reducing balance method is 24 percent of the total depreciation expense; the corresponding percentage among profitable firms is 37 percent [Groupe d'étude sur les durées d'amortissement, 1987, pp. 23-25]. Although these discrepancies may reflect different types of assets or voluntary income smoothing, they also reflect fiscal considerations and interfere with comparisons among companies.

Finally, on the balance sheet, the subtraction of increased depreciation expenses from a base that remains at historical cost results in a general undervaluation of fixed assets. Although this is limited somewhat by the rapid renewal of assets that these measures bring about, in general, net assets will be undervalued. It was thus necessary to allow correction of the balance sheet by a revaluation of fixed assets.

ADJUSTMENT OF THE BALANCE SHEET: REVALUATION OF FIXED ASSETS

Since the end of World War II, the State has repeatedly established legal revaluation procedures. From 1945 to 1959, numerous laws enabled French businesses to revalue their fixed assets, marketable securities, and accounts payable and receivable in foreign currency. The disclosure of these measures is not within the framework of this paper. It is important to note that the revaluations were optional, that the method consisted in using an index that was representative of general price increases and that the holding gains obtained were entered into an owners' equity account that could be expensed over time [for an example, see Cormier, 1984]. A new legal system was established in 1977, which will be discussed later in this paper. Outside of the application of these particular systems, firms had recourse to "optional revaluations."

Optional Revaluations

Since 1960, the absence of regulation has not, theoretically, prevented revaluations. In fact, according to numerous governmental statements, a firm

has always had the right to revalue its balance sheet even in the absence of legal regulation; the firm's primary obligation is to present an exact and accurate balance sheet, and in times of monetary depreciation, a balance sheet that is not revalued may be considered inaccurate [*Journal officiel de la République française*, April 30, 1947, p. 1376, January 14, 1961, p. 27]. During the past 30 years, with the exception of the period between 1977 and 1979 when a legal system was in place, revaluation has been rather unrestricted. It is useful, however, to consider three separate intervals within this period.

From 1960 to 1976 freedom in revaluation was at its greatest. The only constraint was not to redistribute holding gains but to enter them, rather, into an *écart de réévaluation* (revaluation adjustment) account in owners' equity [see Conseil National de la Comptabilité, 1972].

The 1977 legal system influenced the framework of optional revaluations when they were reintroduced in 1980. The COB estimated that, based on a statement by the minister of economy and finances that ". . . the regulations dictated for legal revaluation are consistent with generally accepted accounting principles whose range is not limited to the implementation of this regulation" [*Journal officiel de la République française*, November 9, 1977, p. 2650], the optional revaluation of nondepreciable assets was to be established at their value in use, as defined by the 1977 texts concerning legal revaluation [Commission des opérations de bourse, January 1978, p. 10].

Finally, in 1983, legal accounting requirements were aligned with the procedures adopted by the IVth European Directive. At that time, numerous procedures involving revaluations were introduced into the Code de Commerce [Loi no. 83-353, Article 12-4].

These procedures, which are still in use, officially recognize the possibility of revaluing "the total fixed and capital assets." According to the Compagnie Nationale des Commissaires aux Comptes (CNCC), the national association of auditors, the omission of intangible assets signifies that they cannot be revalued [CNCC, 1984]. It is equally important to note that the use of the word "total" prevents partial revaluations.

The text also specifies that the revaluation adjustment must be entered directly as a liability (that is, without passing through an income statement account) and cannot be used to compensate for losses. As in the past, the adjustment cannot be distributed but may be expensed over time.

Finally the accounting modifications that result from the revaluation must be described and justified in the notes accompanying the financial statements [*Journal officiel de la République française*, Decree issued November 29, 1983].

All these procedures seem rather unrestrictive, especially when compared with the ban on revaluation adopted in other countries. This is all the more surprising in France, where accounting is carefully regulated. The reason lies in the tax consequences of these operations: at no time were optional revaluations used in conjunction with a reduction in tax. In other words, firms

that use optional revaluation must pay normal tax rates on holding gains. The State obviously has no incentive to restrict or strictly regulate a practice that generates voluntary contributions to its revenues. This illustrates once again the importance of fiscal considerations in understanding the accounting regulation framework.

Furthermore, in practice, tax measures make optional revaluations extremely costly, even if, as Burlaud [1979, p. 55] mentions, the taxes paid on the adjustment on revaluation of depreciable assets (holding gains) is compensated by tax savings later on in the calculation of depreciable expenses on revalued bases. Only those companies that have large loss carryovers can consider these operations since in France, a fiscal loss can be deducted from taxable income for five years following the year of the loss. Hence, although precise statistics are not available on the subject, it appears that very few firms used optional revaluation.

In contrast with optional revaluation in effect since 1980, under which firms pay taxes on holding gains, the legal revaluation system in effect between 1977 and 1979 did not tax such gains, as will be seen in the following section.

The Legal Revaluation of 1977

From 1973, the drastic increase in inflation and the lack of success of optional revaluation motivated public authorities to consider instituting a new legal revaluation system, along with tax exemptions for holding gains. Within the framework of the preparation of the VII Plan, a commission was created in order to study the new system. This group, known as the Commission Delmas-Marsalet, from the name of its president, produced a report that served as a basis for regulation [Commissariat Général du Plan, 1976].

The proposals made by the commission were ambitious. The commission recommended a global revaluation of the total balance sheet (fixed assets, current assets, equity and liability). The method suggested was constant purchasing power with a general price index. Assets that had experienced specific price increases, could be revalued at their current or replacement value. Finally, the commission recommended revaluations of balance sheets on an annual basis.

The laws that set the State budget for 1977 and 1978 defined the terms of revaluation. The fact that these procedures came from budgetary texts is yet another example that fiscal aspects had priority when defining accounting procedures. Furthermore, the system instituted by these laws was quite different from the proposals made by the Delmas-Marsalet Commission.

Instead of total revaluation as was recommended, the law stated that only fixed assets could be revalued [Loi des finances pour 1977 (1976), Loi des finances pour 1978 (1977)]. The constant purchasing power method was set aside in favor of the concept of value in use. Finally, revaluations were not

practised on a yearly basis; a single adjustment on the basis of value in use at December 31, 1976, was made instead.

The law stated that nondepreciable fixed assets should be revalued "according to their usefulness to the firm . . . (as approximated by) their estimated replacement and reproduction cost" [Loi des finances pour 1977]. A decree issued later specified that this value was analogous to current value notion defined by the CNC:

> the value to be used for each (nondepreciable) fixed asset should correspond to the amount a prudent corporate executive would accept to pay to obtain the fixed asset if the executive would have had to purchase the asset, taking into account the usefulness of the asset in helping to attain company objectives [*Journal officiel de la République française*, Decree issued June 1, 1977, article 4].

The legislature, judging in all likelihood that a similar approach would result in the overvaluation of depreciable assets, limited the revaluation of these to a ceiling obtained by multiplying the accounting value of the asset on December 31, 1976, by a coefficient set by decree and which represented price changes in the construction industry dating from the acquisition of the asset [Loi des finances pour 1978 (1977)].

The final result of the revaluation adjustment differed according to the type of fixed asset. For nondepreciable assets, the adjustment was entered into a *réserve de réévaluation* (revaluation reserve) account in equity. This reserve, which is not distributable, could be incorporated into equity with very modest taxes (220F at the time).

The revaluation adjustment arising from depreciable assets was also entered in equity, but in a *provision de réévaluation* (revaluation provision) account which was only temporary. The account was, in each fiscal year, debited by a sum equal to the additional depreciation expense resulting from the revaluation. The following example illustrates the method:

Consider equipment acquired in 1971, whose accounting value on December 31, 1976, was 400F. By using the coefficient for 1976, 1.55, the equipment was revalued at 620F. If the residual life on December 31, 1976, were four years, the annual depreciation expense from 1977 to 1980 was increased by $(620 - 400)/4 = 55$F. Each year, this additional expense was compensated by transferring to income a fraction equal to the revaluation adjustment. Through this mechanism, the income of fiscal years following the revaluation was not affected.

This accounting neutrality was accompanied by a fiscal neutrality since the revaluation adjustment was not taxed. But in return, tax authorities stated that in case of subsequent disposal of fixed assets, tax would be calculated on accounting gains increased by the revaluation adjustment that had not been transferred to income, that is, on the accounting gains that would have been obtained without revaluation.

The main problem with this revaluation system is its selective nature; limiting revaluation to fixed assets does not adjust for all the effects of inflation on the balance sheets. As Lecointre [1979] noted, it is particularly unacceptable that gains and losses on monetary items were not taken into account. According to Delmas-Marsalet [1976], president of the workgroup that proposed the revaluation, two factors prevented doing so. First, the State did not want to encourage a general indexing of accounts payable and receivable. Second, the taxation of gains on monetary liabilities that inflation creates should have been accompanied by tax deductions for the corresponding lenders' loss. Being unable to predict all the consequences of the changes to its revenues, the State preferred maintaining the status quo.

The logic behind the method can be criticized. First, a procedure that combines indexing of depreciable assets and evaluation at replacement cost for other assets is questionable. Also, the objective was to adjust for the effects of inflation on the balance sheet without affecting the firm's future income. Normally this is impossible, since the revaluation of fixed assets must result in an increase in the depreciation base. The solution adopted led to a neutral adjustment only by making the effect of the revaluation very temporary. The only revaluation adjustment that can be seen in present-day balance sheets arises from buildings, due to the long life of this particular asset. Accounting neutrality of the adjustment has thus prevented the development of any lasting measures to deal with inflation.

Finally, because the State refused to allow tax deductions on the additional depreciation caused by revaluation, part of the cash flow needed to renew fixed assets was always taxed. Of course, the maintenance of previous tax measures (reducing balance depreciation and abnormally short depreciable life) reduces the tax burden. Nonetheless, as Broncy [1979] notes, the risk of tax appropriation on the capital of the firm remains.

All in all, the legal revaluation of 1977 appeared to many to have limited benefits, due to the temporary and selective nature of the adjustments made on the balance sheets, and also due to the absence of tax reduction measures [see in particular Broncy, 1979; Lecointre, 1979; and Pierret, 1980]. It is thus not surprising that few firms showed interest in it.

A study conducted by Micha [1980] using information from the Centrale des Bilans de la Banque de France (the National Financial Statement Archives) showed that half of the firms that had to revalue their balance sheets, that is, public companies and their main subsidiaries, waited until the last possible year (fiscal 1979) to begin revaluation, and that less than 10 percent of firms for which revaluation was not mandatory elected to use it. Similar findings were obtained in a study conducted by Desreumaux [1982].

Overall, balance sheet revaluation, be they optional or legal, had but limited success; optional revaluations were costly in taxes and legal revaluations were fiscally neutral. The inability to incorporate the effects of inflation directly into

accounts led many researchers to wonder if, considering foreign practices, the solution would be to publish extra-accounting information [see, in particular, Broncy, 1979]. This opinion inspired the latest developments on the subject.

THE OECCA EXPOSURE DRAFT

In 1981, the OECCA published an avis (exposure draft) on the manner in which accounts could be adjusted for the effects of inflation. The document, which never became effective, does not challenge the historical cost principle on which French accounting is based. Rather, its purpose is to complete the information already existing in such a way as to allow a better interpretation of financial information. The approach has two objectives: (1) to adjust the firm's income by matching revenues with their current costs, in order to identify the cash flow needed to maintain production capacity; and (2) to show the effect of inflation on the net monetary position.

The Adjustment of Income by Setting Cost of Goods Sold and Depreciation at Current Costs

Setting cost of goods sold at current cost is accomplished by restating the amount of depreciation and the cost of inventory. To calculate depreciation, the OECCA rejected the use of replacement cost. It considered the notion subjective since replacement frequently occurs only after many years following the restatement and it may not involve an identical good. The recommended method thus consists in calculating depreciation from historical cost, revalued by using a general price index. For the cost of inventory, the OECCA estimates that indexing on purchasing power is not sufficient, since specific price changes may be greater than general price changes. According to the OECCA the best procedure, theoretically, would require that the firm permanently calculate the replacement cost of the inventory it uses. Due to the practical difficulties of doing so, the OECCA suggested the use of LIFO which should result in a relatively similar outcome. (Presently, in France, the use of LIFO is forbidden for financial statements as well as for tax purposes [Loi no. 83-353, art. 12, (1983), and Ministère de l'économie et des finances, Documentation administrative 4A-252 respectively]). The OECCA does not exclude the possibility of experimenting with other methods, namely the use of specific or general indexes or the institution of an inventory replenishment reserve taken from predetermined minimum stock.

It is important to note that the operating profit in the regular French inflation accounting model differs from the operating profit in the American model. This difference is due to the French asset valuation system which is a mixture of current entry prices and indexation by the general price level. In fact, as far as inventory is concerned, France recommends methods aimed at restating

it at current entry prices, which corresponds to the American approach. However, for the revaluation of fixed assets, an index representative of general price changes is suggested. This is not logical, as Lemaire [1983] states.

The operating profit as well as the value of restated assets will differ from reality in the case where specific price changes differ greatly from general price movements. In this sense, the theoretical models developed by Edwards and Bell [1961], Chambers [1965], and others did not contribute greatly to the preparation of the French avis.

Consequences of Inflation on the Net Monetary Position

The treatment of depreciation and cost of inventory does not consider the impact of financial structure on the firm's accounts. However, given that monetary items are affected by the depreciation of money, the effects of inflation on these elements create either gains or losses. French firms can deal with the impact of financial structure in three ways: the monetary gain (or loss), the net financial charge, and the financial adjustment methods. Each will be discussed in turn.

The monetary gain (or loss) method consists of "showing the impact of monetary depreciation (gain/loss on the general price level) on the net monetary situation (net monetary assets/liabilities) of the firm" [Conseil Supérieur de l' OECCA, 1981, p. 6, translation]. According to this method, one arrives at the same result as that obtained under FAS 33 as far as the concept of real financial capital maintenance is concerned.

The net financial charge method requires "indicating what the amount of interest expense would be if it were calculated on the basis of an interest rate net of inflation" [Conseil Supérieur de l' OECCA, 1981, p. 6, translation]. This method consists, on the one hand, in recognizing a monetary gain on borrowed capital and, on the other, in reducing the interest expense by a corresponding amount. The portion of the gain on debt due to the general price level is directly linked to the interest expense. This method may be useful in terms of presentation, but it ignores the effects of inflation on accounts other than interest-bearing loans. However, assuming that the monetary gain (or loss) due to inflation is calculated on each monetary item, the various sources of this gain can certainly yield useful information to the reader. Furthermore, there is considerable, though not unanimous, support for the basic approach:

> Financial experts consider that a portion of interest expense corresponds, during an inflationary period, to an anticipated reimbursement of capital and not to an expense, this anticipated reimbursement of capital being in consideration of the loss of money value [Broncy 1979, p. 8, translation].

Finally, this method can yield very different results from the first when debt accounts for only a portion of net monetary liabilities. The method is acceptable

when used in conjunction with the first method but may be inappropriate when used alone.

The financial adjustment method consists of "applying a ratio representative of the financial structure to adjustments of inventory and depreciation" [Conseil Supérieur de l' OECCA, 1981, p. 6, translation]. This third approach ties in closely with the financial adjustment suggested in Canada in Section 4510 of the Canadian Institute of Chartered Accountants Handbook [CICA, 1982], or the gearing adjustment proposed in SSAP 16 of the Accounting Standards Committee in England and Wales.

The impact of financial structure can therefore be shown in the French approach in three different ways. The first two methods are based on the concept of real financial capital maintenance while the third method refers to the concept of productive capacity maintenance, although this is not specified in the avis of the French public accountants.

The OECCA prefers the first approach since it is coherent with the suggested treatment of depreciation and cost of goods sold: namely, after having done the restatements to account for general inflation on the nonmonetary accounts, the contraaccount of the corrections becomes in a sense the gain or loss on general price level changes due to monetary items.

Impact of Financial Structure and Restatement for Inflation

The amount restated for inflation can be considered the amount necessary for real financial capital maintenance, and, in order to achieve this, it is not appropriate to simply multiply beginning capital by the consumer price index. Although the French model does not require a complete set of financial statements at current cost, it is nonetheless important to understand this restatement to evaluate the implications of the recommendations contained in the avis.

To obtain the amount required for real financial capital maintenance (shown in Table I in Owners' Equity), one must subtract from the fictitious portion of nonmonetary gains the gain on net monetary liabilities. In the case where one decides to consider the impact of the financial structure by calculating the financial expense net of inflation, as permitted in France, the restatement for inflation will be different.

In effect, according to the method of financial expense net of inflation, one does not calculate a gain or loss on net monetary liabilities but rather a monetary gain on the fictitious portion of interest expense. The difference in the amount of restatement for inflation between the two methods corresponds to the gain or loss on monetary assets or liabilities that are interest-free. Hence, monetary depreciation on a portion of monetary items is not taken into account and one can conclude that the method of net financial charge, which is recommended in France, does not fully reflect real financial capital maintenance [for a numerical example, see Cormier, 1984].

Table 1. French Model Under Different Capital Maintenance Concepts

	*RFCM**		
	Monetary Gain Method	*Net Financial Charge Method*	*PCM***
Income Statement			
Sales	S	S	S
Expenses—current cost	ECC	ECC	ECC
Operating profit—current cost	OPCC	OPCC	OPCC
Real realized holding gains	RRHG	RRHG	
Monetary holding gains	MHG		
Financing adjustment			FA
Net profit	NP	NP	
Profit attributable to common shareholders			PAS
Owners' Equity			
Capital Stock	CS	CS	CS
Inflation adjustment	IA	IA***	
Profit	NP	NP	PAS
Total fictitious holding gains			TFHG
Total real holding gains			TRHG
Nonrealized real holding gains	NRHG	NRHG	
Financing adjustment			(FA)
	Total	Total	Total

* RFCM: real financial capital maintenance.
** PCM: productive capacity maintenance.
*** Under the net financial charge method, the holding gain on monetary liabilities is calculated on interest-bearing loans only and, hence, the inflation adjustment figure (IA) differs from that calculated under the monetary gain method (IA).

Positions Taken Concerning the Concepts of Capital Maintenance

France, like Canada, does not seem willing to adopt any particular concept of capital maintenance in its entirety. The Americans, though, have opted for real financial capital maintenance in FAS 33. It is mentioned in the French avis that it is necessary to ascertain if one's economic potential has been maintained; but when the impact of financial structure on income is considered, it is suggested to calculate the gain on the general price level caused by net monetary liabilities, which reflects the concept of real financial capital maintenance.

Since different goals concerning accounting information presentation can correspond to different concepts of capital maintenance, it is beneficial that the accounting profession give company directors latitude concerning which concept they will adopt.

Lemaire, for example, believes that the concept of productive capacity maintenance is a "concept of specialization characterized by rigidity," whereas

the concept of real financial capital maintenance is a "concept of diversified investments over time, characterized by flexibility and mobility" [Lemaire, 1983, p. 21, translation].

Capital Maintenance Concepts and Financial Adjustment

Financial adjustment is an attempt to transfer a part of the gains to the shareholders since creditors participate in the financing of the firm. But in fact, the real transfer from creditor to shareholder is the gain on net monetary liabilities due to inflation, and this amount is applicable only within the concept of real financial capital maintenance.

Financial adjustment is justified only in a current cost model that ignores general inflation (nominal current cost accounting), which is obviously not the model suggested in France, in Canada, or in the United States. Mattessich [1982, p.4], in his critique of the Exposure Draft of the Canadian Institute of Chartered Accountants "Reporting the Effects of Changing Prices-second version," stated:

> If this much more accurate tool (combining specific with general price level changes) is available, then there is no longer any need to calculate the financing ratio (as an adjustment to purchasing power transfer) by applying the debt-equity ratio to the total confusing mixture of real and fictitious holding gains.

Holding Gains That Should Be Part of Financial Adjustment

Both realized and unrealized holding gains should be part of financial adjustment. In the context of a going concern, it is excessively cautious to ignore nonrealized holding gains in calculating the financial adjustment.

The French avis maintains nonetheless that the revaluation must be done on holding gains realized during the period.

French Asset Valuation System and Financial Adjustment

The financial adjustment is affected in two ways by the valuation system suggested in France. First, the ratio differs due to the fact that fixed assets are restated according to changes in general price level rather than to changes in specific prices. Second, the amount of holding gains to which the ratio is applied is based only on realized holding gains. Hence it is a restatement calculated partly on nominal gains and partly on fictitious gains.

CONCLUSION

Although for many years France was not part of the debate involving the accounting treatment of inflation, the financial statements of French firms

have, in the past 30 years, been the object of important corrective measures aimed at compensating for the effects of changing prices.

The main corrective measures involved income calculation. They stemmed from tax procedures that enabled an increase in the rate of depreciation and the establishment of provisions that compensate for increases in inventory cost. The purpose of these measures was not to measure economic profit in constant francs. Rather, the objective was simply to reduce taxes and enable firms to maintain their production capacities despite price increases. The corrective measures thus did not accurately reflect the effects of inflation. They did, however, result in reducing the gap between accounting and economic income.

The adjustments made to the balance sheet were much weaker. Although their legality was always recognized, optional revaluations were in fact very rare, due to their fiscal neutrality. In practice, only the legal revaluation of 1977, due to its tax exemptions of holding gains, adjusted, albeit temporarily and mildly, fixed assets.

The 1981 OECCA exposure draft, which is noticeably influenced by foreign events, rejects the idea of abandoning the historical cost principle. It merely suggests a few restatements that would enable the presentation, along with financial statements, of supplementary information on the consequences of price changes. Although, since the publication of the avis, the implementation of the proposed methods has been the subject of a published study [OECCA, 1984], the text has not been used, probably due to the slowing of inflation since 1982.

This is similar to the recent trend occurring in Great Britain and the United States [FASB, 1986] where, since 1985 and 1986 respectively, information on the effects of inflation is optional. One possible reason for this change is that with a decrease in inflation, the costs of providing such information now outweigh the benefits. But one can also argue that the experience with inflation accounting in the last seven years has shown it not to be as useful as expected. Indeed, empirical studies on the reaction of capital markets to information on the effects of changing prices have shown that the information content seems rather limited [Cormier, 1989].

(Appendix follows)

APPENDIX

Inflation Rates in France, Canada and the United States (1914-1988)

Year	Canada	United States	France
1914	0.4	1.4	—
1915	2.0	1.2	19.0
1916	8.2	7.4	12.6
1917	18.3	17.6	19.4
1918	13.2	17.3	29.4
1919	9.9	15.1	25.1
1920	15.8	15.8	37.8
1921	(12.0)	(10.9)	(12.6)
1922	(8.5)	(6.3)	(3.8)
1923	0.3	1.8	11.0
1924	(1.8)	0.3	14.1
1925	0.9	2.6	7.1
1926	1.0	0.8	30.2
1927	(1.6)	(1.9)	4.3
1928	0.5	(1.2)	(0.2)
1929	1.0	—	6.2
1930	(0.7)	(2.6)	0.7
1931	(9.7)	(9.0)	(3.9)
1932	(9.3)	(10.2)	(8.8)
1933	(4.6)	(5.3)	(3.3)
1934	1.4	3.4	(4.2)
1935	0.5	2.6	(8.4)
1936	2.0	1.0	7.3
1937	3.2	3.5	25.9
1938	1.0	(1.8)	13.5
1939	(0.7)	(1.5)	6.5
1940	4.0	0.8	18.7
1941	5.8	5.0	17.3
1942	4.7	10.8	20.1
1943	1.2	6.2	23.4
1944	0.4	1.6	23.0
1945	0.5	2.3	48.4
1946	3.4	8.5	52.6
1947	9.6	14.5	49.2
1948	14.4	7.6	58.7
1949	3.7	(1.0)	13.2
1950	3.5	1.0	10.0
1951	10.5	8.0	16.3
1952	2.5	2.3	11.9
1953	(1.0)	0.8	(1.0)
1954	1.0	0.3	—
1955	—	(0.4)	1.0
1956	1.0	1.5	2.0
1957	3.9	3.6	2.9
1958	1.9	2.7	14.2
1959	1.9	0.8	6.6
1960	0.9	1.6	3.9
1961	0.5	1.0	3.3
1962	1.2	1.1	4.9
1963	1.8	1.2	4.8
1964	2.0	1.3	3.0
1965	2.0	1.7	2.9
1966	3.8	2.9	2.8
1967	3.7	2.9	2.8
1968	4.5	4.2	4.5
1969	4.3	5.4	6.0
1970	3.3	5.9	5.6
1971	3.2	4.3	5.3
1972	4.9	3.3	5.7
1973	7.4	6.2	7.1
1974	11.2	11.0	14.2
1975	10.1	9.1	11.7
1976	7.7	5.8	9.8
1977	7.8	6.5	8.9
1978	9.1	7.7	9.3
1979	9.1	11.3	10.7
1980	10.1	13.5	13.6
1981	12.4	10.4	13.4
1982	10.8	6.1	11.8
1983	5.9	3.2	9.3
1984	4.3	4.2	7.4
1985	4.0	3.5	5.8
1986	4.1	1.9	2.7
1987	4.4	3.6	3.1
1988	4.0	4.1	2.6

Sources: *Prices and Price Indexes*, Dominion Bureau of Statistics, Government of Canada, Ottawa; *Main Economic Indicators*, OECD, Department of Economics and Statistics; and *Statistical Abstract of the United States*, Bureau of the Census, Washington, D.C.

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AN EVALUATION OF THE REPORTING STANDARDS FOR LITIGATION:

SOME EMPIRICAL EVIDENCE

James H. Thompson, L. Murphy Smith, and John R. Williams

ABSTRACT

The frequency of litigation has increased substantially in recent years. Involvement in litigation often requires that a company present information in its financial statements regarding its exposure to loss. Some researchers and financial statement users have claimed that disclosure of information regarding litigation is not adequate. This paper analyzes the annual reports of a sample of companies as a basis for assessing the adequacy of reporting standards relating to litigation.

Disclosure of information relating to litigation may be inadequate for two reasons. This disclosure depends heavily on the judgment of management. Although many financial statement disclosures depend upon management's judgment, litigation disclosures depend more heavily on judgment than many other decisions.

Research in Accounting Regulation, Volume 4, pages 43-57.
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ISBN: 1-55938-084-5

The usefulness of litigation disclosure may also be limited because a potential conflict of interest exists. On one hand, management has a responsibility to apply, in good faith, the accounting and reporting standards of *SFAS 5*. On the other hand, management is reluctant to provide information that is adverse to its interests, particularly if the information relates to events that are uncertain.

The results of this analysis indicate that litigation disclosure is often very general, vague, or incomplete. A financial statement user would probably have difficulty in drawing valid conclusions regarding a company's exposure to loss from litigation. This study highlights the difficult disclosure decisions faced by management. A more complete assessment of the adequacy of disclosure provisions related to litigation requires additional research regarding the information needs of users as well as the relationship between litigation disclosures and the ultimate outcome of a lawsuit.

The frequency of litigation has increased substantially in recent years [Andresky, 1986]. Corporations are often defendants in lawsuits in which millions and sometimes billions of dollars in damages are sought. The recent multibillion dollar settlement against Texaco illustrates the adverse impact that a judgment can have. Involvement in litigation may require that a company present information about its exposure to loss in its financial statements. The purpose of this paper is to evaluate current reporting requirements regarding litigation. Financial statements of a sample of companies are analyzed to determine whether the reporting requirements for litigation are adequate.

CURRENT REPORTING REQUIREMENTS

Statement of Financial Accounting Standards No. 5 [*SFAS 5*], "Accounting for Contingencies," provides the standards of accounting and reporting for loss contingencies, including litigation. A loss contingency is defined in SFAS 5 as an existing condition, situation, or set of circumstances involving uncertainty regarding possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. When an enterprise is exposed to a loss contingency, the likelihood of incurring a loss must be assessed. The likelihood of loss must be assessed as probable, reasonably possible, or remote. Based on an enterprise's assessment of the likelihood of loss, one of three alternative accounting treatments must be applied: financial statement accrual, financial statement disclosure, or no accrual or disclosure.

A loss should be accrued by a charge to income when both of two conditions exist:

1. It is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and

2. the amount of the loss can be reasonably estimated. The ability to make a point estimate of loss is not a requirement to accrue a loss; that is, the ability to estimate a range of possible loss satisfies the "reasonably estimated" condition.

Even though a loss is accrued when these conditions exist, certain financial statement disclosures may also be necessary. For example, the nature of the contingency and the amount of loss that was accrued may be needed for adequate disclosure in the financial statements.

If an accrual is not necessary because one or both of the above conditions are not met, or if the exposure to loss exceeds the amount that is accrued pursuant to those conditions, disclosure of the contingency is nevertheless required when the likelihood of loss is deemed at least reasonably possible. In these situations, the nature of the contingency and an estimate of possible loss should be disclosed. If the likelihood of loss is deemed at least reasonably possible, and the amount of potential loss cannot be reasonably estimated, the financial statements should so state.

If the likelihood of loss is remote, disclosure of the contingency is not generally required. *SFAS 5* does, however, require disclosure of certain loss contingencies even though the likelihood of loss is only remote.

THE PROBLEM

The disclosure requirements related to loss contingencies, in particular those arising from litigation, involves a considerable level of judgment. Although many financial statement disclosures depend upon management's judgment, the degree to which judgment is involved differs among them. The need to exercise judgment is more pervasive in preparing financial statement disclosures related to litigation than for other items for several reasons.

First, uncertainty surrounds the outcome of a lawsuit. Thus, the disclosure made and the accrual recorded, if any, are based upon management's judgment, generally in consultation with its legal counsel, of what *may* occur in the future. Thus, the accounting treatment reflected in financial statements that are prepared prior to settling the litigation may not reflect the ultimate outcome. Although several financial statement items require some judgment of what may occur in the future (e.g., determination of a going concern) such judgments are more numerous with litigation because of the large number of claims faced by an enterprise.

Second, an enterprise must assess the likelihood of loss from a contingency as probable, reasonably possible, or remote. The likelihood of loss is deemed "probable" when the chance of occurrence of some future event is likely. Similarly, the likelihood is deemed "remote" when the chance of occurrence

of the future event is slight. If the chance of occurrence is more than remote but less than likely, the likelihood is deemed "reasonably possible." Although these assessments are mutually exclusive, they are subjective. Accordingly, disagreement may exist concerning the likelihood of loss in a particular situation. One result is that two companies faced with identical circumstances may come to a different conclusion regarding the proper accounting treatment [Brackner, 1985]. Yet, both companies may believe that disclosure requirements are met even though the nature and extent of their disclosures differ.

Finally, management's judgment regarding disclosure of litigation creates a potential conflict. On one hand, management has a responsibility to apply, in good faith, the accounting and reporting standards of *SFAS 5*. On the other hand, management is reluctant to provide information about events whose outcome is uncertain, particularly when those events are adverse to its interests. Three factors may contribute to management's reluctance to provide this information.

First, the potential negative impact of a loss accrual on earnings may create an adversarial relationship between management and investors. For some firms, accrual of a loss related to litigation may produce a material reduction in income that could lead to a reduction in the company's stock price. In an effort to mitigate the effect of a loss, management may "time" its loss recognition to a period when the effect is less unfavorable.

Healy [1985] cites an example that illustrates management's tendency to time income-reducing accruals. Management often has a financial stake in reported income through bonus plans based on income or through stock options. Some empirical evidence suggests that managers choose financial reporting alternatives that maximize both current and future bonuses. A bonus plan based on income in which a decrease in current income decreases a manager's bonus encourages a manager to defer recognizing an income-decreasing accrual. Whereas, if a decrease in current income will have no effect on a current bonus, the manager may choose to recognize an income-decreasing accrual now rather than recognizing it in a later period when a bonus might be reduced. The important point is that the personal interests of management may influence accrual decisions.

Second, there is a potential legal consideration to accruing or even disclosing a potential amount of loss. Accrual of a loss may be perceived as an admission of "guilt" or an indication of an amount for which the company would be willing to settle. At a symposium on contingencies and forecasts reporting held by Carnegie-Mellon University's Graduate School of Industrial Administration, Robert Kaplan was quoted as follows:

> If you are involved in litigation and have to estimate the magnitude of the loss and disclose it to the public at the very time you are still litigating against having any liability at all, you may well influence the outcome of the litigation [Ijiri, 1980, pp. 45-46].

Finally, disclosure or accrual of possible loss may invite further litigation from other claimants. Additional litigation may arise in spite of the safe harbor rule [Ijiri, 1980]. The safe harbor rule is a rule adopted by the Securities and Exchange Commission that is intended to provide a "safe harbor" for companies from applicable liability provisions of the federal securities laws for statements made in filings with the Commission or in annual reports to shareholders that contain projections or forecasts. Since disclosure of litigation is a forecast, it falls under the safe harbor rule. As long as the information is disclosed on a reasonable basis and in good faith, it would not be deemed to be false or misleading under federal securities laws. Although a company may be protected from such liability, it is not protected from lawsuits being filed and the resulting expense of defending such actions. Thus, management must weigh the costs of disclosure against the benefits. Ijiri [1980] has suggested that financial reporting has become a system of protecting the corporation from legal liability while outsiders try to find something in the report which can be blamed on the corporation.

METHODOLOGY

A random sample of 100 companies was selected from *Fortune*'s 500 largest U.S. industrial companies [*Fortune*, 1987]. The annual reports of these companies were examined for disclosure related to litigation during 1983-1987.

In this study, litigation is defined as legal action taken against the company in which money damages are sought. Actions and investigations by governmental agencies are generally not included except where money damages are sought (e.g., cease and desist orders are not included). Although there may be an economic impact from these actions, the settlement does not require a dollar outlay.

Based upon the examination of annual reports, each company's financial statement disclosures related to litigation were classified into one of four categories: (1) no disclosure of litigation (NN), (2) a general footnote disclosing the existence of litigation but not disclosing details of specific lawsuits (N), (3) disclosure of specific lawsuits but no accrual of loss (D), and (4) accrual and disclosure of estimated loss from litigation (A).

In addition to classifying the companies as described above, actual settlements of litigation were noted for the years being reviewed. Annual reports and the *Wall Street Journal Index* were used to identify settlements made by sample companies during 1983-1987. When a settlement was noted, the annual report of the preceding year was analyzed to determine whether and to what extent litigation was previously disclosed.

FINDINGS

Disclosure characteristics among the 100 companies during the 5-year period are presented in Tables 1-4. Table 5 summarizes the disclosure pattern of companies

Table 1. Summary of Annual Reports for 1983-1987

	Number of Companies Reporting						
						All Years	
Disclosure Made	*1983*	*1984*	*1985*	*1986*	*1987*	*N*	*(%)*
No Disclosure	42	42	41	39	41	205	(41)
General Footnote	34	34	36	43	44	191	(38)
Disclosure, No Accrual	18	19	20	18	14	89	(18)
Accrual of Loss	6	5	3	0	1	15	(3)
Total	100	100	100	100	100	500	(100)

that settled litigation during this period. Figure 1 graphically illustrates the trend of these disclosure characteristics.

No Disclosure of Litigation

As Table 1 reflects, a substantial number of the companies surveyed either disclosed nothing about pending litigation or included only a general footnote about litigation. From 1983-1987, an average of 41 percent of sample companies provided no disclosure (category one in Table 1) relating to litigation. As Table 1 shows, the number of companies presenting this type of disclosure has remained relatively stable over the 5-year period.

General Footnote Disclosure

In this study, a general footnote is one that discloses the existence of litigation but does not provide information concerning specific claims (category two in Table 1). The typical footnote in this category stated:

> The company is involved in various legal proceedings that arise in the normal course of business. In the opinion of management, these matters, when resolved, will not have a material adverse effect on the consolidated financial position of the company or the results of operations.

The following are two examples of such disclosure:

- *Legal Proceedings*

The company is involved in various legal proceedings generally incidental to its business. While the result of any litigation contains an element of uncertainty, management presently believes that the outcome of any known pending or threatened legal proceeding or claim, or all of them combined, will not have a material adverse effect on the company's consolidated financial position [Champion International, *1987 Annual Report*, p. 49].

- *Contingencies*

  Honeywell is a party to a large number of legal proceedings, some of which are for substantial amounts. It is the opinion of management and legal counsel that losses in connection with these matters will not be material [Honeywell, *1987 Annual Report*, p. 42].

The percentage of sample companies that present only a general footnote ranged from 34 percent in 1983 and 1984 to 45 percent in 1987. The number of companies presenting this type of disclosure increased by approximately one-third from 1983 to 1987.

The individual companies that reported no litigation and those which presented only a general footnote were approximately the same during each of the five years. Of the 42 companies that did not disclose any information regarding litigation in 1983, 25 did not disclose litigation during any of the five years. Ten others either presented only a general footnote or did not disclose any information regarding litigation from 1983 to 1987.

Of the 34 companies including only a general footnote in 1983, 20 included only a general footnote in each of the five years. Seven others either presented only a general footnote or did not disclose any information regarding litigation from 1983 to 1987.

On the average, 79 percent of sample companies did not disclose information about specific litigation claims during 1983 to 1987. Sixty-two percent did not disclose information about specific litigation at any time during the period. These percentages suggest that either a majority of the companies studied is not exposed to litigation that requires disclosure in the financial statements or that litigation matters are not being adequately disclosed.

Disclosure of Litigation Without Accrual

When a company is required to disclose but not accrue a loss from litigation, *SFAS 5* states that disclosure should indicate the nature of the contingency and give an estimate of the possible loss or range of loss, or state that an estimate cannot be made. As Table 1 shows, the number of companies that disclosed but did not accrue a loss from litigation ranged from 20 in 1985 to 14 in 1987. Six companies presented this type of disclosure in each of the five years.

All companies using this form of disclosure described the nature of its litigation. Only 2 percent, however, also disclosed an estimate of possible loss. Table 2 shows the number of these companies that gave an estimate of loss during the survey period.

Table 2. Companies Disclosing Litigation, No Accrual: Disclosure of Estimate of Loss

	1983		*1984*		*1985*		*1986*		*1987*		*All Years*	
	N	*%*	*N*	*%*	*N*	*%*	*N*	*%*	*N*	*%*	*N*	*%*
Estimate of Loss Disclosed	1	6	0	0	0	0	1	6	0	0	2	2
Estimate of Loss not Disclosed	17	94	19	100	20	100	17	94	13	100	86	98
Total	18	100	19	100	20	100	18	100	13	100	88	100

American Cyanamid's disclosure for 1987 is characteristic of disclosures in this category. The note is:

- *Contingent Liabilities and Commitments*

The company and its subsidiaries are parties to numerous suits and claims arising out of the conduct of business. Included among such suits are approximately 245 involving personal injury or death occurring in connection with administration of the company's DTP and oral polio vaccines. Also included are approximately 340 suits (200 of which involve about 1,400 claimants represented jointly by a group of lawyers) involving staining of teeth by the administration of tetracycline antibiotics to young children in the 1960's. The company is currently a party to, or otherwise involved in legal proceedings directed at clean-up of 48 Superfund sites. Many of the foregoing cases involve very large damage claims, including claims for punitive damages. In the opinion of management, the ultimate liability resulting from all pending suits and claims (after taking into account insurance coverage applicable to the events giving rise to such pending suits and claims) will not have a material adverse effect upon the consolidated financial position of the company and its subsidiaries [American Cyanamid, *1987 Annual Report*, p. 43].

This company disclosed three claims: one regarding its DPT vaccine, a second regarding tetracycline, and a third regarding cost recovery activities arising from clean-up of Superfund sites. No indication is given as to the amounts sought by the plaintiff in any of the three claims except that claims "involve very large damage claims, including claims for punitive damages." The footnote goes on to say that the company's "ultimate liability resulting from all pending suits and claims will not have a material adverse effect upon the consolidated financial position of the company and its subsidiaries." This disclosure, while providing ample information about the nature of the litigation, neither indicates the amount of damages sought nor estimates the possible loss (except that the company states that it does not believe any loss will be material).

Accrual of Loss Related to Litigation

Table 3 reports disclosure characteristics of companies that accrued a loss related to litigation (category four in Table 1) during the survey period. As reported in Table 3, the number of companies accruing a liability were few

Table 3. Companies Accruing a Loss: Disclosure of Nature of Lawsuit

	1983		*1984*		*1985*		*1986*		*1987*		*All Years*	
	N	*%*	*N*	*%*	*N*	*%*	*N*	*%*	*N*	*%*	*N*	*%*
Nature of Lawsuit Disclosed	4	67	3	60	1	33	0	0	1	100	9	60
Nature Not Disclosed	2	33	2	40	2	67	0	0	0	0	6	40
Total	6	100	5	100	3	100	0	0	1	100	15	100

Table 4. Companies Accuring a Loss: Disclosure of Amount of Estimate

	1983		*1984*		*1985*		*1986*		*1987*		*All Years*	
	N	*%*	*N*	*%*	*N*	*%*	*N*	*%*	*N*	*%*	*N*	*%*
Amount Disclosed	6	100	5	100	3	100	0	0	1	100	15	100
Amqunt Not Disclosed	0	0	0	0	0	0	0	0	0	0	0	0
Total	6	100	5	100	3	100	0	0	1	100	15	100

in number: six in 1983, five in 1984, three in 1985, none in 1986, and one in 1987. Of the nine companies that accrued a loss during the survey period, only six described the nature of the specific litigation in its footnotes.

A company that accrues a loss may also be required to disclose an estimate of that loss. There is a distinction between making an estimate and disclosing the amount of that estimate. By not disclosing the amount accrued, a company either asserts that individual amounts are not material or has not complied with this provision of *SFAS 5*. When a loss is accrued, the company has already made an estimate of possible loss. The amount of the estimate, however, is not always separately disclosed in the financial statements. In fact, Table 4 shows that none of the sample companies gave such estimates.

The H. J. Heinz Company, for example, discloses detail about a federal antitrust suit in its 1987 report. An amount (not disclosed) was charged against income in 1987 that, in management's opinion, approximated the amount for which the claim would be settled. The amount was judged "not material to the 1987 results." This information is confusing to a financial statement reader. If the litigation is important enough to appear in the financial statements, why not disclose the amount? If the amount is immaterial, why is it necessary to disclose the matter? The disclosure for H. J. Heinz is:

- *Legal Matters*

Star-Kist Foods, Inc., a wholly-owned subsidiary of the company, and two other tuna canners, Ralston-Purina, Inc., and Castle & Cooke, Inc., are defendants in a suit brought by owners of 21 tuna fishing vessels which was originally filed in February, 1985 in the United States District Court for the Southern District of California in San Diego. The complaint alleges that the defendants have engaged in price fixing and other violations of federal antitrust laws in connection with the purchase of raw tuna from the plaintiffs.

> Plaintiffs have also asserted in the same litigation, state contract, tort and punitive damage claims. Star-Kist Foods has vigorously defended against this action and in November, 1985, filed its own antitrust and state law counterclaims against the plaintiffs. Most of the plaintiffs have settled with the defendants and settlement negotiations are in progress with the remaining plaintiffs. Management is of the opinion, based on facts presently available, that this action will finally be settled for an amount approximating the amount which has been reserved in the company's 1987 consolidated financial statements. This amount was not material to 1987 results [H.J. Heinz Company, *1987 Annual Report*, p. 49]

Outboard Marine, on the other hand, provided an informative disclosure regarding litigation that it had accrued in 1987. The footnote presents information concerning a nonroutine proceeding against the company. This disclosure is useful because the Company's response to the claim and a pending settlement (including an amount) are discussed. Outboard Marine's disclosure was:

> • *Legal Proceedings*
>
> The Company is engaged in the following nonroutine legal proceeding:
>
> As previously reported, in 1978 the Company, the Monsanto Company and the United States and Illinois Environmental Protection Agencies ("Agencies") initiated various litigation among each other in the United State District Court for the Northern District of Illinois, Eastern Division. The suits alleged presence of polychlorinated biphenyls in the water, biota and sediment of certain waterways adjacent to the Company's Waukegan, Illinois lakefront facility, in groundwater underlying and adjacent to said facility and on certain land of said faculty. The suits by the Agencies sought to require Monsanto and the Company, jointly and severally, to cease any further discharge, to remove and dispose of all allegedly contaminated sediments and soils and to pay certain penalties.
>
> On May 22, 1984, the Agencies jointly requested the Court to dismiss their suits. Their stated intention was to proceed on a "cleanup" of the Waukegan site to be funded under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("Superfund") and thereafter to file a cost-recovery action against the Company. Subsequently, the Agencies indicated that they would implement a "fund-balanced" $27 million remedy. The Agencies have indicated that the remedy remains under design.
>
> On February 6, 1985, the Court, over the Company's objection, permitted the Agencies to withdraw their suits. A condition of the dismissal prohibits the Agencies from refiling their suits and limits any further suit against the Company to a cost-recovery action under Superfund. The Court of Appeals has affirmed the decision of the District Court. The Company's Petition for Writ of Certiorari to the U.S. Supreme Court to review the decision was denied.
>
> The Company presented to the Agencies on December 1, 1986, a proposal to resolve the matter. The cost of the remedy which forms the basis of the proposal is estimated to be $15 million and was charged against 1986 earnings [Outboard Marine, *1987 Annual Report*, p. 39].

SETTLEMENTS

Analysis of settlements of sample companies is complicated by three factors. First, the amount of a particular settlement may be large in absolute terms but immaterial in comparison to other financial statement amounts. This may

be particularly true for large, diversified companies. Thus, disclosure of settlements by these companies may be omitted from the financial statements. Similarly, a company may settle numerous claims within the same year. Although the total amount of these settlements may be material and, therefore, reported separately, disclosure of each individual settlement may not be.

In addition to materiality, another factor affecting the disclosure of settlements is insurance. Often, liability insurance covers all or at least a portion of the settlement. For example, Owens-Corning Fiberglass is involved in well-publicized litigation related to asbestos products. Although the exposure to loss is significant, a major portion of the settlements is covered by insurance. In many instances insurance coverage is mentioned in a footnote. A typical footnote states that "any liability the company may have in excess of that covered by its insurance is not considered to be material." The note for Owens-Corning Fiberglass for 1987 is:

- *Contingent Liabilities*

The Company is a co-defendant with former manufacturers and distributors of products containing asbestos and miners and suppliers of asbestos fibers (the "Producers") in personal injury and property damage litigation. The personal injury claimants generally allege injuries to their health caused by inhalation of asbestos fibers from the Company's products. The property damage claimants generally allege property damage to schools and other public buildings resulting from the presence of products containing asbestos.

As of December 31, 1987, approximately 52,700 personal injury asbestos claims were pending directly against the Company, 23,000 of which were received in 1987. Of these pending claims, 2,900 are being handled directly by the Company and 49,800 are being handled by the Asbestos Claims Facility (the "Facility") established pursuant to the so-called "Wellington Agreement" entered into among the Company, certain other Producers and certain insurance companies. Under the Wellington Agreement, each subscribing Producer pays a fixed percentage of the compensatory damages and defense fees and expenses attributable to each claim for which the Producer has designated the Facility to act on its behalf, whether or not the Producer is named defendant in such claim. The Company has designated the Facility to act on its behalf with respect to all claims made against any subscribing Producer before October 3, 1987; claims made against the Company after October 2, 1987 are being handled directly by the Company outside of the Facility.

The contributions, defense fees and expenses related to personal injury asbestos claims are covered by the Company's product liability insurance policies, subject to deductibles, exclusions, retentions and policy limits. The Wellington Agreement resolved certain disputes between subscribing Producers and subscribing insurers and confirmed favorable application of insurance coverage to the Company by signatory insurers for all personal injury asbestos claims, whether handled by the Facility or directly by the Company.

Although any opinion is necessarily judgmental and must be based on information now known to the Company, in the opinion of management, based upon the Company's experience in these claims to date, the Company's analysis of insurance coverage available to it and its assessment of the Company's information available on asbestos-related claims, the additional costs which may arise out of pending personal injury and property damage asbestos claims, and additional similar asbestos claims filed in the future, will not have a materially adverse effect on the Company's financial position [Owens-Corning Fiberglass, *1987 Annual Report*, pp. 33].

Table 5. Number of Companies Settling Litigation: 1983-1987

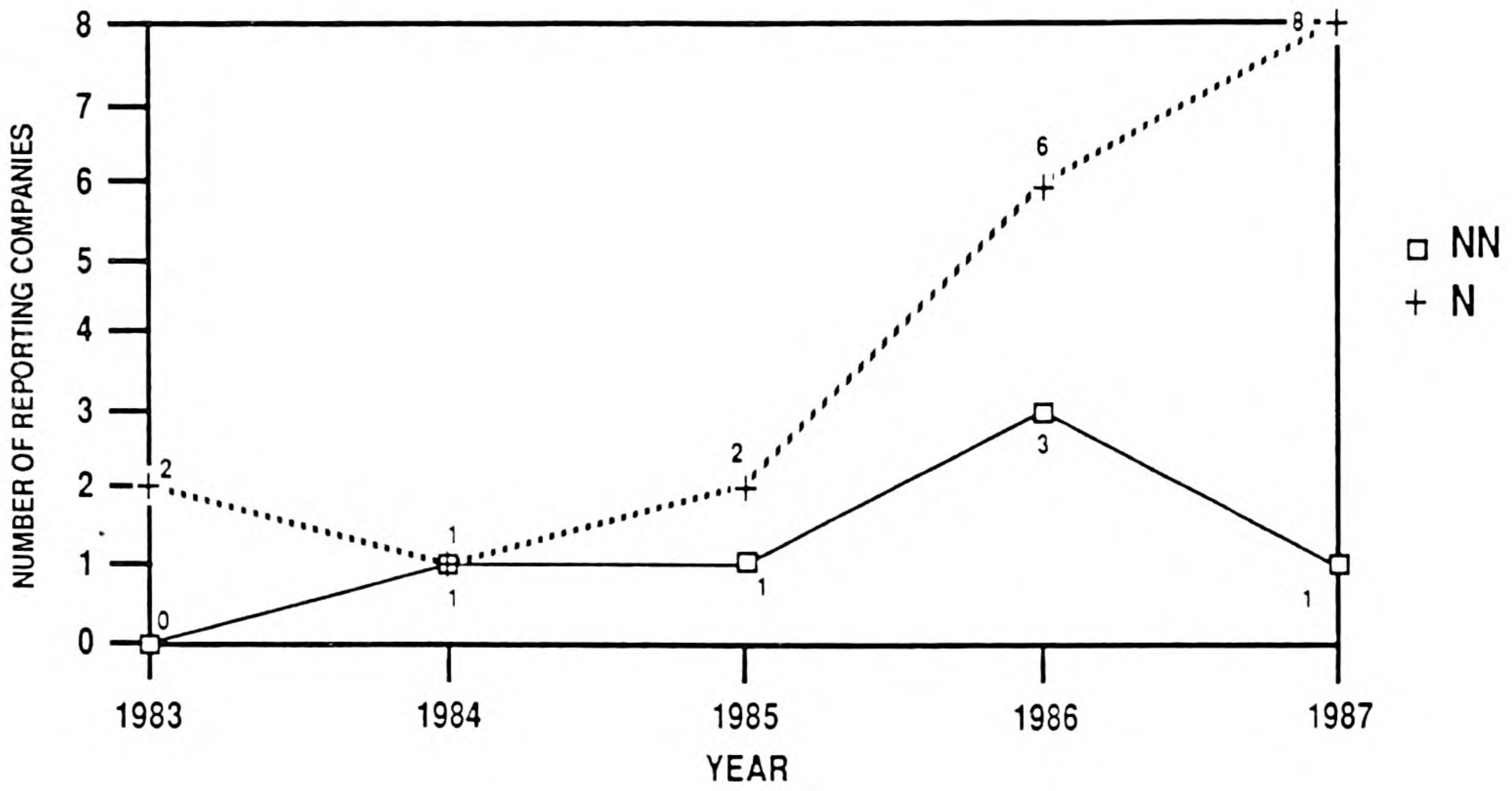
	Number of Settlements						
						All Years	
Disclosure Made in Prior Years	*1983*	*1984*	*1985*	*1986*	*1987*	*N*	*%*
No Disclosure	0	1	1	3	1	6	15
General Footnote	2	1	2	6	8	19	48
Disclosure	1	1	1	3	4	10	25
Accrual	2	2	1	0	0	5	12
Total	5	5	5	12	13	40	100

Finally, even though a "settlement" is disclosed, there is some likelihood that the company may not ultimately be liable for the entire amount or even a significant amount of the initial settlement. Texaco's recent litigation with Pennzoil indicates that a "final settlement" may be in doubt for quite some time. Table 5 reports the number of settlements of litigation during the five-year period and the technique of disclosure used in the preceding year's financial statements.

As reported in Table 5, 25 of 40 (63%) sample companies that settled litigation during 1983-1987 had not previously disclosed details regarding specific claims. Of companies involved in these 25 settlements, six had not acknowledged any involvement in litigation in the preceding year. The remaining 15 companies that settled litigation during this period had disclosed some specific information about litigation. Of these 15 companies, 5 had accrued a loss, and 10 had only disclosed exposure to loss. Figure 1 shows the trend of disclosure in the year preceding the settlement: the number of settlements by sample companies that have not previously disclosed specific information regarding litigation (categories NN and N) has increased significantly over the 5-year period. The number of settlements by sample companies that have previously disclosed specific information regarding litigation (categories D and A) has, however, decreased over the same period. During this period, the number of settlements, overall, has increased. Thus, the sample companies appear to be underdisclosing their exposure to loss from litigation. Furthermore, the extent of underdisclosure for these sample companies increased during the time period studied.

CONCLUSION

A majority of the financial statements analyzed in this study present little or no disclosure related to possible loss from litigation. The information that is contained in financial statement disclosures related to litigation is sometimes vague and incomplete. For example, the disclosure in the 1985 financial



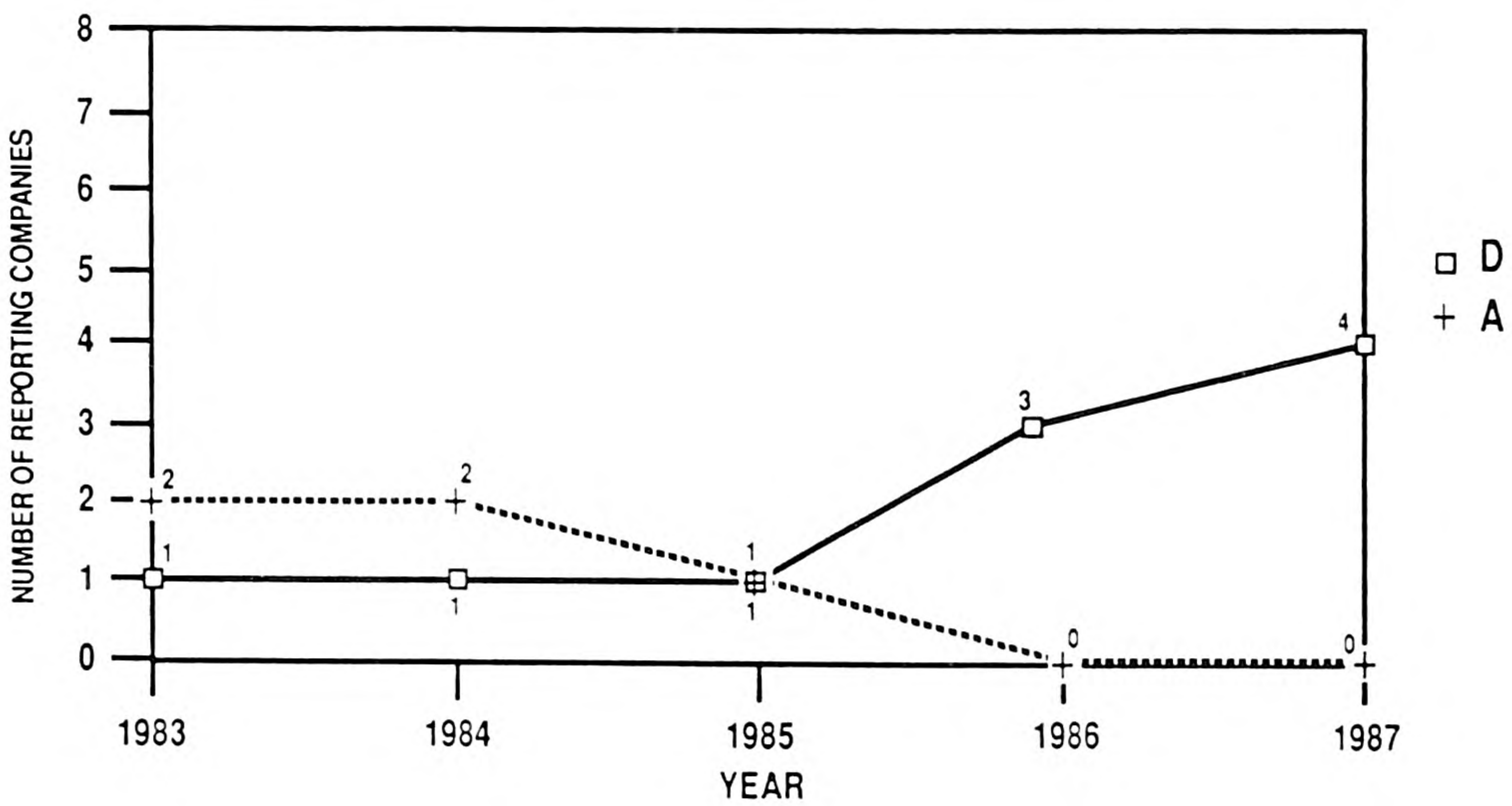


Figure 1. Settlement of Litigation: 1983-1987

statements of Kidde relating to the sale of Victor common stock says only that the suit seeks recovery of the amount paid for the stock "along with certain costs and damages." The costs and damages are not specified nor are they quantified. The note for Kidde is:

- *Legal Matters*

The Company is among those named in a class action brought in August 1983 on behalf of certain purchasers of the common stock of Victor. The action relates to the public sale in March 1983 of 4,500,000 shares of common stock of Victor (including 2,000,000 shares sold by the Company) at $17.50 per share and seeks recovery of the amounts paid for such stock along with certain costs and damages. An answer has been filed denying the substantive allegations contained in the complaint [Kidde, *1985 Annual Report*, p. 21].

By contrast, Owens-Corning's disclosure relating to lawsuits arising from asbestos products in its 1987 financial statements (illustrated previously) is more informative. The company tells what steps it has taken to settle these issues and how they are being handled. This information could have been improved by providing an estimate of the cost of settling such claims during 1987.

Based on the findings of this study, a financial statement user may have difficulty drawing valid conclusions concerning possible loss from litigation for three reasons. First, the existence of litigation may be viewed as immaterial by management; therefore, no accrual or disclosure may be made. Second, some companies may charge income for estimated losses related to litigation but not disclose the nature of specific lawsuits due to a lack of materiality of any one claim. Finally, due to the sensitive nature of information concerning pending lawsuits, management is reluctant to disclose more than the minimum required.

This analysis suggests several avenues of additional research. First, are the information needs of users being met by the reporting requirements of *SFAS 5*? If not, what additional or alternative information would be useful? Second, is there a relationship between disclosure by a defendant and the ultimate outcome of a lawsuit? If so, what is the natue of that relationship? The answers to these and related questions can provide further evidence regarding the adequacy of the disclosure requirements of *SFAS 5*.

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AN EXAMINATION OF AUDITOR INDEPENDENCE: FURTHER EVIDENCE ON THE EFFECT OF SYSTEM DESIGN PRACTICE ON AUDITOR JUDGMENT

Van E. Johnson and Steven E. Kaplan

ABSTRACT

A longstanding controversy concerns whether auditor independence is adversely affected when an external auditor also performs nonaudit services for the company. In 1979, Public Oversight Board identified a special concern over system design work where the audit firm is placed in the position of reviewing its own work. The only study to examine the concern that an auditor may audit a system designed by the auditor's firm more favorably than one designed by another source was by Corless and Parker in 1987.

The present study extends the study by Corless and Parker and provides additional evidence to evaluate the concerns over audit firms evaluating systems designed by their firms. An experiment was conducted using practicing Big 8

Research in Accounting Regulation, Volume 4, pages 59-75.
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ISBN: 1-55938-084-5

auditors assigned an internal control evaluation task. Auditors evaluated internal control system strength and determined planned audit hours. The independent variable, system designer, was manipulated across subjects at four levels. The results indicated that auditors' judgments for a system designed by their own firm were no different than the judgments of auditors evaluating an identical system designed by another Big 8 firm. However, both auditors' internal control evaluations and planned audit hours were significantly more favorable for a system designed by their own firm than for an identical system designed by either the client personnel or a nonaccounting consulting firm.

Policymakers such as Congress and the Securities and Exchange Commission (SEC) as well as the American Institute of Certified Public Accountants have long recognized the fundamental importance of external auditor independence [e.g., see Metcalf Committee, 1976; Moss Committee, 1978; Dingell Committee, 1985; Commission on Auditors' Responsibilities, 1978; and Public Oversight Board, , 1979]. Auditor independence is an essential part of a financial reporting process that aims to produce company financial reports that are credible. In this regard, auditor independence embodies both independence in fact and independence in appearance. That is, an auditor must not only appear to be independent but must also act in an unbiased manner towards the company.

A longstanding controversy concerns whether auditor independence is adversely affected when an external auditor also performs nonaudit services (NAS) for the company. Dopuch [1988] traces these concerns to the 1950s. The issue, however, is still unsettled. For example, the SEC has recently announced that it will study the independence issue in cases where both audit and nonaudit services are involved [*Public Accounting Report*, 1989, p. 7]. Commenting on the controversy, Price Waterhouse Chairman Shaun O'Malley has stated, "The threat to independence posed by nonaudit services is largely illusory, while the benefits of those services can be real and substantial" [*Journal of Accountancy*, 1989, p. 151]. This controversy, however, has been fueled by recent research [Beck, Frecka, and Solomon, 1988; Hillison and Kennelley, 1988; Palmrose, 1986; Simunic, 1984] contending that performance of NAS has economic effects which, in turn, impact the auditor-client relationship. Further, the independence literature identifies a special concern over system design work. Unlike other types of NAS, with systems design work an additional concern relates to the auditor reviewing his or her own work. A significant amount of research has examined whether systems design work affects the independence perceptions of financial statement users [see Pany and Reckers, 1987, for a review]. Research examining whether the system designer (e.g., was system design work performed by the auditor or some other supplier)

affects auditor judgments, however, is scant. The only exception is a recent study by Corless and Parker [1987].

In this paper we report the results of a study which examines the effect of the system designer on auditors' internal control and planning judgments. The purpose of the study was to extend the work of Corless and Parker and to provide additional evidence on whether NAS affects the auditor-client relationship. This evidence could be useful in policy debates related to a single firm performing both audit and NAS to a client. We extend the Corless and Parker study in two ways. First, we consider a broader set of system designers. Whereas Corless and Parker included two system designers, the present study includes four different system designers. Thus, we are able to assess whether the overall pattern of results is consistent with auditors evaluating their own systems more favorably. Second, the participants in this study were a relatively homogeneous group, all employed by the same firm and all with approximately the same level of experience. While this potentially limits the external validity of the study, it also strengthens the ability to detect statistical differences.

The second section of the paper reviews the regulatory background and relevant audit research. The third section presents the research questions. The fourth section provides a description of the experiment, and the fifth section details the results of the study which are then discussed in the concluding section.

BACKGROUND

Regulatory History

The issue of auditors performing NAS for their clients has been considered by several governmental bodies. The Metcalf Committee [1976] concluded that the provision of both auditing and NAS is inconsistent with an auditor's responsibility to remain independent from the client. In contrast, the Cohen Commission [Commission on Auditors' Responsibilities, 1978] found little evidence to suggest that auditors' professional judgments are likely to be biased when their firm also provided NAS to a client. In response to these congressional committee reports, the Securities and Exchange Commission issued *Accounting Series Releases* (*ASR*) 250 and 264. *ASR 250* required auditors to disclose the type of NAS performed during the prior fiscal year and the percentage relationship that the NAS fees, both individually and in aggregate, bear to the total audit fee. Further, in *ASR 264* the SEC stated its belief that the accounting profession and its clients are inadequately sensitized to the issue of NAS and independence. The SEC subsequently rescinded both *ASR 250* and *264*. Presently, the only disclosures relating to NAS is by member firms of the SEC Practice Division of CPA Firms. The

disclosures are limited to the aggregate NAS provided to all clients and do not require auditors to report on any specific client. Changes in regulation related to NAS, in terms of either disclosure requirements or additional operational guidelines, is again a possibility. Specifically, the SEC has commenced a study to reconsider whether independence is adversely affected by the provision of both audit and NAS to the same client [*Public Accounting Report*, 1989, p. 7].[1]

Relevant Related Research

Research examining the relationship between NAS and audit fees has found a positive association between audit fees and NAS, after controlling for company size and other company specific factors [Palmrose, 1986; Simunic, 1984]. Additionally, Beck, Frecka, and Solomon [1988] examined whether audit firm tenure was affected by the magnitude of NAS. Based upon information disclosed through *ASR 250*, the authors compared the tenure distributions of companies purchasing high versus low levels of NAS from the auditor. The results of the study were mixed, finding a significant difference in audit tenure distributions for only recurring NAS and only in one of the two years examined. Together, these studies indicate that the performance of both audit and NAS has an impact on the economic relationship between a firm and a client. These studies, however, do not provide evidence about individual auditor judgment.

Corless and Parker [1987] employed an experimental approach to directly investigate whether knowledge of the system designer affects auditor judgments. The authors investigated whether knowledge of the system designer affects auditor error rate judgments. Two different system designers, "our firm" and "another firm," were included in the study. In the first condition, the experimental materials indicated that the auditor's own firm "had been heavily involved" in the client's design work. The experimental materials for the second condition indicated that another firm had "helped design" the client's control system. Each subject made three error rate judgments which served as the dependent measures. The results of the study showed that subjects' judgments for a system designed by "our firm" were not significantly different from subjects' judgments for an identical system designed by "another firm."

In interpreting the results from the Corless and Parker study it is important to consider the backgrounds of the auditors participating in the experiment. The auditors all had from one to four years of audit experience and were employed with small, medium, and large audit firms. Although subjects had the appropriate level of audit experience for the audit task, two concerns may be raised with respect to participants' audit firm membership. First, including auditors from audit firms of different sizes may increase the extent of individual differences across the participants. This could occur if audit firms systematically

attract individuals with different backgrounds or experiences. Individual differences also might be enhanced to the extent that audit firms adopt different audit approaches. Cushing and Loebbecke [1986] report that audit structure differs markedly across medium and large audit firms. Additionally, two studies have reported that firm size and audit judgments are associated. Wright [1983] found differences between the disclosure judgments made by auditors from small firms and large firms. Also, Parker, Corless, and Tucker [1988] found auditors from small and large audit firms did not reach similar internal control judgments. The effect of large individual differences would be to increase within-cell variance and make it more difficult to detect differences between treatment conditions. Secondly, although all participants were employed by firms that performed NAS, the level and type of service may not be the same across all of these firms. More specifically, auditors' perceptions of the quality of NAS may be affected by audit firm membership. Accordingly, the tendency for auditors to rate systems designed by their own firm more favorably may be more likely to occur in large audit firms than small audit firms. Not controlling for such differences may also have contributed to the lack of significant findings.

RESEARCH QUESTIONS

The first research question considers whether auditors evaluate a system designed by their own firm differently than one designed by another supplier. If auditors were found to evaluate internal control systems designed by their own firm more favorably than systems designed by other suppliers, then questions regarding auditor independence would be raised. That is, an internal control system that is evaluated more favorably solely because it was designed by the audit firm would be consistent with a lack of independence in fact.

Alternatively, auditors may evaluate systems designed by a Big 8 audit firm more favorably than one designed by a non-Big 8 supplier. This type of finding would indicate that auditors' judgments are affected by perceived service quality differences across suppliers. The acculturation process a Big 8 auditor experiences might lead to perceived service quality differences between the Big 8 and other suppliers of NAS. As part of the acculturation process an auditor will tend to internalize the values of a reference group of superior auditors [Farmer, Rittenberg, and Trompeter, 1987]. Service quality differences between the Big 8 and others might be among the values held by the reference group. Additionally, prior to starting work, educational experiences such as Beta Alpha Psi membership may have also played an important role in acculturating or socializing students to the audit work environment and instilling a quality differential to Big 8 firms. This leads to the following research question:

Research Question 1. Are auditors' evaluations for identical internal control systems affected by knowledge of the system designer?

As described by Felix and Kinney [1982] and Cushing and Loebbecke [1986], auditing is primarily a sequential process. That is, although there are some continuous activities, a great majority of auditor decisions are sequential in nature. Internal control evaluation usually serves as a basis for additional audit judgments. Thus, a favorable internal control evaluation may be associated with other audit judgments that are also favorable. Specifically, professional auditing standards require that auditors study and evaluate internal control as a basis for establishing the nature, timing, and extent of audit procedures to perform during the audit. In this regard, Pany and Reckers [1983, p. 50] state, "Much of the audit plan (program) develops out of a preliminary auditor review of internal control. A biased evaluation of client accounting and control systems poses a significant threat to the validity of the audit." Thus, if an internal control system designed by the audit firm is evaluated more favorably than it should be (e.g., stronger than an identical system designed by other suppliers), then additional concerns may be raised whether other aspects of the audit are being conducted in a less intensive or less skeptical manner. One indication of the extent of auditing is planned audit hours. This discussion leads to the following research question:

Research Question 2: Are auditors' planning decisions for identical internal control systems affected by knowledge of the system designer?

METHOD

An experiment was conducted using practicing auditors assigned an internal control evaluation task. The purpose of the experiment was to provide evidence on the potential effect of the system designer on internal control and audit planning judgments. The task, independent variable, dependent variables, and subjects are described below.

Task

Each participating auditor received a booklet containing a cover letter, the experimental materials, and a debriefing questionnaire. The Appendix presents the instructions and task information given to subjects. The cover letter indicated that the study dealt with internal control evaluation. The instructions indicated that auditors were assigned the role of new in-charge for a continuing audit client. Their task was to review the revenue and cash receipts cycle and make several audit judgments related to the control system.

Auditors were given background information about the client and additional information and documentation about the internal control system for revenue and cash receipts. The client was a publicly held manufacturer of component parts used in the construction of refrigeration units. The company and industry were described as stable and growing slightly. Sales, cost of sales, accounts receivable, and net income information for each quarter of the prior and current year was provided to the subject. The internal control system was documented following the firm's normal approach. This included a flowchart and descriptions of relevant controls of the system. The new system as described did not contain any significant weaknesses. Finally, subjects were told the prior year's audit of the system was entirely substantive (due to weaknesses in the control system) and required 73 hours. This set of information was held constant across all cases. After familiarizing themselves with the case, auditors were asked to make several audit judgments and complete a debriefing questionnaire.

Independent Variable

The experiment contained one independent variable, the designer of the new internal control system, that was manipulated between subjects. Thus, each auditor received only one case. The four different types of system designers were:

- *Group 1*–The system was designed by the consulting department of our firm.
- *Group 2*–The system was designed by the consulting department of another Big 8 firm.
- *Group 3*–The system was designed by the consulting department of a non-accounting firm.
- *Group 4*–The system was designed by client personnel.

The Appendix illustrates how the system designer variable was operationalized in the study. Four different groups were included because system design work may be performed by several suppliers. Other than the audit firm, the study includes three alternate suppliers. We chose to use four groups for two reasons. First, specifically identifying the system designer in all cases should reduce any ambiguity about the system supplier. Ambiguity may have occurred if the system designer was labeled as "another firm." Second, we were interested in whether auditors' judgments would be similar across different alternate suppliers. Differences in auditor judgment across alternate suppliers may also suggest a possible lack of objectivity.

Dependent Measures

Two dependent measures were included in the experiment. First, subjects were asked to rate the strength of the internal control system. The response scale was continuous and anchored by "extremely weak" and "extremely strong." Responses were later converted to an 11-point scale. Dependent measure one corresponds to Question 1 in the Appendix. Second, subjects were asked to provide budgeted hours for the audit of receivables. This second dependent measure was included to evaluate whether the system designer affected auditor judgments subsequent to the internal control evaluation. Specifically, this second measure corresponds to Question 2 in the Appendix and is intended to indicate whether system designer affects the extent of evidence collected by the auditor. These two dependent measures have previously been employed by Joyce [1976] and Kaplan [1985].

Subjects

Eighty-eight subjects from one Big 8 firm participated in the experiment. Subjects, from offices throughout the United States, were attending staff training for advanced seniors. Two primary factors affected our decision to employ auditors from a single audit firm. First, use of a single firm was expected to minimize the extent of individual differences across auditors. Second, by using a single audit firm we were able to describe the internal control system using the approach and terminology of the participating audit firm. Members of the audit firm were consulted several times to ensure the information was presented in a manner typical of the firm. This strategy was intended to enhance task realism and reduce task ambiguity and/or auditor uncertainty due to unfamiliar terminology and/or approach. It may be noted that the participating audit firm was a Big 8 firm. We selected a Big 8 firm because they audit the majority of public companies.

Auditors were randomly assigned to one of the four levels of system designer. Seven of the auditors were dropped from the study for failing the manipulation check contained in the debriefing questionnaire. Additionally, six other auditors were dropped because they did not respond completely.[2] Thus, the analysis is based upon 75 auditors. The debriefing questionnaire collected information regarding the auditor's total experience (in months), day to day in-charge experience (e.g., little versus large), and audit risk tendencies (e.g., many less versus many more). These questions are included in the Appendix as Questions 3 through 5. The variables were included both to ensure that subjects had the necessary background to perform the task and to determine whether the auditors were relatively homogeneous on several potentially significant dimensions. Descriptive statistics, by treatment level, for the three variables are shown in Table 1. As shown, auditors had an average of over

Table 1. Descriptive Statistics For Subjects Means and Standard Deviations[a]

	Group 1: N = 18	*Group 2: N = 21*	*Group 3: N = 19*	*Group 4: N = 17*	*Total: N = 75*
Months of Audit	39.1	37.0	39.4	39.6	38.7
Experience	(5.2)	(7.2)	(6.0)	(8.3)	(6.8)
Senior	6.6	6.6	6.7	6.7	6.6
Experience*	(0.5)	(0.7)	(0.6)	(0.7)	(0.6)
Audit Risk	5.0	5.2	4.5	4.9	4.9
Tendencies**	(1.8)	(1.6)	(1.9)	(1.9)	(1.8)

Group 1 = our firm.
Group 2 = another Big 8 firm.
Group 3 = nonaccounting firm.
Group 4 = client.

[a] Standard deviations in parentheses.

* Auditors were asked to what extent they had had in-charge responsibilities in the past year where 1 represented few senior responsibilities and 7 represented a great deal of senior responsibilities.

** Auditors were asked to rate their approach to auditing from 1, much less risky than other auditors to 11, much more risky than other auditors.

three years of experience and had extensive day to day in-charge experience during the past year. Thus, auditors appeared qualified to perform the task. The standard deviations indicate that the auditors were relatively homogeneous in terms of experience and audit risk. There were no significant differences for any of these variables across the system designer variable.

RESULTS

The results are presented in two sections. In the first section the results related to Research Question 1 are detailed. Results for Research Question 2 follow. Analysis-of-variance (ANOVA) and a priori planned comparison tests were conducted to address the research questions. We performed a priori planned comparison tests because they directly test whether the "our firm" treatment was more favorable than other suppliers.[3] Note that for each of the two dependent measures three separate planned comparison tests are necessary. Specifically, responses from subjects in Group 1 (our firm) were compared to responses from subjects in each of the remaining three groups.

In addressing the research questions, three categories of results from the a priori planned comparison tests are possible. First, responses from Group 1 (our firm) may be significantly more favorable than each of the other three groups, which would be consistent with a lack of auditor independence in fact. Second, the responses from Group 1 may not be significantly different from any other group, which would indicate that system designer information would appear to be irrelevant for auditors' internal control evaluations and audit

Table 2. Analysis of Variance Results

Source	*Sum of Squares*	*Degrees of Freedom*	*Mean Square*	*F-Statistic*	*Prob.*
Panel A. Auditors' Internal Control Evaluations					
Group	31.08	3	10.36	3.02	.035
Error	243.73	71	3.43		
Panel B. Auditors' Planned Audit Hours					
Group	1333.04	3	444.35	3.55	.019
Error	8892.24	71	125.24	3.43	

planning decisions. Third, the responses from Group 1 may be significantly more favorable than a subset of the remaining three groups, which would indicate that system designer information would appear to be relevant for auditors' internal control evaluations and audit planning decisions. This third result would not be consistent with a lack of auditor independence in fact, but may indicate auditor bias.

Research Question One

The first research question examined whether auditors' internal control evaluations were more favorable for a system designed by their own firm (or another Big 8 firm) than for an identical system designed by another supplier. Evidence to address this question was provided by performing an analysis of variance followed by three a priori planned comparison tests. That is, the responses of Group 1 were compared with each of the other three groups. The dependent measure for these tests was auditors' internal control strength judgments.

The results of the analysis of variance, presented in Panel A of Table 2, indicate that a significant difference exists in the internal control judgments of the groups. Panel A and Panel B of Table 3 present descriptive statistics and a priori planned comparison test results for internal control judgments, respectively. The results of the a priori planned comparisons are useful in determining the nature of the group effect. The results show that the "our firm" treatment was rated significantly more favorably than the "nonaccounting consulting firm" group and the "client" group. No differences in internal control evaluations were found between the "our firm" treatment and the "another Big-8 firm" treatment.

Treatment means and standard deviations shown in panel A of Table 3 indicate that the "our firm" treatment received the most favorable mean internal control evaluation. The mean rating was approximately 1.2 higher than a system designed by a nonaccounting consulting firm and approximately 1.5

Table 3. Results of A Priori Planned Comparison Tests for Internal Control Evaluations and Planned Audit Hours

Panel A: Treatment Means and Standard Deviations [a]

	Group 1: N = 18	*Group 2: N = 21*	*Group 3: N = 19*	*Group 4: N = 17*	*Total: N = 75*
Internal Control	6.28	6.17	5.09	4.80	5.61
Evaluation *	(1.82)	(1.78)	(2.06)	(1.71)	(1.93)
Planned Audit	53.06	56.57	64.26	60.82	58.64
Hours **	(12.38)	(9.31)	(10.84)	(12.33)	(11.75)

[a] Standard deviations in parentheses.

* Scale: 1 — Extremely Weak, 11 — Extremely Strong

** Auditors were asked to budget the hours necessary to audit the area this year, given that last years (purely substantive) audit took 73 hours.

Panel B: Planned Comparison Tests for Internal Control Evaluations

	Difference in Mean Internal Control Evaluation	*T-Value*	*Prob.*
Group 1 vs. Group 2	.11	.19	.425
Group 1 vs. Group 3	1.19	1.96	.027*
Group 1 vs. Group 4	1.48	2.37	.011*

* Probabilities reported are for one-sided tests. The difference is significant at conventional levels.

Panel C: Planned Comparison Tests for Planned Audit Hours

	Difference in Mean Planned Audit Hours	*T-Value*	*Prob.*
Group 1 vs. Group 2	3.51	.98	.165
Group 1 vs. Group 3	11.20	3.05	.001*
Group 1 vs. Group 4	7.76	2.05	.022*

Group 1 = our firm.
Group 2 = another Big 8 firm.
Group 3 = nonaccounting firm.
Group 4 = client.

* Probabilities reported are for one-sided tests. The difference is significant at conventional levels.

higher than a system designed by a client. Overall, the results provide evidence that auditors rate internal control systems designed by "our firm" similarly to one designed by another Big 8 firm but more favorably than those designed by non-Big 8 suppliers.

Research Question Two

The second research question addressed whether auditors' planning decisions for identical internal control systems will be affected by knowledge of the

system designer. Again, an analysis of variance was performed followed by a priori planned comparison tests. The dependent measure for these tests was auditors' planned audit hours.

The results of the analysis of variance, shown in panel B of Table 2, indicate that significant differences exist among audit planning judgments of the groups. Panel A of Table 3 presents descriptive statistics for planned audit hours. The results of the a priori planned comparison tests, shown in Panel C of Table 3, indicate that the hours planned for the system designed by the "our firm" and the "another Big 8 firm" groups were not significantly different. However, the hours planned for the "our firm" system were significantly fewer than than those planned for the systems designed by either a "nonaccounting consulting firm" or the "client." Compared to the mean for "our firm," the nonaccounting consulting firm and client treatments were over 12 and 7 hours higher, respectively. Overall, the results for audit hours mirror the results from internal control evaluations. When systems are designed by their own firm, auditors plan fewer audit hours than when the systems are designed by non-Big 8 suppliers, but they plan approximately the same number of hours as when designed by another Big 8 firm.

DISCUSSION

The present study was motivated by the need for additional evidence to assess whether auditors' actual judgments are more favorable when an internal control system is designed by the audit firm. Before discussing the results, several limitations should be noted. First, the subjects used in the study were participating in in-house training from a single Big 8 public accounting firm. Because subjects were not randomly selected from the population of auditors from a particular firm of from all auditors, inferences can not be made to the larger population of auditors. However, as indicated earlier, use of only one firm also provided several advantages. For example, by using only one firm "our firm" meant the same firm for all subjects.

Second, the study was limited to individual audit judgment. As such, the possible effects of group procedures that may normally be part of the audit process were not addressed. These factors may significantly alter the judgments made by individuals. However, it is not clear how group judgments would differ from individual judgments. Potentially, judgments made by an audit team could be even more biased than these made by individuals [see Schultz and Reckers, 1981, for a discussion of the choice-shift phenomenon].

Since the results from the two research questions were similar, we discuss them jointly. The results indicate that although the "our firm" system was evaluated more favorably than the "client" or "nonaccounting consulting firm" systems, it was not evaluated more favorably than the "another Big 8 firm" system. Similarly, significant differences in planned audit hours were found

between the "our firm" treatment and the same two other suppliers. Thus, groups with significant differences in internal control evaluations also had significant differences in planned audit hours.

Overall, while the results indicate that auditors' judgments about a system are affected by the system's designer, the pattern of results do not support the concerns about independence raised by policymakers. That is, auditors did not evaluate systems designed by their own firm better than systems designed by all other suppliers. The pattern of results from the study does indicate that auditors viewed systems designed by Big 8 firms more favorably than those designed by non-Big 8 suppliers.

The results imply that auditors perceived service quality as being higher for Big 8 firms than for non-Big 8 firms. Our speculation is that such perceptions about the quality of Big 8 firms versus other suppliers evolve from the socialization or acculturation process in Big 8 firms. That is, Big 8 firms may promote and instill values supporting a quality difference between the Big 8 and other suppliers of both audit and NAS. Farmer, Rittenberg, and Trompeter [1987] discuss the acculturation process in public accounting and its potential adverse consequences.

Because system design information significantly influenced auditor judgment, the results call into question the objectivity of auditor judgment. The concern that auditors in the experimental task were not completely objective is based on the belief that system designer information should not have affected auditor judgment. To elaborate, a distinction may be made regarding this experiment and much of the audit quality research (see DeAngelo [1981] and Simunic and Stein [1987] for reviews). In the audit quality research, the contention is that an auditor's brand name is informative to market participants because it serves as a surrogate for an unobservable, audit effort. In this experiment, however, the internal control system was presented and described. That is, the system did not go unobserved by the auditor. Thus, it is not clear why knowledge of the system designer should still affect audit judgment once the system has been presented and fully described to the auditor. This would indicate either a lack of objectivity by auditors, or, auditors, perhaps, did not view the experimental system descriptions as complete.

Finally, the results potentially have important practical implications. For example, planned audit hours were more than 20 percent greater for the system designed by a "nonaccounting firm" as compared to the hours from "our firm." Such differences in planned hours may impact the type, nature, and timing of audit evidence that is collected.

FUTURE RESEARCH

Research considering whether the system designer affects auditor judgment is just emerging and in this regard this study should be viewed as exploratory in nature. Further, because of the limitations already discussed our results

should be interpreted with caution. This study does, however, provide a basis for additional research concerning how auditor judgments may be affected by the system designer. Further research which includes auditors from both Big 8 and non-Big 8 firms may be able to directly address the issue of acculturation resulting in a perceived Big 8/non-Big 8 quality differential. Research that incorporates aspects of the review process may shed light on whether review is adequate to mitigate the type of bias noted in this paper.

APPENDIX

Illustration of Case Materials and Questionnaire

Instructions

You have been assigned to be the new in-charge on Warren Inc., a publicly held manufacturer of component parts used in the construction of refrigeration units. Some preliminary interim work has already been performed prior to you taking over the job from the previous senior who has left the firm.

As one of your first tasks, it is necessary for you to review a new control system in the revenue and cash receipts cycle. This new system was *designed by the client* in response to previous management letter comments regarding weaknesses in the old system. As part of the preliminary work done by the previous senior, the internal control flowchart and accompanying description were completed at interim and are included here.

Additional information which you may find useful in making decisions follows:

1. Interim review suggests that the client's business and industry are stable and growing slightly. Warren Inc. has no sales to end users of refrigeration systems which lends stability to the business. A review of a summary of this year's and last year's quarterly results suggest that this year's revenues and receivables are very close to the prior year's.

	First Qtr.	*Second Qtr.*	*Third Qtr.*	*Fourth Qtr.*	*Annual*
Last Year					
Sales	634*	702	641	603	2580
Cost of Sales	412	460	406	389	1667
Net Income	121	141	135	106	503
Accts. Recvble.	67	77	71	65	65
This Year					
Sales	652	722	631	591	2596
Cost of Sales	418	469	400	386	1673
Net Income	126	144	133	99	502
Accts. Recvble.	66	81	68	59	59

* All figures are in US $ Thousands.

2. Last year's audit of receivables was purely substantive because of the weakness in the revenue and receipts cycle. The hours required to complete this area last year (using primarily a first year assistant) were 73. This excludes the internal control documentation time.

3. This is a returning client and there is some presssure to reduce hours and use the most efficient audit methods to increase realization wherever possible.

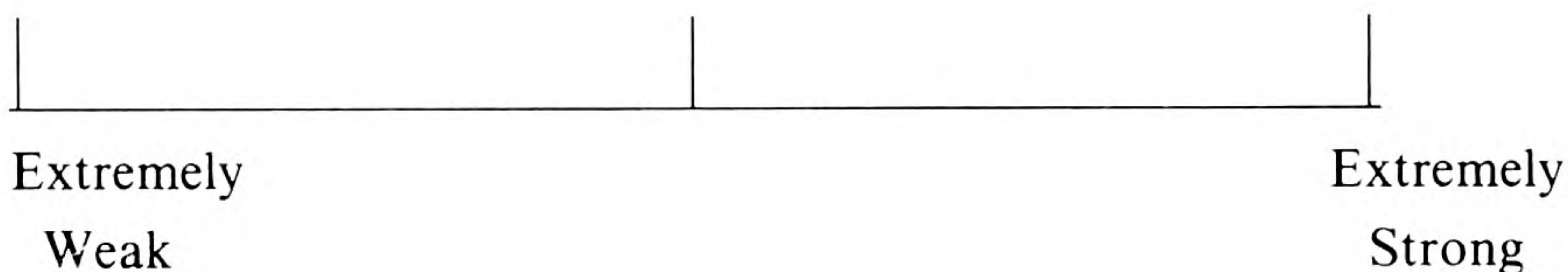
4. The new control system was *designed by the client*. It was put in place shortly after the completion of last year's audit and has been in place and operating for eight and a half months.

Manipulation (italicized passage):

Group 1—designed by our firm.
Group 2—designed by another Big 8 firm.
Group 3—designed by a nonaccounting consulting firm.
Group 4—designed by the client.

Questionnaire

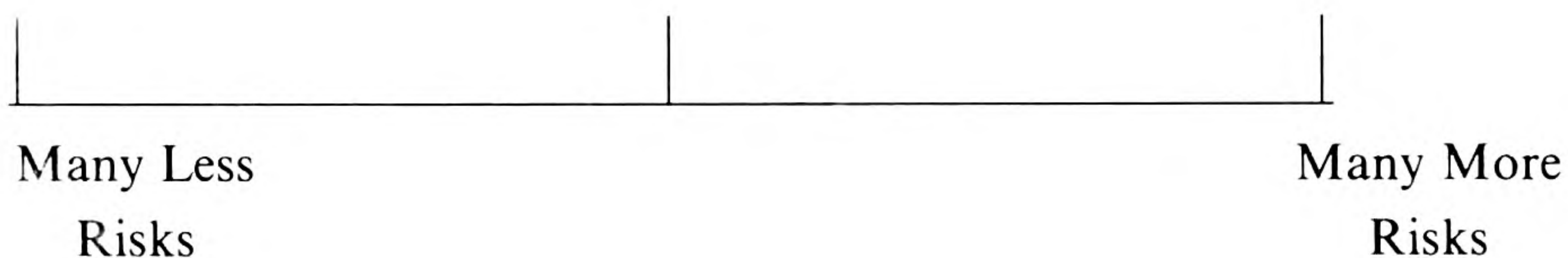
1. How would you rate the system of internal controls as documented in the work papers?



Extremely Weak — Extremely Strong

2. Last years audit of receivables (excluding control documentation) was purely substantive and took 73 hours. Given the new system, what will you plan for this year's audit of the area?

3. Compared to other auditors, do you think you take more or less risks in auditing a client?



Many Less Risks — Many More Risks

4. To what extent have you had day-to-day in-charge ("senior") experience on jobs during the past year?

Very Little Senior Experience		Very Large Senior Experience

5. How many months of experience do you have with your present firm?

ACKNOWLEDGMENT

Support for this project was provided to Steve Kaplan by the Council of 100, College of Business, Arizona State University.

NOTES

1. The independence issue was brought back to the forefront when the Big 8 collectively responded to the SEC position regarding auditor independence in prime/subcontractor arrangements. The SEC position in the matter is considered to be a primary reason for the collapse of the Arthur Andersen/Price Waterhouse merger.
2. Seven subjects failed to correctly identify the system designer that was mentioned in the case. Two subjects did not evaluate the internal control system and three subjects did not provide an estimate for audit hours. Overall, three subjects were deleted from group one, two subjects were deleted from groups two and three, and six subjects were deleted from group four.
3. A priori planned comparison tests are more powerful tests than a posteriori comparisons. See Kirk [1982] for a detailed discussion of testing for a main effect followed by a posteriori comparisons versus a priori planned comparisons tests.

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FROM CONTRACT TO TORT: THE EVOLUTION OF ACCOUNTANTS' LEGAL LIABILITY FOR NEGLIGENCE

Orace Johnson and William D. Terando

ABSTRACT

The scope of legal liability of accountants to injured third parties for negligent misrepresentation has been gradually expanding for two decades. It is becoming more and more common to see accountants defending their actions against parties who have suffered financial losses from (allegedly) relying on faulty financial statements and reports prepared by accountants. This paper surveys the developments in case law and federal legislation that have driven the expansion process from privity under contract to reasonably foreseeable third-party users. The paper concludes with an analysis of the current scope of legal liability of accountants with respect to injured parties.

Research in Accounting Regulation, Volume 4, pages 77-97.
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ISBN: 1-55938-084-5

Evolution of accountants' legal liability to injured parties for negligent misrepresentation has not been smoothly continual from the earliest court decisions to the present time. In the early 1900s, the courts strictly applied the doctrines of contract law. As a result, the accountant was liable only to injured parties in contractual privity. Other injured parties with whom the accountant was not in contract and who may have suffered financial losses as a result of relying on the accountant's negligent misrepresentations could not recover damages. However, the courts have gradually applied the principles of tort law to more and more situations when defining the legal liability for negligence. Consequently, auditors are finding themselves in the unenviable position of defending their actions in suits brought by outside third parties as well as by contract clients, both of whom have (allegedly) suffered financial losses in transactions through reliance upon (allegedly) negligently prepared financial statements and reports.

The accountant's legal liability for *negligent* misrepresentation is in direct contrast to his legal liability for *fraud* or conduct *closely resembling fraud.* It has been well established that accountants are subject to legal action in contract as well as tort to clients and other parties not in contractual privity who have suffered financial losses through reliance on *fraudulently* prepared financial statements. Since the accountant's legal liability for fraud or conduct closely resembling fraud has been fairly straightforward and consistently applied by the courts over the years, this paper will not dwell on this area. Rather, it will concentrate on examining the relevant case law and federal legislation that attempted to define the boundaries of the accountant's legal liability to injured third parties for statements which were *negligently* prepared. Hopefully, this analysis will help us to better understand the position the accountant finds himself in today.

The paper is structured this way. The first section discusses the various ways that an accountant can be negligent in his duties, and how negligence may be exhibited. The second section discusses the historical background of negligence in nonaccountant cases, the first major negligence suit involving accountants, leading cases that were subsequently used as precedents by injured third parties to distinguish their cases, and statutory law of negligence. The third section explores recent cases that have used these precedents, and analyzes the expansion of the accountant's scope of legal liability for negligence. The fourth section ends this paper by commenting on the current status of accountants with regard to legal liability to injured parties as a result of negligent misrepresentations.

SOURCES OF ACCOUNTANT LITIGATION

Liability to a client or to an injured third party will arise whenever the conduct of the accountant falls below the minimum standards of his profession. Liability may be based on breach of contract, on fraud, or on negligent behavior.

Contract law provides that the duty owed by the accountant to his client depends upon the agreement he has made with the client. Implicit in every contract for employment is the duty to perform the contracted services with the skill to be expected of a reasonably prudent man possessing the accountant's training and knowledge. When the accountant does not exhibit this high level of skill, he is liable to his clients under contract for any damages suffered.

Tort law does not require contractual relations. The purpose of tort law, including both fraud and negligence, is "to protect the interests of people in their property and persons from damage by others" [Cooter and Ulen, 1988, p. 327]. In both contract law and tort law, it is incumbent upon the accountant to maintain a high level of skill in the course of performing his duties. To fail to do so may make him liable to injured third parties as well as to injured clients for the damages suffered. Because the law of liability is premised on a departure from the conduct expected from a reasonably prudent person under like circumstances, the degree of care exercised by the accountant during performance of his task is the critical issue which must be evaluated in order to determine whether the accountant incurs any liability for his actions. The classical theory of tort law contained three elements: (1) harm suffered by a plaintiff, (2) as an immediate or proximate result of (3) a breach of duty owed to the plaintiff by the defendant. The party at fault for unintentionally causing harm to person or property is said to be "negligent."

Since the accountant is a skilled professional in a specified area of expertise, the level of care to which the accountant is held bound by the courts is the higher standard of conduct as specified by the profession as a whole. Consequently, the accountant's conduct in the performance of his duties is evaluated in terms of the level of care that would be expected of a "reasonable CPA." Because the services being rendered by the accountant are highly specialized, and because the public is generally ignorant of the complexities of the profession, a higher standard of conduct is required. The measures used to operationalize the "reasonable CPA" test are the accounting standards of the profession as a whole. The care and competence reasonably expected from the members of the profession has been summarized by Hawkins [1959, p. 803] as follows:

a) To ascertain the facts on which the report is made;
b) in drawing inferences from the facts not stated in the report; and
c) in communicating the information so that it may be understood.

These general duties are formally codified in the AICPA Statements of Professional Standards [Committee on Auditing Procedure, 1954, pp. 13-14]. These statements codify the general field work requirements as well as the reporting standards. Specifically, they require that:

1. the accountant have competent evidential matter to support his findings;
2. the report state whether the financial statements are presented in accordance with generally accepted accounting principles;
3. the informative disclosures in the report be regarded as reasonably adequate unless stated otherwise;
4. the report contain either an opinion respecting the financial statements taken as a whole, or reasons why such an opinion cannot be expressed; and
5. the report contain a clear-cut explanation of the character of the auditor's examination and the degree of responsibility which he assumes.

Negligence in adherence to these standards is most often exhibited by either negligent investigation, negligent inference, or negligent communication [Hawkins, 1959, pp. 804-807].

Negligent investigation occurs when the accountant fails to uncover substantial material errors during the audit process. For negligence on the part of accountants to be proven in this instance, the procedures performed during the audit must be shown to be deficient in relation to the audit procedures common for the specific industry being examined, and/or in relation to the procedures commonly used by the profession as a whole.

In *National Surety Corp. v. Lybrand* [1939], the accountants failed to discover an embezzlement involving petty cash. This occurred primarily because they failed to request or examine duplicate deposit slips and investigate differences between information on the deposit slips and entries in the deposit books. The court noted that "if there had been any substantial compliance with the requirements of verifying cash in banks, the cash shortages would have been detected. . . . Their representations that there had been a verification of cash was a pretense of knowledge when they did not know the condition of the bank accounts and had no reasonable basis to assume that they did" [*National Surety*, 1939, p. 556]. In *Maryland Casualty Co. v. Cook* [1940] the accountant was held to be negligent by not discovering embezzlements and misappropriations by the city treasurer through alterations in the tax rolls. The court noted that if the accountant had made an attempt to circularize the delinquent accounts or to compare the tax rolls to the assessor's office, "the discrepancies would have immediately come to light" [*Maryland Casualty*, 1940, p. 165].

Negligent inference occurs when the accountant draws improper inferences from the facts. The accountant may have correctly gathered all the relevant facts necessary to arrive at a decision, but failed to apply the due care necessary to draw the proper inferences. Since the accountant purports to be a professional possessing specialized skills in dealing with figures as well as having expert knowledge in matters coming within his professional competence, he is expected to provide a higher minimum quality of professional judgement than the ordinary layman.

As noted by the court in *Gammel v. Ernst and Ernst* [1955, p. 367], "Ordinarily, the standards of reasonable care which apply to the conduct of auditors or public accountants are the same as those applied to lawyers, doctors, architects, engineers, and other professional men engaged in furnishing skilled services for compensation."

In analyzing this issue, the key is to determine whether the accountant exercised the quality of judgement expected of him by other members of the profession. Did the accountant properly consider all available options and accounting pronouncements in making his judgement? This was the primary issue in *Goss v. Crossley* [1983]. In situations where there is more than one method of accounting for a particular transaction, an accountant will not be held to have breached his duty of professional care merely by choosing one accepted method of accounting over another. Even if the accountant's judgement is subsequently proven incorrect, or if other previously unconsidered alternatives are brought to light, negligence by the accountant is not necessarily to be implied.

The accountant does not guarantee correct or even optimal judgments, just technical competence as measured by the minimum standards of his peers. As the court in *Gammel v. Ernst and Ernst* [1955, p. 367], said of auditors, "The imposition of such standards does not leave them without adequate protection since their liability in damages arises only as the results of methods or practices in the performance of their work which indicates lack of reasonable care, fraud, or bad faith, and since they are entitled to a wide discretion in the selection of such methods and in determining which of several practices or principles is the most sound or the best suited for the work undertaken by them." It is the *process* the accountant follows to draw inferences, as well as the judgments themselves, which will be analyzed and evaluated to determine whether there was negligent performance of professional duties.

Negligent communication occurs through the drafting and publishing of financial statements and reports, whether audited or unaudited. The accountant may have properly collected all of the necessary supporting documentation and made the appropriate inferences about the evidentiary matter being collected. The report as a whole may be negligently prepared as a result of either omitted, partial, or misleading disclosures.

In *Board of County Commissioners v. Baker* [1940] the accountant failed to state in the report that the cash account was comprised of personal checks of the individual who had custody of the account. The court ruled that because of "the inexcusable failure to report facts of serious character . . . on a record which amply supports such findings, we must conclude that the appellees failed, in a fundamental and essential particular, to furnish the expert and faithful service which they contracted to furnish"[*Board of County Commissioners*, 1940, p. 171]

In the case of *London & Gen. Bank* [1895; as cited by Hawkins (1959), p. 808] the accountant's report failed to disclose relevant information regarding the unsatisfactory state of the bank's loan portfolio, even though he had reported this fact verbally to the bank directors. The court ruled that the accountant's duty of reasonable care was not discharged by merely putting the readers on inquiry.

Negligent communication may also arise when the accountant relies on unverified secondary sources of information disclosed in the report [Hawkins, 1959, p. 807]. In *C.I.T. Financial Corp. v. U.S. Glover* [1955] action was brought against a public accounting firm by a lender who failed to call in a loan because of his alleged reliance on the accountant's statements concerning the borrower's financial condition. The plaintiffs argued that the accountants should have pointed out the necessity for larger loan reserves due to certain stagnant collateral. The court ruled that the company's business was such that "the accountants had to rely to a great extent on management statements about the nature and value of collateral, and that, since the audit report disclosed this reliance, the defendants were not liable for whatever factual errors might have occurred" [*C.I.T. Financial*, 1955, p. 46]. Thus, if the accountant failed to disclose the secondary sources and his reasonable reliance on information supplied by others, then a plaintiff might have grounds for a negligence suit.

Negligent communication is a very common type of negligence alleged against accountants. It is also very difficult to prove because its impact has to be considered in light of both the materiality of the omitted/partial/misleading disclosure and also the other disclosures contained in the report. The accountant will be held negligent to the extent that the report misleads the users of the financial reports.

The purpose of this section has been to define negligence and to describe, generally, the various ways an accountant may be negligent in his duties.

BACKGROUND: 1842-1967

This section presents an overview of historical developments in the law of negligence. First we note significant cases which did not involve accountants, but which set the broad litigation stage for a change in the attitude toward accountant responsibility. We then discuss early accountant negligence cases, especially *Ultramares v. Touche Niven & Co.* [1931]. This material has been covered thoroughly in the law and accounting literature, but we review it here for readers who are not familiar with this general history, and for its background relevance to our discussion of current developments.

One of the first cases to address the rights of injured third parties not in privity of contract was *Winterbottom v. Wright* [1842]. It applied the doctrine of strict privity when defining the boundaries of a defendant's legal liability

for negligence. The Postmaster General, Party A, contracted with Party B to provide horse-pulled carriages to be used as mail delivery vehicles. Under the terms of the contract, Party B was responsibile for keeping the carriages in a fit, proper, safe condition. The Postmaster also contracted with Party C to operate these carriages. Party C subsequently subcontracted with Party D to operate the carriages and deliver the mail from place to place. A defectively made carriage broke and injured Party D who then sued Party B to recover lost wages and medical expenses. The Winterbottom court denied recovery to the plaintiff based on the fact that he was not in contractual privity with Party B. Consequently, Party D's only avenue of redress was to recover from the party with whom he was in contract, Party C. Subsequently, Party C might sue to recover damages from Party A, since they were in a state of contractual privity. The Postmaster General, Party A, alone could sue Party B.

The strict privity doctrine created in *Winterbottom* stood for 74 years. Then as a result of three cases, it gradually gave way to a requirement similar to tort law, the duty to reasonably foreseeable third parties. *MacPherson v. Buick Motor Co.* [1916] virtually eliminated privity as a relevant consideration in product liability actions [Weiner, 1983, p.242]. *Glanzer v. Sheppard* [1922] extended liability of defendants for negligent misrepresentations to third parties who suffered pecuniary losses. *Palsgraf v. Long Island RR Co.* [1928] required that injuries to third parties be proximately rather than ultimately caused by the defendant's negligence.

In *MacPherson* [1916] the court imposed strict liability on manufacturers of automobiles and other dangerous products for personal injuries to *tangible* interests resulting from the use of negligently made defective products. The issue was whether a car manufacturer owed a *duty of care* to anyone other than the immediate purchaser of a product. The court extended the foreseeability test beyond situations where the negligently made product was an inherent object of destruction in and of itself, to situations were it was probable that a negligently made product would place persons other than the buyer in peril. The court ruled that the manufacturer of the automobile should be held to a higher standard of care in the performance of his duties. If this duty is not met, then the defendant should be held liable not only to parties in contractual privity, but also to third parties who used the negligently prepared products and were subsequently injured by them.

In *Glanzer* [1922] the court extended a defendant's liability for negligent misrepresentations to injured third parties who suffered only *financial* losses. The defendants were public weighers who contracted with a seller of beans to certify their proper weight in order to establish their proper selling price. At the time of the contract between the seller of the beans and the public weigher, the public weigher knew the identity of the third-party purchaser as well as the fact that both buyer and seller were relying upon the weight receipt to fix a value on the beans. The purchaser paid accordingly for the beans, but

discovered later that the certified weight, and hence the purchase price of the beans, had been overstated. Consequently, the purchaser sued the weigher for losses incurred because of the latter's negligence. The court ruled that the duty of care owed by the public weigher extended not only to the party in contractual privity, but also to any specific party who would foreseeably be induced to act through reliance on the information being certified. The court said that since the plaintiffs knew the weight certificate was "the end and aim to the transaction," and because " the defendants held themselves out to the public as being skilled and careful in their calling," the defendant's duty of care was extended to encompass the reasonably foreseeable purchaser, as well as the party to whom the public weigher was in contract [*Glanzer,* 1922, p. 275].

In *Palsgraf* [1928] the court ruled against a plaintiff who had been injured by falling tile while waiting in a train station. The tile fell from the ceiling due to an explosion which occurred on the other side of the station when a passenger, attempting to board a departing train (assisted in this endeavor by two conductors), dropped a box of firecrackers. The injured bystander sued the railroad for damages caused by the explosion. The defendant was found to be not liable for negligence because the railroad company was not "proximately" responsible for the injury. The court noted that "if the harm is not willful, he [the plaintiff] must show the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended" [*Palsgraf,* 1928, p. 101].

After the Glanzer decision, it would have appeared reasonable to assume that case law precedents would be applied equally to accountants. However, this did not happen immediately.

The court in *Ultramares Corp. v. Touche Niven & Co.* [1931] applied contract law strictly in setting the accountants' scope of legal liability for negligence only to injured parties with contractual privity. The defendant in this case was a certified public accounting firm that had been hired by Fred Stern & Co. to audit its financial statements. The accountants were aware that Stern would show the audited statements to creditors in order to obtain loans for operations, but they did not know specifically to whom the statements would be shown. Relying upon the negligently prepared financial statements, a third party loaned money to Stern. When the company declared bankruptcy, the loan became uncollectible. The third party sued Touche for the economic losses they sustained, citing their direct reliance on the negligently prepared financial statements in assessing the financial condition of Stern.

In arriving at the court's decision, Justice Cardozo—who had written the opinion in the *Glanzer* case just nine years earlier—noted that the service being rendered by the certified public accountant was "primarily for the benefit of the Stern Company" and "a convenient instrumentality for use in the development of the business and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter. . .

Foresight of these possibilities may change with liability for fraud but the conclusion does not follow that it will change with liability for negligence" [*Ultramares*, 1931, p. 446].

Thus, the accountant was held not liable to the creditor on the basis of negligence, even though the defendant had reason to know that his report might be used by Stern to obtain credit. The court believed that to hold otherwise could threaten "liability in an indeterminant amount for an indeterminant time to an indeterminant class" of plaintiffs [p. 444]. To hold otherwise would extend the scope of duty to refrain from negligent misrepresentations as far as the duty to refrain from fraud. Negligence might be evidence from which to draw an inference of fraud, but it was no substitute for fraud as the basis for liability.

In distinguishing the facts in *Ultramares Corp. v. Touche Niven & Co.* [1931] from the facts in *Glanzer v. Sheppard* [1922], Justice Cardozo noted that in Glanzer the weigher's certificate was the "end and aim of the transaction," and the purchaser of beans was specifically known to the defendant at the time of the contract with the seller [*Ultramares*, 1931, p. 445]. These essential elements were missing in *Ultramares*, as the third party was only incidentally or remotely involved in the contractual accountant/client relationship. The Ultramares court refused to apply to accountants the Glanzer precedent, based on tort law; and relied instead on contract law.

The *Ultramares* decision has been criticized on many grounds. One area of concern is Justice Cardozo's basic fear of cotermining liability for fraud with liability for "negligent speech" on the part of accountants [Solomon, 1968, p. 71]. Prior to *Ultramares*, it appeared that a satisfactory theory was developing to extend negligence liability beyond the boundaries of contractual privity in cases of injury to purely commercial interests. However, the theory of liability was now shifted from negligence to fraud out of a concern for the limitless consequences of extending accountants' liability to the established boundary of foreseeable risk. This decision was thought to be unjustified and incorrect because the accountant could now be held liable to third parties for injuries only if there was an intent by the accountant to deceive or cause harm. Many cases in tort law other than accountant's liability had recognized the distinction between the *reckless* misrepresentation essential to an action for fraud and the *negligent* misrepresentation that may be actionable apart from any allegation of fraud [see *Bloomquist v. Farson*, 1918]. However, as a result of *Ultramares*, accountants were liable for negligence only to parties with whom they were in contractual privity.

A second area of criticism in the *Ultramares* case is the court's assertion that a public accountant's services are rendered primarily for the client. This is counter to the "public watchdog" role for accountants that has developed over modern times [Solomon, 1968, pp. 73-75]. Ultramares was decided before the Securities Acts of 1933 and 1934. At that time, the rights of innocent third parties injured in security transactions by fraudulent misrepresentations had not yet become part of statutory law.

Critics have also discounted Justice Cardozo's fear of subjecting the accounting profession to indeterminant liability. But, "Why should innocent third-parties be forced to carry the risk of the accountant's malpractice?" [*Rusch Factors*, 1968, p. 91]. Would not the risk be more easily and more fairly distributed by imposing it on the accounting profession? In turn, the accountants could pass the cost on to clients, who in turn could pass the cost on to the entire consuming public.

Subsequent to *Ultramares* the courts have basically accepted the general proposition of no third-party liability for negligent misrepresentations [Hawkins, 1959, p. 815]. However, there was one subtle shift in the approach the courts were to take in applying the *Ultramares* precedent to subsequent accountant negligence cases.

In *State Street Trust Co. v. Ernst* [1938], the auditor was charged with failure to call attention to the unsatisfactory state of collections on a large block of loans, the audited entity's principal asset. It appeared that the auditor had exercised poor judgement in reporting the debits as good receivables when in fact they were not. The Court of Appeals thought that this was enough to have the case go to the jury on a question of fraud. Their reasons for this decision were stated [pp. 111-112] as follows:

> We have held that in the absence of a contractual relationship or its equivalent, accountants cannot be held for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit. . . . Accountants, however, may be liable to third parties even where there is lacking deliberate or active fraud. . . . Heedlessness and reckless disregard of consequence may take the place of deliberate intention.

The State Street Trust decision represented a subtle shift from *Ultramares*. In his dissenting opinion, Justice Lehman [*State Street Trust, 1938, p. 128*] noted that Justice Cardozo had been careful in *Ultramares* to point out that "liability cannot be predicated upon error however great in the exercise of judgement." Thus, in *Ultramares*, fraud was the basis of liability, and gross negligence was not a substitute. However, in *State Street Trust* the court ruled that a finding of fraud could be based on what basically amounted to negligent judgments at worst [Hawkins, 1959, p. 816]. Consequently, in *State Street Trust*, gross negligence became a substitute basis for liability.

For nearly forty years the *Ultramares* precedent raised the shield of privity to bar third parties not under contract from suing the accountants for losses suffered because of their negligence. There were only three possible avenues around the privity barrier [Besser, 1976, p. 516]:

1. An allegation by the plaintiff of fraud;
2. conduct of the accountant raising an inference of fraud; and

3. a relationship between the accountant and third-party within which the equivalent of privity could be established.

Not until *Rusch Factors Inc. v. Levin* [1968] would a nonprivity plaintiff be allowed to maintain an action against an accountant. In *Rusch Factors* and subsequent cases, the courts would not attempt to create new law by overturning *Ultramares*. Rather, they would distinguish the facts of their cases from *Ultramares*, and rely on other precedents and legislative action to expand the scope of liability.

Biakanja v. Irving [1958] was another nonaccountant case that would be used later to extend the legal liability of accountants. This case involved an action for damages regarding the invalid drawing of a will. The defendant, who was not an attorney, prepared the will but at the time of its creation did not have it properly witnessed. The will was later determined to be invalid. The plaintiff, who had been the sole heir to the estate according to the original now invalid will, ended up with only one-eighth of the total inheritance. Consequently, he sued the preparer of the will for the damages caused by his alleged negligence.

In *Biakanja* the court considered the precedents handed down in *MacPherson, Glanzer, and Ultramares*. However, they chose not to base their ruling on any of those precedents. Citing the facts of their case as distinguishable from *Ultramares* and the others, the court noted that the "defendant must have been aware from the terms of the will itself that, if faulty solemnization caused the will to be invalid, plaintiff would suffer the very loss which occurred" [*Biakanja*, 1958, p. 19]

The court went on to create a "balancing test" to determine the defendant's liability to injured third parties. The determination whether the defendant would be held liable to the third party not in contractual privity would be a matter of policy, and would include a balancing of the following four factors [p.19]:

1. The extent to which the transaction was intended to affect the plaintiff;
2. the foreseeability of harm to the plaintiff;
3. the degree of certainty that the plaintiff suffered injury;
4. the closeness of connection between the defendant's conduct and the injury suffered.

After applying this test, the court ruled that the criteria had been met, and allowed recovery to the plaintiff despite the absence of privity. The importance of this case rests in the "balancing test" it created. This test will be applied by the courts to hold accountants liable for their negligent misrepresentations.

In addition to relying on the *Glanzer* and *Biakanja* precedents to extend accountants liability beyond the walls of contractual privity, certain courts rely on the principles enunciated in Section 552 of the *Restatement (Second) of*

Torts [American Law Institute, 1976]. Section 552 rejects *Ultramares* to the extent that privity was the sole definitional criterion of duty [Hagan, 1987]. The Restatement does not allow recovery where the reliance by the injured third party is merely "foreseeable," but it does extend the defendant's liability to a member of an "actually forseen" class [Besser, 1976, p. 526]. The Restatement [American Law Institute, 1976, Section 552, p. 132] prescribes that before negligence can be alleged, the party providing the information must know that the recipient intends to supply it to another individual or group. Furthermore, recovery is limited to the loss suffered through forseen reliance [Section 552, p. 127].

The last avenue open to injured third parties in their attempts to expand the scope of an accountant's legal liability is contained in federal securities legislation [Marinelli, 1971]. Section 11 of the 1933 Securities Act expands the accountant's third-party liability significantly beyond that previously discussed in common law. Contractual privity is not necessary to establish liability, and the misrepresentation need not be addressed to nor intended to influence the particular investor. It imposes civil liability for misrepresentations or omissions of material facts in the registration statement of a company.

Although Section 11 provides the foundation for extremely broad third-party liability to accountants, it has resulted in relatively few lawsuits [Marinelli, 1971, p. 129]. This is primarily due to two reasons. First, Section 11 applies only to registration statements filed under the Security Act of 1933; it does not apply to all published financial reports. Second, the Act allows the accountant to assert three defenses. The accountant will not be held liable if he can prove that:

1. He had ceased to act as an accountant before the effective date of the registration statement on which liability is asserted and the Securities and Exchange Commission was notified of this fact;
2. part of the registration statement became effective without his knowledge, and he informed the Commission and gave reasonable public notice of the fact; and
3. he had, after reasonable investigation, reasonable grounds to believe, and in fact did believe, that at the time the registration statement became effective the information it contained was true.

The Securities Act of 1934 also addresses the liability of accountants for misleading statements. Section 18 expressly imposes liability on those who make false and/or misleading statements in any document filed with the Securities and Exchange Commission. Like Section 11 of the 1933 Act, Section 18 of the 1934 Act requires that the misstatement be material; but unlike Section 11, Section 18 allows for a good faith defense where the defendant had no knowledge that the statement was false and misleading [Marinelli, 1971, p. 133].

There have been relatively few lawsuits involving accountants under Section 18, perhaps because of this good faith defense.

Finally, Section 10(b) of the 1934 Act and SEC rule 10b-5 imply civil liability of accountants for financial misstatements. However, the decision in *Ernst & Ernst v. Hochfelder* [1976] watered down the potential impact of Section 10(b). The court ruled that 10b-5 violations covered only intentional fraud, and not negligence. Therefore, this legislation has been of scarce use in attacking the citadel of privity.

CURRENT CASE LAW

The purpose of this section is to narrate when and how third parties were first able to hold accountants liable for negligence, and to analyze the continual expansion of auditors' legal liability to more and more classes of foreseeable injured third parties.

Surprisingly, the theory of recovery recognized in *Glanzer* and *Biakanja*—that a duty of care is owed to recognized primary beneficiaries of a written representation whether or not strict privity exists—was generally not adopted by courts before 1960. Not until the late 1960s did the courts explicitly start to distinguish their cases from *Ultramares*, and begin to apply the precedents of *Glanzer* and *Biakanja*. A nonprivity plaintiff was first permitted to maintain an action against an accountant for ordinary negligence in *Rusch Factors Inc. v. Levin* [1968]. The facts of this case are as follows [p. 86]:

> In late 1963 and early 1964 a Rhode Island corporation sought financing from the plaintiff who requested certified financial statements to measure the corporation's stability. The defendant accountant prepared statements that represented the corporation to be solvent by a substantial amount. In fact, however, the corporation was insolvent. Relying on the statements, the plaintiff loaned money to the defendant's client. Subsequently, the corporation went into receivership and the plaintiff was able to recover only a fraction of the original loan.

The court recognized that the reluctance of prior courts to hold the accounting profession to an obligation of care that extended to all *reasonably foreseeable* reliant parties was predicated upon the social utility rationale first articulated in *Ultramares*. However, it did not understand why an innocent third party should be forced to carry the weighty burden of an accountant's professional malpractice risk. Additionally, it wondered whether the risk of loss would be more easily distributed and fairly spread by imposing it on the accounting profession, which could pass the cost of insuring against the risk onto its customers. The court concluded that a rule of foreseeability would elevate the cautionary techniques of the accounting profession as a whole.

In holding for the plaintiff, *Rusch Factors* marked the *first real extension* of an accountant's scope of liability for negligence to third parties not in

contractual privity. In so holding, the court distinguished its case from *Ultramares* and relied upon the foreseeability concepts of *Glanzer*. But the court went far beyond *Glanzer* when it announced that it would sustain a course of action in favor not only of a *specifically foreseen third party* but also to *unknown members of a specifically foreseen and limited class of parties* [*Rusch Factors*, 1968 p. 93]. *Rusch Factors* represented a sharp change from the contract-oriented approach of *Ultramares*, and really started the process of extending the scope of accountants' legal liability for negligent misrepresentations beyond the walls of contractual privity.

One year after *Rusch Factors*, in *Ryan v. Kanne* [1969] the Iowa Supreme Court allowed a specifically foreseen reliant party to recover damages from a negligent accountant. In this case, the successor corporation of the auditor's client sued Ryan for losses incurred following its reliance on an unaudited financial statement used to take over the assets and liabilities of Kanne Lumber and Supply Inc. The accounts payable amounts presented on the financial statements were severely understated—a situation caused by the accountant's failure to search for open invoices. Even though the statements were clearly marked "Unaudited," the accountant had previously guaranteed their accuracy within $5,000.

The court held that since the accountant was made aware of the intended purpose of the financial statements and the identity of the intended users, lack of privity should not be a valid defense to a claim of damages from the outside third-parties as a result of the accountant's negligence [*Ryan v. Kanne*, 1969, p. 40]. Because there was a reliant known third party, the court was able to distinguish this case from *Ultramares* and rely on *Glanzer* to extend the accountants' scope of legal liability.

The movement away from *Ultramares*, however, had not found unanimity among the courts. For example, the Tenth Circuit, in *Stephens Industries v. Haskins and Sells* [1971] refused to depart from the "generally accepted rule" established in *Ultramares*, and denied recovery to a specifically foreseen injured third party. In *Milliner v. Elmer Fox & Co.* [1974] the Utah Supreme Court also rejected an invitation to expand accountants' liability beyond contract to the limits of foreseeability contemplated by *Glanzer* and *Rusch Factors*. However, the court really did reject the *Ultramares* rule in favor of *Rusch Factors* by dismissing the plaintiff's claim because Milliner could not bring himself within the class of "primary beneficiaries." In so ruling, the court displayed an unwillingness to hold accountants responsible to contemplated but not specifically foreseen reliant third parties.

Although the courts were not in clear unanimity, the trend of holding accountants liable for their negligence to certain reliant injured third parties was clearly gaining favor. In *Aluma Kraft v. Elmer Fox* [1973], the court relied on *Glanzer* and *Biakanja* to hold an accounting firm liable to a specifically foreseen injured third party for their negligently prepared financial statements.

Solmica Co., the successor corporation, relied on the audited financial statements of Aluma Kraft to determine the purchase price. The book value of Aluma Kraft and hence its purchase price was later discovered to have been overstated. The court rejected the privity doctrine and applied the *Biakanja* balancing test. Incorporating the *Glanzer* precedent, the court found that since the defendant knew that the plaintiff would be relying on the financial statements, the evidence satisfied the first element of the *Biakanja* test.

White v. Guarente [1977] and *Haddon View Investment Co. v. Coopers & Lybrand* [1982] continued the expansion of liability for negligence. In both cases, the central issues were whether the accountants retained by the limited partnerships to perform auditing and tax return services could be held responsible to an identifiable group of limited partners for negligence in the execution of their professional services. The identifiable group in this instance were the limited partners of the entities at the time the accountants' services were being performed. These limited partners would be the most likely individuals to use for their own purposes the tax returns and financial statements prepared by the accountants. The plaintiffs alleged that the services of the accountants were not extended to a faceless or unresolved class of persons, but rather to a known group possessed of vested rights.

In distinguishing the *White* case from *Ultramares*, the court noted that "while *Ultramares* made it clear that accountants were not to be liable in negligence on the generalized basis and that a contract for professional services creates liability in favor of the general populace, this plaintiff seeks redress, not as a mere member of the public, but as one of a settled and particularized class among the members of which the report would be circulated for the specific purpose of fulfilling the limited partnership agreed upon arrangement" [*White*, 1977, p. 320].

The courts in both *Guarente* and *Haddon* applied the *Glanzer* and *Rusch* precedents to hold the accountants liable. The decisions further extended the scope of legal liability to unknown members of a specifically foreseen class. Thus it was clear that accountants could no longer hide behind the citadel of contractual privity to escape liability for their negligence. The only question that remained was how far would the boundaries of the accountants' legal liability be extended.

Spherex Inc. v. Alexander Grant & Co. [1982] continued the expansion. The issue before the court was the extent to which an accountant could be held liable for damages in tort to third parties for negligent misrepresentations contained in unaudited financial statements. General Home Products Corp. (GHP) engaged Alexander Grant to prepare an unaudited financial statement for the 12 months ending December 31, 1977. GHP submitted these statements to Spherex for the purpose of obtaining credit. The credit was approved and Spherex proceeded to loan GHP substantial amounts. GHP subsequently declared bankruptcy and was unable to repay the debt. Spherex subsequently

sustained financial losses and filed suit in district court alleging that (1) Alexander Grant either knew the unaudited financial statement was inaccurate or was negligent in preparing the statement, and that (2) Alexander Grant knew GHP would show the statement to Spherex, and that Spherex detrimentally relied on the statement in extending credit to GHP.

The court in *Spherex* relied primarily on Section 552 of the *Restatement (Second) of Torts* to base its decision, noting that it represented a "reasoned approach to the issue of professional liability for negligent misrepresentation. . . . while an accountant is to employ a sufficient degree of care in the performance of professional activities in order to protect himself from liability, the law must not arbitrarily extend that liability beyond his reasonable expectations as to whom the information will reach" [*Spherex*, 1982, p. 1312] The court believed that Section 552 preserved such boundaries of liability [p. 1312].

Spherex thus added a third precedent available to the courts to distinguish cases from *Ultramares*: the reasonably foreseeable test of *Glanzer* and *Rusch*, the balancing factors test of *Biakanja*, and now the actually forseen test of Section 552 of the Restatement of Torts.

H. Rosenblum v. Adler [1983] used the the *Glanzer* and *Rusch Factors* precedents to extend accountants' liability. The fundamental issue was whether there should be any duty by accountants to respond in damages for economic losses sustained by a foreseeable user who was neither in contractual privity nor intended by the accountant to be the user of the financial statements. The court considered all precedents and noted [pp. 148-151]:

1. The independent auditor should be expected to detect illegal or improper acts that would be uncovered in the exercise of normal professional skill and care.
2. It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor. Moreover, it is common knowledge the companies use audits for many proper business purposes.
3. The responsibility of a public accountant is not only to the client who pays his fees, but also to investors, creditors and others who may rely on the financial statements which he certifies.
4. Independent auditors have apparently been able to obtain liability insurance covering these risks or otherwise to satisfy their financial obligations.

In finding for the plaintiff, the court ruled [pp. 152-153] that:

> when the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom the auditor should reasonably foresee as recipients from the Company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes. . . . The extent of financial exposure has certain built-in limits. The plaintiffs would have to establish that they received the audited statements from the company pursuant to a proper company purpose and that

> they, in accordance with the purpose, relied on the statements and that the misstatements therein were due to the auditor's negligence and were a proximate cause of the plaintiffs damage. The injured party would be limited to recovery of actual losses due to reliance on the misstatement.

While recognizing the auditor's responsibility to outside third parties, the court in *H. Rosenblum* limited that responsibility to the auditing function, and left responsibility for the financial statements with the client company being audited [Hagan, 1987, p. 85]. For example, if the company management chooses an accounting method solely because it results in greater net income, the courts will not hold the CPA liable for the misrepresentation provided that the accounting method is currently being used by some other entities. Thus, as long as a CPA complies strictly with the applicable AICPA professional standards, he will not breach the duty of care required in auditing even if the financial statements prove to be misleading.

This concept was subsequently applied in *Goss v. Crossley* [1983]. The defendant, Peat Marwick Mitchell & Co. (PMM) was asked to prepare pro forma financial statements reflecting the purchase and reorganization of two companies. The board of directors of the acquiring company asked PMM to express an opinion as to the most advantageous means of combining the companies, and whether or not the transaction should be accounted for as a pooling of interest or as a purchase. PMM delivered the pro forma statements to the client, and the business combination was accounted for as a purchase. Later, at the time of the actual purchase and reorganization, PMM was required as a condition precedent to the reorganization to provide a comfort letter. PMM stated that, on the basis of a limited review, nothing had come to its attention that caused it to believe that there had been any material adverse changes in the consolidated financial position or operations of the reorganized companies [*Goss,* 1983, p. 613].

In its complaint against PMM, the survivor company alleged that the accounting firm exhibited negligence by (1) recommending the wrong accounting treatment for the reorganization, and (2) not disclosing material adverse changes in the purchased company in their comfort letter [*Goss,* 1983, p. 617]. After hearing considerable expert testimony, the court said that while PMM's recommendation regarding the choice of accounting method for the reorganization was creative, it was also evident that this was a unique situation which required careful analysis and judgment [p. 621]. The court found no evidence to suggest the defendant had not complied with its professional responsibilities under Generally Accepted Auditing Standards (GAAS) when making their judgment regarding the proper accounting treatment for the business combination or when conducting the limited review for the purposes of issuing the comfort letter. The court concluded that the board of directors, were in effect, attempting to shift the blame to persons other than themselves for a purchase gone bad.

The decision in *Goss v. Crossley* [1983] borrowed from the fundamental concept discussed earlier in *Gammel v. Ernst and Ernst* [1955]: an accountant will not be held liable for negligence as long as he maintains a high duty of care in the normal performance of his duties. Where there is more than one method of accounting for a particular transaction, a CPA will not be held to have breached his duty of professional care merely by choosing one accepted method of accounting over another. If there is an official pronouncement dealing with a particular method of accounting or auditing procedure, but there is disagreement within the accounting profession as to its applicability, the CPA will not be held to be negligent by choosing one method or procedure over another.

Subsequent to *Goss*, the Wisconsin Supreme Court relied on Section 552 of the Restatement in the case of *Citizens State Bank v. Timm, Schmidt & Co.* [1983]. Citizens made loans to Clintonville Fire Apparatus, Inc. (CFA) based on the Company's 1975-1977 financial statements which had been audited by Timm. In 1977 material errors were discovered in the 1975 statements. Subsequently, CFA went into bankruptcy and Citizens sued the accounting firm to recover its damages. In ruling for the plaintiff, the court quoted from Comment h of Section 552 when it stated: "It is not required that the person who is to become the plaintiff be identified or known to the defendant as an individual when the information is supplied. It is enough that the maker of the representation intends it to reach and influence either a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might reasonably be expected sooner or later to have access to the information and foreseeably to take some action in reliance upon it" [*Citizens State Bank*, 1983, p. 366].

In a similar case, *Raritan River Steel & Co. v. Cherry & Beckaert* [1986], the Court of Appeals of North Carolina criticized the Restatement test for creating an undesirable inflexibility that denies injured third parties recovery simply because they do not fall within a specific class of persons [*Raritan River Steel,* 1986, p. 68]. The court was asked to decide whether a third person not in privity of contract with a certified public accountant has a claim against that accountant for negligent misrepresentation which resulted in a financial loss to the third party. The court considered the different precedents and decision aids being brought to bear on this issue by other courts in the country. It chose to apply the Biakanja balancing test and ultimately found for the plaintiff.

The strict privity doctrine was also attacked in *International Mortgage Co. v. John P. Butler Accountancy Corp.* [1986]. This case further extended accountants' legal liability to large groups or classes of individuals whom *accounting information is intended to reach and influence in the normal course of business.* The plaintiff, in reliance on a broker's financial statement, contracted with that broker to purchase and sell government loans. As a result

of the defendant's alleged negligence in auditing and certifying the broker's financial statements, the brokers net worth was grossly overvalued. In fact, his true net worth was far below the minimum amount needed to qualify to deal in government loans. The auditor was aware of the net worth requirements at the time of the audit, but had no knowledge of the plaintiff or of the plaintiff's receipt of, or reliance upon, the financial statements. In deciding for the plaintiff, the court reasoned that the protectionist rule of privity in *Ultramares* was no longer viable, because the role of the accountant in our modern society had changed [*International Mortgage,* 1986, p. 819]. The court refused to accept the premise that, absent duty, a person was free to be as negligent as he chooses, and said that "an independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on negligently prepared and issued unqualified audited financial statements" [p. 819]. Consequently, the court used the *Glanzer* and *Rusch* precedents but extended them when deciding that an innocent plaintiff who *foreseeably relies* on an independent auditor's unqualified financial statement should not be made to bear the burden of the professional's malpractice.

The most recent case involving an accountant's alleged negligence is *Blue Bell Inc. v. Peat Marwick Mitchell & Co.* [1986]. The plaintiff, relying on the 1981 audited financial statements of Meyers Department Stores, extended credit to Meyers. In November 1982, Meyers filed for bankruptcy. Blue Bell recovered through bankruptcy proceedings only a portion of the balance due on its account from Meyers. The court based its decision on Section 552 of the Restatement, but adopted a less restrictive interpretation than had been done previously. The court held that, "if under current business practices and in the circumstances of this case, an accountant preparing audited financial statements knows *or should know* that such statements will be relied upon by a limited class of persons, the accountant may be liable for injuries to members of that class relying on his certification of the audited reports" [*Blue Bell,* 1986, p. 412]. This decision is consistent with the ruling in *International Mortgage* and confirms that, in at least some sections of the country, accountants' legal liability for negligence extends to all third parties who would use the financial statements in their normal course of business.

CONCLUSION

In half a century, the accountant has seen the boundaries of his legal liability for negligent misrepresentations expand from only parties in contractual privity to all parties who would be reasonably expected in the normal course of business to rely on his financial statements and reports. However, since courts in different jurisdictions may use different precedents in defining a "foreseeable user" of a financial report, the accountant's range of liability is not consistent

across the country. Some states have attempted to deal with this uncertainty by enacting "privity laws" that would limit the accountant's legal liability for negligence. But the constitutionality of these laws has not been tested.

At a minimum, it is safe to say that the courts have abandoned the principles of contract in defining the scope of an accountant's legal liability for negligence, and have extended the scope of legal liability beyond the walls of contractual privity. The limit of liability may be settled only if and when another accountant negligence case is heard in the United States Supreme Court.

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THE SIMPLE MAJORITY VOTE REQUIRED FOR PASSAGE OF A STATEMENT OF FINANCIAL ACCOUNTING STANDARDS:

AN ANALYSIS OF ONE ASPECT OF THE STANDARDS OVERLOAD PROBLEM

Janet S. Omundson, Karl B. Putnam, and Richard G. Schroeder

ABSTRACT

Accounting standards overload is a complex, controversial topic. One aspect of the standards overload issue has been the change in 1977 by the Financial Accounting Stadards Board (FASB) to allow passage of Statements of Financial Accounting Standards (SFASs) by a 4 - 3 vote of the members. The impact of this change and the subsequent release of several complex SFASs has been noted by financial statement preparers and users. The FASB is faced with conflicting arguments when deciding on the number of votes necessary for passage of an SFAS. A Special Advisory Group to the FASB summarized the arguments for and against returning to the 5 - 2 majority vote for passage procedure. Due to

Research in Accounting Regulation, Volume 4, pages 99-109.
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ISBN: 1-55938-084-5

a diversity of opinion among its members, the Group did not make a recommendation on this issue. The study reported herein examined the impact of the change to the 4 - 3 majority vote for passage procedure on: (1) the number of statements issued, and (2) the relationship of the original majority votes for passage of a Statement of Financial Accounting Standards with the frequency with which those statements were later amended. Both the number of statements issued and the number of statements requiring amendment increased following the decision to allow a Statement of Financial Accounting Standards to be passed by a simple majority vote of the Board. It was concluded that the question of whether the number of votes for passage of a proposed SFAS should be 4 - 3 or 5 - 2 turns on the perceived relative importance of: (1) the standards overload issue, and (2) the need to react to a changing environment.

In recent years the Financial Accounting Standards Board (FASB) has been criticized for imposing too many accounting pronouncements on the business community. This has been termed the standards overload problem. One facet of the standards overload problem is that many Statements of Financial Accounting Standards (SFASs) are revised shortly after they have been issued. Each SFAS and revision of an SFAS causes public accounting firms to spend additional time reviewing the applicability of these statements and amendments to its clients and consequently results in additional costs. Changes in existing pronouncements require practitioners to learn the new rules and to forget the old ones [Dominiak, 1989]. Thus, many public accounting firms are finding it increasingly difficult to stay abreast of the constantly changing standards. To illustrate, David Mosso [1983] conducted a survey that asked CPAs to state the amount of time necessary to be spent, and the time actually spent annually, to remain current with generally accepted accounting principles (GAAP). Small-firm CPAs estimated that an average of 81 hours were required versus 54 hours actually spent. Large-firm CPAs were closer to the mark with 109 estimated hours necessary versus 105 actually spent. The results of Mosso's study indicate that CPAs feel more time is needed than is currently available to remain up-to-date with GAAP.

One aspect of the standards overload problem that requires investigation is the relationship between the orginal votes for passage of an SFAS by the members of the Board, and the number of SFASs issued. That is, has the number of SFASs issued been affected by the number of affirmative votes required to issue a new standard? From the period of its inception until mid-1977, a 5 - 2 affirmative vote by the members of the FASB was required for the adoption of an SFAS. Subsequently, the FASB changed its rules and only required a simple 4 - 3 majority vote for passage of a proposed SFAS. In recent years many SFASs have been amended shortly after they have been issued.

Thus, a second aspect of the standards overload problem is the relationship of original votes for passage of an SFAS and the subsequent need to amend the statements.

The purposes of this paper are to examine: (1) the number of statements issued when the vote for passage was 5 - 2 as contrasted to when it was 4 - 3, and (2) the relationship of the orginal votes of the members of the FASB with the frequency with which those statements were later amended. This paper is organized as follows: (1) a discussion of the standards overload issue, (2) a discussion of FASB voting patterns, (3) a description of the study, and (4) the presentation of some conclusions.

STANDARDS OVERLOAD

The purpose of FASB pronouncements is to require corporations to provide full disclosure of the results of their activities. However, many critics of the FASB contend that too many standards are being released resulting in standards overload. The controversy relating to standards overload has been ongoing, and a solution does not seem imminent. For example, David Mosso [1983 p. 120] stated: "When I first encountered the subject, 'standards overload' looked like the legendary Gordian knot, so intricate it couldn't be untied by any ordinary mortal. After five years of wrestling with the problem, however, I think maybe it isn't a Gordian knot after all—it looks more like a hangman's noose." The standards overload issue must be viewed in the context of the need to provide full disclosure. Full disclosure has benefits to external users, provided the users are not subject to information overload.

Two other major considerations of the standards overload issue are: the cost to comply with new standards and the effect of compliance on managerial decision making. The societal benefits to external users of full disclosure may also be offset by the costs of producing and assimilating the information. The promulgation of each new standard results in additional costs to public accounting firms and their clients. Additionally, company management needs stable financial accounting standards to make decisions. Any externally imposed standards tend to be disruptive and therefore involve a net cost to the company. Brown [1986] also identified some possible costs of converting accounting systems to a new or modified standard, including: increased auditing costs of processing and reporting the required information, and reading and understanding the new rules and adjustments to contractual arrangements.

Another issue to be considered is the effect of new standards on small companies. In 1976, the American Institute of Certified Public Accountants (AICPA) Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses recommended that although the same

measurement principles should be used for all entities regardless of size, relief for smaller or closely held entities from the increasing burden of required financial statement disclosures should be provided. In 1980, the AICPA's Special Committee on Small and Medium-Sized Firms reported that accounting standards overload was one of many problems faced by these firms.

Part of the standards overload problem may be perceptual. That is, many accountants may not be fully cognizant of the role of the FASB. In an opinion poll conducted by Harris and Associates [1985], approximately 66 percent of the accountants surveyed stated that the FASB should deal only with broad, pervasive issues, rather than narrow issues. Moreover, standards overload was seen as an important issue in that approximately 60 percent of those surveyed indicated a belief that the FASB issued too many new standards.

The FASB and the profession are aware of the magnitude of the standards overload issue and have attempted to address the problem. In both 1980 and 1981, the FASB issued an invitation to comment on standards overload. In 1983 the AICPA established the Special Committee on Accounting Standards Overload. One recommendation of this committee was that a FASB objective should be the simplification of standards for all entities by avoiding complex and detailed rules to the extent possible. However, the committee also concluded that the complexity of economic activities being accounted for has contributed to the intricacy of the standards. Consequently, the FASB must simultaneously deal with two issues: (1) a constituency that is increasingly coming to regard standards overload as an overriding issue, and (2) the need to provide standards that accurately reflect the complex economic transactions faced by many businesses.

FASB VOTING PATTERNS

Assessing the voting pattern of the members of the FASB is difficult because the promulgation of accounting standards has political as well as economic implications [Newman, 1981]. That is, the members of the FASB are continually subjected to lobbying efforts from groups such as management, auditors, and financial analysts; and recent congressional investigations of the accounting profession have focused attention on the political nature of the accounting standard-setting process. However, Brown [1981] concluded that the FASB does not appear to consistently position itself with any one external constituency including public accounting firms. This finding led Van Riper [1987, p. 130] to the conclusion that the FASB has lived up to its stated expectation because: "Members are expected not to represent the interests of particular segments of the Board's constituency." On the other hand, Miller and Redding [1986, p. 26] stated that"... the answer to the question of whether the FASB is a political institution is a clear 'yes.' This answer should be

understood to mean that the FASB governs by negotiation and compromise rather than by manipulative means. . . . It would be naive to believe that manipulative methods and motives never enter into the activities of the Board and its constituents."

The fact that the FASB is of necessity a political institution may not be well understood. The Board now adopts standards by a majority vote of its seven members. To many, a 4 - 3 vote may indicate a lack of consensus among the members of the Board. However, proponents of a simple majority argue such is not always the case. For example, Robert Van Riper [1986, p. 2], of the FASB staff stated: "Given the complexity of most issues confronting the Board and the diversity of views about them throughout the constituency, it is not surprising that 4 - 3 votes are fairly frequent. But even though the vote on the final statement is 4 - 3, there may have been unanimous agreement on the fundamental broad issue. Each of the three dissenters may have had a different reason for dissenting. This implies that negotiation and compromise are necessary in order to reach agreement among at least four Board members."

Critics of the FASB's deliberative process maintain that due process not only forces the FASB to waste time on minutiae, it also sometimes results in unworkable rules. By trying to satisfy everybody, these rules end up being costly for companies to implement and are sometimes ineffective [Berton, 1984].

In 1988 the Financial Accounting Foundation's Board of Trustees appointed a Special Advisory Group to review the FASBs standard setting process. This group, commonly known as the Groves Committee, was formed in response to concerns in the constituent community (preparers, auditors, and users) over standard implementation issues. Of particular concern was the feeling of many that too much change had taken place in too short a time.

One of the subjects studied by the Special Advisory Group was the FASB's voting procedures. The Group's deliberations indicated that its members held differing views. Some members favored returning to the 5 - 2 majority voting requirement. They believed this change would:

1. strengthen the Board's decision by increasing members' participation in the give and take needed to arrive at timely workable solutions to problems;
2. increase the perception that: (a) there is significant unity among Board members on contentious issues, and (b) the resolution of such issues was not dependent on a single Board member; and
3. enhance the fundamental premise that standards have achieved a high degree of acceptance among the FASB members.

Other members of the Special Advisory Group did not favor a change from the existing 4 - 3 simple majority procedure. They held that:

1. the general acceptance of standards depends more on the overall performance of the FASB and the quality of the standard setting process rather than on whether decisions are made by a 5 - 2 versus a 4 - 3 vote, and
2. the concept of a simple majority is typical of the decision making process in this country.

Due to the diversity of views among its members, the Special Advisory Group did not make a specific recommendation regarding a change in the FASB's voting procedures. Consequently, additional study is needed to provide information on the impact of the FASB's voting procedure. The study reported herein is an attempt to provide such information.

THE STUDY

This paper explores the relationship of the original vote by the members of the FASB on SFASs, with (1) the number of statements issued and (2) later amendments to SFASs. The specific methodology used compared the number of SFASs issued when the original vote for passage of a statement was 5 - 2 with the number of statements issued when the required vote for passage became 4 - 3. Subsequently, all SFASs were analyzed to determine if they amended previously issued statements. For purposes of this analysis, SFAS No. 97 was the last statement reviewed for amendments, and SFAS No. 102 was the last statement reviewed for amendments to previously issued SFASs. There is a 14-month lag between the issuance of *SFAS 97* and *SFAS 102*, consequently every SFAS examined has had a period of at least 14 months to be amended.

The percentage amendment to each revised SFAS was then calculated by dividing the number of paragraphs amended by the total number of paragraphs in the statement. This approach adjusts for the relative length of the SFASs. It assumes that the characteristics of all paragraphs are similar in terms such as difficulty and controversiality. A paragraph that had been amended more than once was counted as a new amendment. A statement that had been superseded or withdrawn was considered 100 percent amended. But statements which had been amended and then superseded or withdrawn were never considered more than 100 percent amended. The votes on each statement were also tabulated for *SFASs 1-97*, and categorized as follows: 7 - 0, 6 - 1, 5 - 2 or 4 - 3.[1]

FINDINGS

During the approximate 4-year period when a 5 - 2 vote for passage of a statement was required, fifteen SFASs were issued for an average of about 4.19

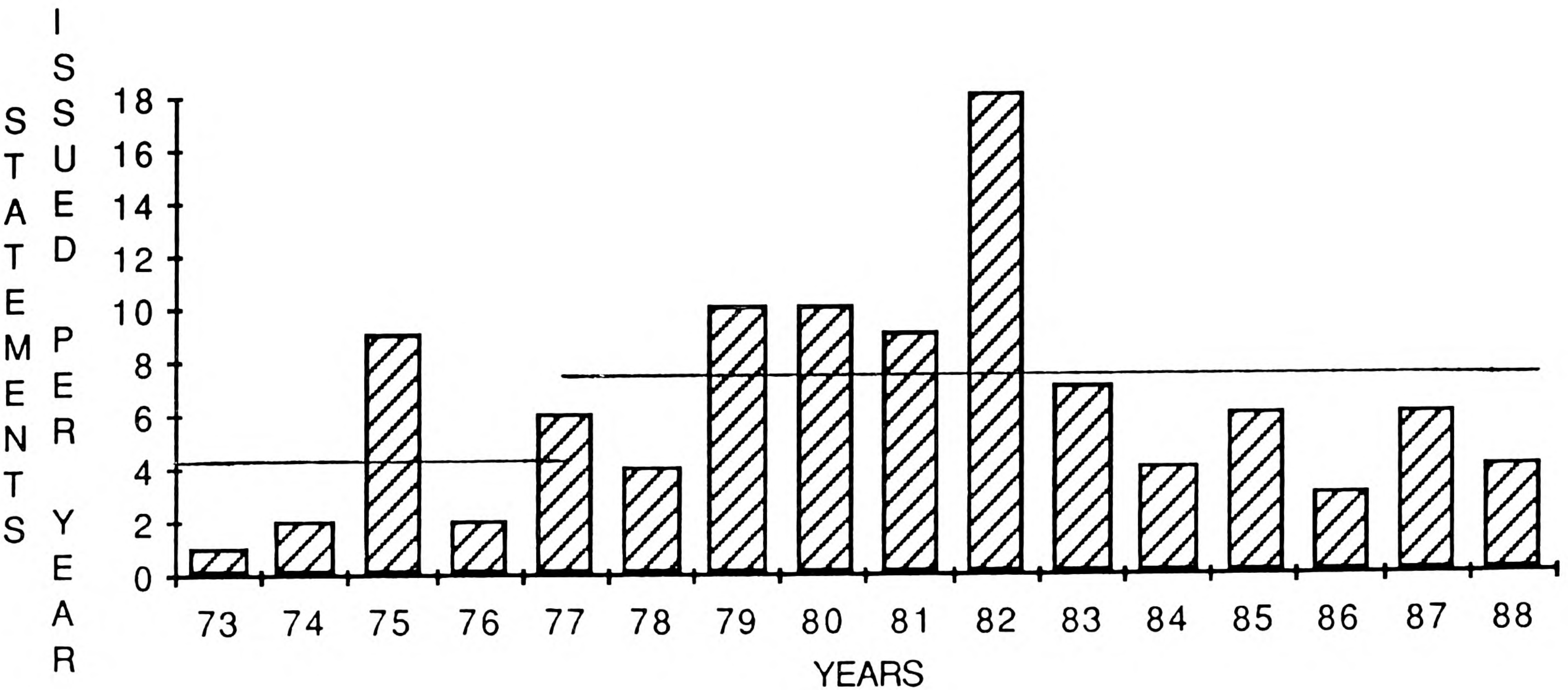

Figure 1. Statements of Financial Accounting Standards Issued by the FASB by Year

Table 1. Percentage of Statements Amended by Vote

Vote	7-0	6-1	5-2	4-3
Number of SFASs that were passed by the given vote	37	22	20	18
Percentage of above FASB Statements:				
A. Requiring no amendment	49	59	25	17
B. Requiring amendment				
1. Requiring partial amendment	27	23	55	72
2. Requiring 100 percent amendment	24	18	20	11
3. Total requiring amendment	51	41	75	83

Table 2. SFASs Partially Amended: Actual Percentages of Amendments by Individual SFAS[a]

Vote	
7-0	19(28); 16(65); 10(60); 8(57); 7(5), 6(29); 4(51); 3(49); 3(2); 2(93).
6-1	18(4); 10(55); 9(7); 8(14); 1(91).
5-2	50(24); 33(13); 12(22); 6(21); 5(43); 4(38); 4(44); 2(12); 2(66); 1(15); 0(96)*.
4-3	15(90); 13(34); 10(69); 10(71); 8(16); 7(19); 6(25); 6(95); 4(52); 2(76); 2(89); 0(35)*; 0(87)*.

[a] SFAS number in parentheses.
* Percentage amendment rounds to 0%.

Table 3. SFASs Amended 100%

Vote	*SFAS Number*
7-0	1, 9, 20, 26, 31, 37, 46, 59, 82
6-1	8, 36, 71, 74
5-2	17, 33, 39, 40
4-3	41, 54

statements per year. From that time until February 1989, eighty-seven SFASs were issued for an average of 7.40 per year. Figure 1 graphically illustrates this increase in the issuance rate.[2]

The relationsip between original votes for passage and subsequently amended SFASs is disclosed in Table 1. This exhibit indicates an apparent inverse relationship between the number of original votes for SFASs and the number subsequently amended. For example, when the members of the FASB originally adopted a statement by a 7 - 0 vote, an average of one out of every two statements (51%) was subsequently amended. In comparison, 83 percent of the SFASs originally adopted by a 4 - 3 vote were later amended. This trend of an increasing likelihood of amendment with decreasing majority vote is even more pronounced in view of the fact that five affirmative votes were required

to pass an SFAS during the period when the first fifteen SFASs were adopted by the FASB. These results indicate that the margin of passage for a particular SFAS is associated with its potential subsequent amendment and that only requiring a simple majority of FASB members for approval of an SFAS may be exacerbating the standards overload problem.

Tables 2 and 3 report the actual SFASs amended, the percentage amendment to each statement, and the original vote for passgae of each amended SFAS. The data in Table 2 report partially amended SFASs and Table 3 reports on 100 percent amended SFASs.

CONCLUSIONS

The results of this study indicate that the standards overload problem may be compounded by: (1) requiring a simple majority vote by the members of the FASB for passage of an SFAS and (2) partial, complete, and in some cases repeated revisions of SFASs. Additionally, an apparent inverse relationship was found between the original vote for passage of an SFAS and the likelihood of its amendment.

One possible method of alleviating the standards overload problem would be to increase the majority vote necessary for passage of an SFAS back to 5 - 2. However, although the results of this study indicate that this change in procedure might reduce the number of SFASs issued, it would not necessarily lessen the need for subsequent amendments. That is, from Table 1 it can be seen that the percentage of statements requiring amendment that originally passed by 5 - 2 votes (75%), is not markedly different from the percentage of SFASs subsequently amended that were originally passed by a 4 - 3 vote (83%). This finding only partially supports the argument, put forth by members of the Special Advisory Committee who favor changing the FASB's voting procedures, that requiring a 5 - 2 majority for passage of an SFAS would not only preclude the passage of marginally acceptable SFASs but also reduce the amount of subsequent amendments. This change in procedure would probably increase the discussion time for each proposed statement, allow more time for a thorough evaluation of alternatives, and make future amendments less likely.

One additional concern of the standards overload problem is that the cost of compliance may be adversely affecting the practice of accounting. Hertz [1983, p. 33] maintained that although the universally accepted high ethical and technical standards do not reduce professionalism, such standards should not be equated with detailed operational requirements, and that perhaps "'standards overload' is merely a euphemism for regulations overload."

Another aspect is "implementation overload," that is, difficulty in obtaining data for required disclosures. Recently there has been some discussion of the lack of support from accoutants for statements of increasing complexity. For

example, Wyatt [1988] states that professionalism is declining and cites as evidence the increase in "loopholism" in applying accounting standards. He goes on to state that standards will only be effective if they are enforced and the only effective enforcement is their acceptance by the majority of accountants. To illustrate, *SFAS 13*, "Accounting for Leases," requires companies to capitalize leases. The intent of this pronouncement was to force more companies to record leases as debt. But the standard, which runs 226 pages and includes seven amendments, six interpetations, and nine staff bulletins, has so many loopholes that most companies have figured out ways around it [Berton, 1984].

Gerboth [1988] argued that "loopholism" does not reflect the failure of standard setters to appreciate the importance of professional support as much as it reflects their failure to understand the limits on that support. In particular, there may not have been a realization that divergent values need to be accommodated.

In order to eliminate "loopholism" and expand the limits of professional support, additional consensus on the need for new standards and their applicability is needed. Perhaps requiring a 5 - 2 vote to pass new standards would force the Board to broaden standards and allow for more judgment on the part of the accountant. This in turn could bring back some support for accounting standards. As noted by Snavely [1987, p. 47], "What is needed is not a paper with no authority by only seven (or less) members of a select committee. Instead what is needed is an authoritative document approved by thousands." The FASB must also deal with the counter argument that GAAP should be sensitive to changes in conditions in the accounting environment, and that retaining a simple majority vote by the members of the FASB to pass a new SFAS helps to maintain this sensitivity. Therefore, the question of the number of votes that should be required by the members of the FASB to pass a particular SFAS turns on the perceived relative importance of (1) the standards overload issue, and (2) the sensitivity to a changing accounting environment argument. It is hoped that the data reported in this study will assist in assessing these issues.

NOTES

1. In several cases the FASB either did not have seven members, or all seven members did not vote. One 6 - 0 vote was tabulated as a 6 - 1 vote, one 5 - 1 as a 5 - 2 vote, and one 4 - 2 vote as a 4 - 3 vote.

2. These averages may be slightly distorted because of the start-up time necessary to study the accounting issues that faced the FASB at its inception. After four years the FASB was in a position to respond to issues more quickly, and in the early years of the FASB there may not have been as many accounting issues that needed attention as there were later.

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TRUST OR ANTITRUST FOR THE PROFESSION OF ACCOUNTANCY?

Billie M. Cunningham, Rasoul Tondkar, and Edward N. Coffman

ABSTRACT

Early in 1986, the American Institute of Certified Public Accountants retained Louis Harris and Associates to conduct a public opinion poll on CPA qualifications and services, and on regulation of the profession. While the overall result of the poll was positive, there was concern over the few CPAs who behave less than professionally. The poll supported more regulation of the profession and a stronger system of enforcement of professional standards, and reflected very high expectations for the future performance of accountants.

Actually, the response to this poll should not be surprising, for the public has always had a healthy skepticism about the effectiveness of professional self-regulation and about the real motives of professionals. In the last two and a half decades, the broad area of competition or restraint of trade in the professions, or antitrust, has been one focus of public skepticism. The purpose of this paper is to provide a general historical overview of legislation, litigation, and investigation involving antitrust issues relating to the professions in general, and the accounting profession in particular. It traces the interpretation of antitrust laws from the points of view of legislators, regulators, and the general public, as well as from the viewpoint of professional accountants.

Research in Accounting Regulation, Volume 4, pages 111-128.
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ISBN: 1-55938-084-5

INTRODUCTION

As far back as 1776, economist Adam Smith [1937, p. 108] commented that "people of the same trade seldom meet together even for merriment and diversion, but the conversation ends in a conspiracy against the public or in some contrivance to raise prices." Similarly, in 1911, George Bernard Shaw [p. xxii], in his scathing critique of the medical profession, made a similar observation: "No doubt the same may be said of all professions. They are all conspiracies against the laity."

In their time, these opinions about members of trades and professions may have represented those of many people. But even though the Sherman Antitrust Act was enacted in 1890 to prevent such conspiracies, the professions remained unaffected for decades. Beginning in the mid-1960s, though, the sentiment espoused by Smith and Shaw seems to have grown stronger and more vociferous, as reflected in a flurry of investigative, judicial, and legislative activity involving antitrust issues and the professions. The purpose of this paper is to illustrate the evolution of antitrust legislation, litigation, and investigation involving the professions in general, and the accounting profession in particular.

THE ERODING ANTITRUST IMMUNITY OF THE PROFESSIONS

Theories of Immunity

Until the mid-1960s, professional immunity to the antitrust laws was more or less taken for granted by professionals and by some judges. This alleged immunity of professionals to the antitrust laws has been based on at least three different theories [Bauer, 1975]. The first theory is that professional activities are not "trade or commerce" within the intended meaning of the Sherman Act.[1] This notion is sometimes referred to as the "learned profession exemption." According to Bauer, professionals render services and personal efforts rather than sell goods or conduct trade. Furthermore, according to Bauer [1975], there are two apparent underlying ideas that distinguish professional activities from "trade or commerce":

1. Professionals use their extensive training to work in the interest of their clients and the general public. Therefore, any restraints of trade that the professional engages in are not motivated by a desire to lessen competition.
2. Some ideals and ethical values of professionals that exist to protect clients and the public from incompetent and unscrupulous practititioners are not consistent with competition and may actually be jeopardized by conduct that the antitrust laws seek to promote.

One question raised today is whether the distinction between "trade or commerce" and professional activities is enough to warrant a blanket professional exemption from the antitrust laws. Over the last two and a half decades, professionals have taken on more commercial activities not necessarily requiring professional licensure, such as the performance of financial and tax write-up work and management advisory services by accountants. At the same time, unlicensed practitioners have been participating in more activities normally performed by professionals, blurring the fine line between professional activities and commercial activities. Perhaps, then, the "learned profession exemption" should apply to only those activities requiring professional licensure rather than to entire professions.

The second theory on which the alleged immunity of professionals has been based is that the activities and practices of professionals do not fall within the scope of the Sherman Act because their activities are local and not interstate, as stated in the Sherman Act. It has become increasingly difficult to apply this theory to all professionals now that the business environment includes multinational firms and firms with segments all over the United States. While it can be argued that some professional practices are local and not interstate, others, including practices of many lawyers and accountants, must be interstate in order for these professionals to service large corporations and multinational firms.

The third theory is that state officials actively supervise and regulate some professional conduct, thereby displacing the federal antitrust laws under the constitutional concepts of federalism and state sovereignty (the state action doctrine). Because of the complexity of this issue, the courts currently decide on a case-by-case basis where the authority of the federal government ends and the authority of the state governments begins.

Eroding Professional Immunity in the Courts

Specific professional immunity to the antitrust laws was recognized by the courts in 1932. In attempting to define the boundaries of the Sherman Antitrust Act, the judges determined that the definitions of the words "trade" and "commerce" as they appear in the act, exclude the "learned professions" [*Atlantic Cleaners and Dyers, Inc. v. U.S.*, 286 U.S. at 431 (1932)]. This decision was based on a previous interpretation of commerce as interstate transportation and "contracts to buy, sell or exchange goods to be transported across state lines" [*United States v. E.C. Knight Co.*, 156 U.S. 1, 13 (1895)].

Later [*Parker v. Brown*, 317 U.S. 341 (1943)], the Supreme Court refined the substance and scope of the Sherman Act by specifically declaring that "state action" was exempt from the act. The specific ruling held that the Sherman Act was not intended to prohibit a program or activity that had "derived its

authority and efficacy from the legislative command of the State" [*Parker v. Brown*, 317 U.S. at 350]. This has come to be known as the state action doctrine. Many professionals and judges induced that since most professions (e.g., accountancy, law, medicine, and so forth) and professional activities are regulated in some way by the states through state licensing boards and sunset laws, these activities would be included in this ruling and would, therefore, be exempt from the Sherman Act under this doctrine. However, this case specifically addressed only the regulatory actions of state legislatures. There was no direct guidance for state courts, agencies, or regulatory bodies, nor for the combined actions of state agencies and private parties.

From *Parker* forward, judges have subjected this state action exemption to varying degrees of restriction and expansion. In 1975, however, the state action exemption began to be interpreted more narrowly. Bar associations' minimum fee schedules were held to be illegal as a classic case of "price fixing" affecting interstate commerce, even though the bar association is considered to be an agent of the state [*Goldfarb. v. State Bar of Virginia*, 421 U.S. 773, 785-788 (1975)]. The Supreme Court established the initial point of inquiry for applying *Parker's* state action doctrine as being "whether the [anticompetitive] activity is required by the State acting as sovereign" [*Goldfarb*, 421 U.S. at 790]. In other words, the activity in question must have been compelled by the state in order to be protected by the state action doctrine. This effectively shifted the focus of the state action doctrine from whether the activity was regulated or non-regulated by the state to the strength of the act of regulation. The fact that the State Bar is a state agency would not necessarily create an antitrust shield that would allow it to foster anticompetitive practices for the benefit of its members.[2] The court also determined that the regulatory actions of state courts were also protected under the state action doctrine.

The interpretation that the activity in question must be compelled by the state in order for it to be protected by the state action doctrine was reinforced in *Cantor v. Detroit Edison Co.* [428 U.S. 579, 598-599 (1976)]. Mere state "authorization, approval, encouragement, or participation in restrictive private conduct confers no antitrust immunity" [*Cantor* 428 U.S. at 952]. Tolerance of regulatory restrictions is not enough. The state must clearly identify, regulate and enforce the action of the agency in question.

In May of 1976 [*Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council*, 96 S. Ct. 1817 (1976)], and in June of 1977 [*Bates and O'Steen v. State Bar of Arizona*, 97 S. Ct. 2691 (1977)], though, state action was again held to be immune to Sherman Act proscriptions. Restrictions on advertising by lawyers and pharmacists were not considered to be illegal per se, but were considered to be actions of the states since the professional organizations promulgating these restrictions were acting as agents of the state. (These advertising restrictions were clearly articulated as state policy and were supervised by the state supreme courts.) However, the advertising bans were

summarily rejected on first amendment grounds. These are the first major cases that balanced the state's interest in economic regulation with the first amendment rights of the individual.

In 1980, a significant step was taken toward clarifying the analysis to be employed in the application of state action immunity to mixtures of public and private action (for example, those state agencies composed of members of the professions being regulated by those same agencies). According to the decision in *California Liquor Dealers Association v. Midcal Aluminum, Inc.* [445 U.S. 97 (1980)], two criteria must be met in order for a public/private action to be protected under the state action exemption.

1. The action must be clearly articulated and affirmatively expressed as state policy.
2. The policy must be actively supervised by the state.

However, this case did not address *Goldfarb's* criteria of compulsion by the state so there remained a question about its applicability. Later, *Southern Motor Carriers Rate Conference, Inc. v. United States* [105 S. Ct. 1721 (1985)] liberalized *Midcal's* "clear articulation" requirement by stating that clear intentions on behalf of the state acting as a sovereign would satisfy the test.

In 1985, the U.S. Supreme Court denied a petition for a *writ of certiorari* (an appeal proceeding for re-examination of a decision made by a lower court) [*Deak Perera Hawaii, Inc. v. Department of Transportation,* cert. denied, 105 S. Ct. 1756 (1985)], leaving in place the lower courts extension of state action immunity to some limited areas of a state's executive branch. The criteria for exemption here include:

1. those areas serving fundamental government functions which are vital, such as schools, police services and fire protection;
2. those which are statutorily created;
3. those which retain sole authority for regulation; and
4. those which do not rely on the authority of private parties.

These criteria virtually eliminated an automatic exemption for professions regulated by state agencies in the executive branch of state government since these agencies are typically composed of members of the professions which they regulate. The courts must consider other previously determined criteria in granting immunity to the actions of these agencies.

Despite its inconsistent development, the state action doctrine, as it is interpreted today, can be briefly stated. Actions by a state legislature, measures adopted by a state supreme court, and some activities of a state's executive branch will be accorded state action immunity. State regulatory boards will be immune if it can be shown that they acted according to a clearly articulated

state policy to displace competition. If the regulatory board members come from private interests, the board must also be subject to active state supervision.

This cursory look at federal antitrust cases reveals that there is certainly no "blanket" immunity to the antitrust laws for any profession. However, it does appear that the professions may have been given some special consideration when the outcomes of antitrust cases involving professions were decided.

> It would be unrealistic to view the practice of professions as interchangeable with other business activities, and automatically to apply to the professions antitrust concepts which originated in other areas. The public service aspect, and other features of the professions, may require that a particular practice, which could properly be viewed as . . . [violations] . . . in another context, be treated differently [*Goldfarb,* 421, U.S. at 788 n. 17].

POSSIBLE CAUSES OF ERODING PROFESSIONAL IMMUNITY

The public has always been skeptical about the assumption of immunity of professionals to the antitrust laws, the effectiveness of professional self-regulation, even under state supervision (witness the Dingell Commission investigation of self-regulation of the accounting profession), and the real motives of professionals.

Although professionals may have more of an interest in serving their collective clients than in furthering their own pecuniary interest, the behavior of professionals could be interpreted as indicating that their motives are less than altruistic.

> Far from respecting the received tradition of "free enterprise," most professionals repudiate it. . . . The expression of their disbelief in the economies they praise outside the office is to be found in the literally tens of thousands of state and local laws, regulations and ordinances which license the practice of professions, fix prices, and define what services and products may be offered for sale and in what manner [Lieberman, 1970, p. 7].

Lieberman [1970] contended that the following alleged activities and developments have caused the public to question the motives of professionals.

1. The supply of professionals has been controlled by licensing examinations often written and graded by members of the profession with whom the applicant would compete upon passing the exam. The supply has also been controlled by unreasonable entrance requirements to the limited number of professional schools, and by long apprenticeship periods. Consequently, freedom of entry, the first condition of a competitive industry, is gone. The long apprenticeship periods cause the initial investment of time and money to be high. Therefore, commitment to a profession as a career choice is usually lifelong. There is no free mobility among professionals.

However, while these activities may somewhat limit the supply of professionals, the motives of the professionals should be considered. Licensing examinations, high entrance requirements to professional schools, and long apprenticeship periods are methods of assuring the public of at least minimum competence of the professionals in an area foreign to the average untrained layperson. Surely, these motives far outweigh the disadvantage of a limited market.

2. Single professions have been subdivided into specialized areas of practice, thus limiting the competition among those professionals who are already practicing. Members of the same profession who have different specialties do not compete with each other. For example, one could contend that auditors would not compete with tax specialists. Because of specialized training, mobility within professions is difficult.

In the accounting profession, this is not a totally valid assertion. One can readily see mobility within the specialized areas by watching the training process in some public accounting firms where trainees move from one area of specialty to another before their training is complete. Mednick and Previts [1987, p. 233] suggest that future CPA firms organize "practice units across functional lines" in order to integrate the skills of accounting practitioners.

3. State licensing boards, often composed of members of the profession being licensed, have restricted professional practice to those who meet specific professional and/or personal requirements. Additionally, the requirements in one state may be different from the requirementes of other states, again restricting mobility and effectively restricting members of the same profession from competing with each other.

This may be a valid assertion. However, most states have reciprocal agreements with other states where members of professions who are licensed in one state may obtain a license in the other state.

4. Prices have been either fixed or administered through the use of minimum fee schedules. This limits competition to product differentiation, which untrained consumers of professional services may find difficult to perceive.

While this may be valid for some professions and in some states, it is no longer valid for the accounting profession as a whole. Some customers of accounting firms are now practicing "price shopping" in deciding which accounting firm to hire.

5. Advertising and solicitation have been restricted by many professional codes of ethics. This type of restriction even further restricts the ability of consumers with limited knowledge of a profession's services to effectively select professional services.

Currently, in the accounting profession, restrictions on advertising and solicitation pertain only to false, misleading, or deceptive information. This is generally true for most professions.

Clearly, in an industrial setting, behavior such as this would be a direct violation of the federal antitrust laws. But it is not so clear whether this alleged behavior in a professional context is a direct violation of the antitrust laws. However, whether or not these are violations of the antitrust laws may not even be the issue. It is the public's perception of the intent of professional behavior which causes the problems for the professions.

THE PROGRESSION OF INVESTIGATIVE AND JUDICIAL ACTIVITIES INVOLVING THE ACCOUNTING PROFESSION

Events that have occurred since the mid-1960s represent a direct challenge to the assumption of professional immunity to the antitrust laws. The U.S. Department of Justice (DOJ) has scrutinized codes of professional ethics pertaining to competition, the FTC has begun investigations into several professional practices, and many consumers of professional services have brought actions in the courts against professions and their members. Even state governmental agencies and courts have been investigating possible antitrust violations made by the professionals within their jurisdictions.

The accounting profession is one of many professions that the antitrust agencies have been scrutinizing during the last two and a half decades. After a DOJ warning in 1966 that Rule 3.03 of the Code of Ethics of the American Institute of Certified Public Accountants (AICPA), prohibiting competitive bidding, would probably be judged to be a restraint of trade, the AICPA adopted a policy of not enforcing the rule [Olson, 1982]. In 1971, however, the DOJ apparently not satisfied that this would be enough of a change, began a full-fledged investigation of the AICPA. In June of 1972, the AICPA entered into a consent judgment with the DOJ [*U.S. v. AICPA*, 1972].[3] The provisions of the consent judgment required that the Institute must delete from its Code of Ethics, rules, bylaws, resolutions, and other policy statements, any stipulation that prohibits or limits submission of price quotations for accounting services by members, or any clause that states or implies that such submissions are unethical, unprofessional, or contrary to any association policy.

After its own investigation of the accounting profession, the U.S. Senate subcommittee on Reports, Accounting and Management of the Committee on Government Operations (The Metcalf Committee) in 1976 reported a number of assertions that were disturbing to the committee. One assertion of particular relevance to the antitrust agencies was the lack of independence and dedication in public protection shown by large accounting firms performing the key function of independently certifying the financial information reported by major client corporations, and the resulting anticompetitive effects. (One characteristic distinguishing professions from trade or commerce was that they

work in the interest of their clients and the general public.) When the FTC and DOJ investigations began, all states, the District of Columbia, and all national accounting associations restricted advertising, solicitation of new clients, and encroachment. Nineteen states barred competitive bidding, and 47 prohibited "feeder" occupations—unrelated businesses that might generate clients for an individual's accounting practice. ["State Developments," 1980, para. 10,434]. Shortly thereafter, on March 24, 1977, spurred on by the Metcalf Committee findings and the current professional restrictions, the FTC and the DOJ reopened the attack on the AICPA's rules of conduct.

Investigations by the FTC and DOJ included the AICPA, state societies, CPA firms, and state boards of accountancy. Matters examined by the FTC included the effect of state requirements for entry into the accounting profession, the impact of codes of ethics that bar advertising and solicitation, competitive bidding and incompatible occupations, and the degree of possible control by major accounting firms over the industry. The DOJ limited its study to the prohibition of advertising, solicitation, and encroachment by members on private practices of other members, recommending in 1978 the commencement of an injuctive suit against the AICPA to prevent restraints on advertising and solicitation [Olson, 1982, p. 113].

The result of the above probes into the profession was a significant change in the rules of state boards and societies, and what is now the AICPA's Code of Conduct. Rule 502 prohibiting advertising and solicitation, now prohibits only false, misleading, or deceptive advertising and solicitation. Rule 504 prohibiting incompatible occupations was modified to prohibit members from engaging in businesses that would create conflicts of interest in the rendering of professional services. The AICPA repealed Rule 401, prohibiting encroachment by accountants on practices of other accountants, and Rule 402, prohibiting offers of employment to employees of other accountants without prior notice.

In September 1980, three years after beginning its examination of the accounting profession, the FTC closed its inquiry. Because of the changes to the Code of Ethics, and cooperative spirit of the AICPA, the FTC was generally satisfied that the accountants were trying to comply with the antitrust laws. However, it warned that Rule 502, Interpretation 502-4, "Self designation as an expert or specialist," may be the focus of future investigative pressure because of its potential anticompetitive effect. Since accountants had to meet no criteria for qualifying as a specialist, the FTC considered the possibility that some accountants could gain an undeserved share of the market through questionable claims of expertise. The FTC also stated plans to monitor the profession for any changes to its Code of Conduct.

While the FTC's investigation was in progress, the DOJ brought suit against the Texas State Board of Public Accountancy (TSBPA) [*U.S. v. TSBPA* (1979)]. One question addressed by the court was whether the TSBPA's ban

on competitive bidding by Texas accountants fell within the jurisdiction of the Sherman Act or whether the TSBPA was acting as an agent of the state of Texas and, therefore, exempt from the reach of the Act. The court ruled that if the Texas Public Accountancy Act had mandated, rather than allowed, the board to promulgate rules regulating the activities of accountants, state action would have prevailed. However, because of the permissive language of the Texas Public Accountantcy Act, the TSBPA was not required by the state to promulgate rules regulating the activities of accountants, specifically the ban on competitive bidding. Therefore, the TSBPA fell within the jurisdication of the Sherman Act and the Texas accountants had to eliminate the ban on competitive bidding.

In March 1985, the AICPA disclosed that it was the target of an FTC probe of its professional code of ethics, specifically, pertaining to advertising and solicitation and contingency fees ["FTC is Investigating," 1985, p. 476]. This was a nonpublic, preliminary investigation to determine whether these provision in the code of ethics injured consumers or unreasonably restrained competition. In October 1985, the AICPA Council, the governing body of the AICPA, defeated a proposal that would have allowed a firm to accept engagements on a contingency fee basis and accept commissions for referrals to tax shelters. The reason for the defeat was that the Council wanted to preserve the independence of accountants as advisors to businesses and as auditors of financial statements.

In 1986, a special committee on standards of professional conduct for CPAs (The Anderson Committee) that had been appointed by the AICPA in 1983, issued its final report, *Restructuring Professional Standards,* in which it recommended restructuring the Institute's code of professional ethics to include new standards of professional conduct and revised rules of performance and behavior. One of the recommendations of the committee was that Rule 302 - Contingency Fees be slightly altered [Anderson and Ellyson, 1986]. Instead of prohibiting all contingent fees, it would permit contingent fees with the warning that the accountant would have lost independence with regard to that client. Therefore, the accountant who accepted contingency fees from a client would not be able to perform an engagement for that client that required independence. This provision would make accountants more competitive with non-CPAs who are not restricted in their fee arangements.

An August 25, 1986, letter from Anthony L. Joseph, attorney for the FTC Bureau of Competition, to Philip D. Corsi, attorney for the AICPA, expressed reservations the FTC had about the proposed Rule 302. The FTC was concerned about the following possible anticompetitive effects of a restriction on contingent fees.

1. Efficiencies available to the clients if one accounting firm performed both attest and nonattest services for that client may be lost.

2. Rivalries may diminish among accounting firms for attest and nonattest business because one firm would not perform both services for the same client, thereby performing one type of service and not competing for the other type of service.
3. Lower quality accounting services may be performed due to reduced incentive by accountants to provide higher-quality services. (Apparently, the FTC believed that the contigent fee provides the incentive to provide higher-quality services.)

Of course, the reasoning behind the proposed Rule 302 was to ensure that accountants performing attest services remain independent, while allowing accountants performing nonattest services to compete with non-CPAs who have no contingent fee restrictions. The proposed rule, then, was more competitive than the current Rule 302.

In 1987, a U.S. District Court dismissed a suit by the U.S. Justice Department against the State Board of CPAs of Louisiana ["Louisiana State Board," 1987, p. 18]. The suit charged that the state board's rules on advertising and solicitation violated the Sherman Antitrust Act. The board contended that these rules were exempt under the state action doctrine, since they were authorized, reviewed, and approved by the state legislature and were, therefore, actions of the state itself. Interestingly, the first amendment issue did not prevent the court from dismissing the case, contrary to the *Bates* and *Virginia State Board of Pharmacy* cases.

In July 1987, the AICPA Board of Directors rejected a consent order proposed by the FTC staff that would have had the AICPA eliminate prohibitions against the payment of referral fees, against vouching for the achievabilty of forecasts, against allowing CPA firms to operate as corporations with non-CPA ownership, and against the acceptance of commissions and contingency fees. This proposed consent order would have allowed unrestricted advertising by AICPA members.

In August 1988, the Council of the AICPA approved a settlement with the FTC staff that allows accounting firms to accept commissions or contingent fees from clients. Under this settlement, the AICPA retains its right to prohibit members from taking commissions or contingent fees from clients for whom the CPA performs audit, review or compilation services, or for whom the CPA performs examinations of prospective financial statements.

The ban on advertising or solicitation by false, misleading, or deceptive statements will be retained in the settlement, although certain interpretations relating to self-laudatory or comparative claims, testimonials and endorsements, and advertising that "lacks professional dignity and good taste" will no longer apply. [*In re American Institute of Certified Public Accountants,* File No. 851 0020, FTC, 3/28/89].

PRESSURE BY THE PROFESSIONS FOR RELIEF

Other professions, including medicine, law, architecture, engineering, dentistry and optometry, have had similar experiences within the last two and a half decades. For most of these professions, the lawsuits and investigations have created heavy burdens involving out-of-pocket expenses, time, and opportunity costs. Because of these costs, many members of professions took the stand that although some inquiry into the activities of professions and professionals by the antitrust agencies may have been justified, the FTC's scrutiny concerning professionals was becoming excessive [U.S. Congress, Senate, 1981]. In July 1981, the U.S. Senate, responding to pressure by professionals, held a hearing on the FTC's activities concerning professionals [U.S. Congress, Senate, 1981]. Those professions represented at the hearing, including physicians, lawyers, dentists, veterinarians, and optometrists expressed the view that the FTC should be severely limited in regulating professionals. (Nurses, psychologists, and chiropractors, however, praised the FTC for fighting anticompetitive behavior.) A similar response occurred during a hearing by the House of Representatives in April, 1982 [U.S. Congress, House, 1982].

The representatives of the professions repeatedly cited the following reasons for limiting the FTC's actions against professionals [U.S. Congress, Senate, 1981].

1. Preparation of the information requested by the FTC is costly, both in time and dollars. The opportunity costs are excessive.
2. Most of the information requested by the FTC is readily available from other agencies, such as the Securities and Exchange Commission. The FTC should not burden the professional with preparing the information again.
3. In antitrust litigation, many professionals have found that defending meritorious positions takes and overwhelming amount of time and resources. Therefore, they choose, instead, to enter into consent decrees with the FTC. Here the professional is forced into a self-serving action (avoiding the costs) rather than upholding the ideals of the profession.
4. Activities of professionals are different from those of the retail and wholesale businesses that the FTC was established to regulate.
5. Existing mechanisms for regulating professions are working well without intervention from the FTC. The states are fulfilling their regulatory function through state sunset laws, licensing boards, and state antitrust laws.
6. Recent Supreme Court decisions indicate that federal agencies should not attempt to regulate activities of professionals that are already regulated by the states.

7. There are possible dangers of professions being regulated by a group with little or no experience in the field. Some activities that appear to be anticompetitive are necessary to preserve the essential integrity of the professional. Without knowledge of the profession, the FTC might sacrifice this integrity in the interest of competition. For example, an accountant would not be considered independent in the function of auditing a company whose president is a close relative of the accountant. While this activitiy is forbidden by the profession in order to maintain the independence of the auditor, it may still be anticompetitive.

A letter written by then FTC chairman James C. Miller, III [1982] to Senators Packwood and Kasten indicates that the FTC vigorously resisted these efforts to limit the FTC's actions against the professions.

THE CONGRESSIONAL ATTEMPT TO EXEMPT PROFESSIONS FROM FTC ACTION

After the lobbying and other pressure tactics of many professions, some members of Congress attempted to exempt state-licensed professionals from FTC regulation. For example, in 1980 and 1981, Senators McClure and Melcher presented bills to preclude the FTC from preempting state laws regulating professions. The 1980 Senate bill was rejected by two votes. The 1981 Senate bill, although passed by the Senate Commerce Committee in 1982, was never voted on by the Senate. In 1982, Representatives Luken and Lee, with strong support from the American Medical Association (AMA) sponsored a House bill that would prohibit the FTC from taking actions involving professionals unless Congress provided it with specific authority to do so. This bill did not pass. However, in 1982, the House did pass a restriction on the FTC's jurisdiction over professionals that was not matched with a similar bill in the Senate.

The wording, content, and timing of the passage of these bills and amendments in the House and Senate were different, effectively preventing Congress from granting any FTC exemption to the professions. Much of the argument in both Houses centered around whether professions should have complete immunity, partial immunity, or no immunity to the actions of the FTC.

In 1983, after lengthy congressional debate, one of the strongest professional lobbies, the AMA, which had previously pushed for complete immunity, developed a compromise in conjunction with the FTC. Under this compromise, the Commissions's jurisdiction over unfair methods of competition by professions (to prevent anticompetitive conduct) would be limited by the same "state action" antitrust immunity that has been granted in some Sherman Act

cases. The FTC would be prohibited from using its consumer protection authority to preempt state laws prescribing experience, education, or training requirements for the licensing of professionals, or from determining tasks or duties that professionals may perform based on specialized training or education.

Congress debated the merits of including the AMA compromise in the reauthorization act. The House bill was the most specific, attempting to further define the difference between commercial practices and duties that professionals may perform because of their high level of training or education in specialized areas.

The reauthorization act did not receive floor action in 1983. Congress adjourned before the House could reach a compromise about the FTC's jurisdiction over state-regulated professions. However, there was such a flurry of activity at the end of the year that it seemed likely that the act would see some action in 1984.

During 1984, however, the House's reauthorization bill remained silent about the FTC's jurisdiction over state-regulated professions. The Senate's reauthorization bill contained two new measures prohibiting the FTC from interfering with certain regulatory functions of the states.

1. Section 5 of the Federal Trade Commission Act would contain a provision applying the same "state action" antitrust immunity to the FTC's "unfair methods of competition" cases as the courts have used in litigation under the Sherman Act.
2. A new Section 24 would prohibit the FTC from using its "unfair or deceptive acts or practices" authority to overrule state laws prescribing education, training, or experience requirements for the licensure of professionals or for the duties that professionals may perform based on specialized training or education.

While the Senate bill seemed clearly written and ready to be passed, the House bill needed more clarification and support before a vote could be taken. One issue that needed clarification in the House's FTC reauthorization bill was not directly related to professional regulation by the FTC. Rather, the bill had been stymied because the House could not arrive at a compromise about how to replace the legislative veto. (The alternatives considered were whether Congress should only react to those FTC rules that it disapproves of, or whether Congress should reserve the right to affirmatively approve all FTC rules.)

During 1985, the Senate proposed a bill with the same wording that was on the 1984 bill except for the so-called professions compromise language (derived from the AMA's 1983 compromise with the FTC). At the Consumer Subcommittee hearing on FTC authorization earlier in the year, continued need for this provision was questioned [U.S. Congress, Senate, 1985]. The

subcommittee suggested that this provision was no longer necessary in light of certain Supreme Court decisions clarifying the scope of the state action doctrine, particularly *Southern Motor Carriers Rate Conference v. United States.* Also, the subcommittee perceived that the FTC had been sensitive to professional self-regulation and state concerns in this area. This new Senate bill had the support of the American Bar Association and the American Medical Association.

The House of Representatives also deleted from its bill language regarding the FTC's jurisdiction over professions, once it was sure that professional groups reached a consensus that their interests were protected by recent Supreme Court decisions on the state action doctrine. (The House had held a hearing for this purpose [U.S. Congress, House, 1985]. Again, the two houses could not agree on wording and were not successful in passing a reauthorization bill.)

In the Senate's version of the 1987 reauthorization act, there was only one reference to state action immunity [U.S. Congress, Senate, 1987]. Section 2 of this bill added a new subsection to Section 5 of the FTC Act, applying the same state action antitrust immunity to the FTC's "unfair methods of competition" cases as are developed by the courts in litigation under the Sherman Act. This action merely attempted to make official what has been common practice in the courts.

A 3-year FTC reauthorization bill cleared by the Senate Commerce Committee in August 1989 contains no language addressing professional immunity to the antitrust laws [U.S. Congress, Senate, 1989]. The Senate appears to be satisfied with the current relationship between the FTC and the professions.

IMPLICATIONS

When the FTC is reauthorized without instructions to give antitrust immunity to the professions, the effect on the professions will be dependent on the FTC's attitude toward enforcement against professions, and on the courts' interpretations of the new law. The courts' responses are left to be seen, but James E. McCarty, Acting Executive Assistant to the Chairman of the FTC, gave accountants a clue to potential actions of the FTC at a meeting of the National Society of Public Accountants ["FTC's Concerns," 1986, p. 908].

According to McCarty, the FTC can get involved with accountants in two ways:

1. through its intervention program, in which it makes state boards and legislatures aware of the implications of regulations being considered through written comments; and

2. through investigations—if these unearth antitrust violations, the FTC will try to resolve them through a consent agreement or it will issue an administrative complaint.

McCarty listed six types of ethical restrictions that the FTC has looked at (truthful advertising, uninvited direct solicitation of clients, encroachment, use of trade names, branching, and form of practice). However, the FTC's response to the Anderson Committee indicates that they also have a strong interest in contingent fees. McCarty also listed two areas in which the FTC is not active (competence to practice and licensure). The last two areas are currently deferred to state legislatures and licensing bodies. At this time, the FTC appears to be following the intent of the AMA compromise that was considered for inclusion in the reauthorization bill.

The FTC has not interfered with the current merger activity of the major accounting firms. Even though the accounting profession is becoming even more concentrated, it appears that the amount of concentration has not yet arrived at the level necessary for FTC intervention. While the mergers may be justified by the idea that global firms need global accountants, and that accounting firms must be strong in all areas in order to compete globally, at some level of concentration, the FTC may challenge the merger of any of the biggest accounting firms.

Early in 1986, the AICPA retained Louis Harris and Associates to conduct a public opinion poll on CPA qualifications and services and on regulation of the profession. While the public gave the profession high rankings overall, there was concern over some CPAs who behave less than professionally. Therefore, the public supported more regulation of the profession, wanted a stronger system of enforcement of professional standards, and apparently had "soaring expectations" for the future professional performance of accountants ["How the Public Sees CPAs," 1986].

Regardless of what the FTC or the courts do in the next three years, it seems that the public and the antitrust agencies are looking for an appearance of professional compliance with the spirit of the antitrust laws, as well as reasonable compliance in fact. The public also appears to want strong professionalism and high standards of conduct. Since competition and professionalism do not completely compliment each other, accountants must perform a delicate balancing act. CPAs must step up enforcement, tighten standards, and require an even better qualified membership. At the same time, CPAs must anticipate and correct any perceived weaknesses in their compliance with the antitrust laws, rather than reacting defensively to outside pressures. By undertaking the above actions, the trust of the public and the regulatory agencies in the accounting profession will be greatly enhanced, thus providing a basis for continued self-regulation of the accounting profession.

NOTES

1. The first section of the Sherman Act reads, "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states or with foreign nations, is hereby declared illegal" [15 U.S.C.S. 1].

2. Some activities, like price fixing, are conclusively presumed to be unreasonable and, therefore, illegal per se because of their pernicious effect on competition and their lack of any redeeming virtue. No elaborate inquiry as to the motives of the business or profession, or as to the precise harm they have caused is deemed necessary [*White Motor Co. v. United States,* 03 S. Ct. 696 (1963)].

3. Under a consent judgment, the accused does not contest any charges the DOJ might have made. However, this is not the same as a plea of guilty. It cannot be used as prima facie evidence of guilt in private suits by companies injured by the offender's actions. A third party must still collect evidence and prove the offender's guilt in court.

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AUDITOR/CLIENT JOINT INVESTMENTS AND INDEPENDENCE

John M. Lacey

ABSTRACT

This study examines the effect of investments by CPA partners and client principals on the perception of auditor independence. Specifically examined are the effect of (1) a joint investment by a CPA partner and a client's Chief Financial Officer (CFO) in a limited partnership unrelated to the audit client, and (2) a direct investment by a CPA in a client company. Auditors, preparers, and users of financial statements returned a total of 630 completed questionnaires.

The results show an inconsistency between the respondents' perception of risk of loss of independence and the AICPA independence rules. Specifically, respondents are more concerned about certain joint investments, which are acceptable under AICPA rules, than they are about small percentage, financially immaterial direct investments which are unacceptable under AICPA rules. CPAs perceive that the risk of loss of independence when there is direct ownership of stock by the CPA is greater than any other group perceives the risk to be.

Research in Accounting Regulation, Volume 4, pages 129-149.
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ISBN: 1-55938-084-5

INTRODUCTION

Questions about perceived auditor independence arise when a member of a CPA firm and a key employee or principal of an audit client jointly invest in a project unrelated to the client company. While this is not a direct investment by the auditor in the client firm, the existence of such a joint investment may indicate a financial dependence between the two parties that could become problematic. This paper reports on a study commissioned by the Chief Accountant of United States Securities and Exchange Commission (Chief Accountant) to address those questions.[1]

Specifically, the independence rules of both the SEC and the AICPA preclude a general partnership relationship between a CPA firm partner and a client's chief financial officer (CFO). Both sets of rules also provided guidance about investment by a CPA firm partner and a client's CFO in a limited partnership unrelated to the client company. There are two underlying problems in a limited partnership relationship. The first problem is the appearance itself. Establishing a partnership relationship with a principal of a client company may raise doubts about the objectivity of the auditor. Second, the viability of the limited partnership may be contingent upon additional financial involvement by the limited partners. This may mean that at some point the value of the auditor's investment in the partnership could be affected by the ability of the client principal to contribute additional money to the partnership. The client principal's ability to contribute money to the partnership may be contingent on the earnings or stock price of the client company. The objective of this study is to provide empirical evidence about the effect that limited partnership joint investments may have on perceived auditor independence.

The dimensions of the relationship addressed in the independence rules are (1) the materiality of monetary investment to each party's wealth, (2) each party's percentage ownership of the partnership, and (3) the awareness each party may have of the other's involvement.

In this study, these three dimensions of the relationship are manipulated to provide evidence about their effect on perceived independence. The eight groups surveyed include preparers, auditors, and six user groups (individual investors, institutional investors, loan officers, financial analysts, credit managers, and labor unions) judged by the Chief Accountant as representative of his constituents. It is hypothesized that the perceived risk of loss of independence will increase: (1) as percentage of ownership of the partnership increases, (2) as materiality of the monetary investment to the individuals' wealth increases, and (3) as each individual is aware of the other's investment. It is also hypothesized that users will assess the risk of loss of independence as higher than will preparers and auditors, and that concerns about lack of independence will not change with years of job experience.

Two scenarios were included as benchmarks against which to compare the responses to other independence scenarios in the analysis of results. These scenarios involve the *direct investment* by a CPA in a client company. This relationship is clearly precluded by both AICPA and SEC rules and is a more direct financial relationship with the client than a joint limited partnership investment by a CPA and the client CFO. It is hypothesized that the perceived risk of loss of independence will be higher for direct investments than for joint investments.

A second set of hypotheses relates to the existing rules governing joint investments in limited partnerships. It is hypothesized that there is no difference in the perceived risk of loss of independence between (1) scenarios that are acceptable under both SEC and AICPA rules and (2) scenarios that are acceptable under the AICPA rules, but not the SEC rules.

The hypotheses were tested using factorial analysis of variance techniques.

HYPOTHESES AND CHOICE OF VARIABLES

The hypotheses tested and variables examined in this research project were chosen from the existing rules relating to joint investments. Specifically, the focus was on those variables that are treated differently in the SEC and AICPA rules. The variable these "independent" variables were expected to affect (the dependent variable) was chosen to be risk of loss of independence. These are the variables that policy setters at the SEC and AICPA have agreed may affect perceptions of independence.

Hypotheses

The hypotheses in this study are divided into three groups. The first group hypothesizes that perceptions of the risk of loss of independence increase along the basic dimensions and combinations of those dimensions of the problem defined in the existing rules. The second group hypothesizes that respondents will perceive a higher risk of loss of independence for direct investment relationships (clearly in violation of all independence rules) than joint investment relationships which are acceptable under SEC or AICPA independence rules. The third group involves background variables and hypothesizes that the users will assess the risk of loss of independence as higher than will preparers and auditors, and that concerns about lack of independence will not change with experience. The following section discusses the existing SEC and AICPA rules on joint investment, and the differences between them, as a basis for the first set of hypotheses.

Existing Rules on Joint Investment and Related Hypotheses

The AICPA rules on joint investment apply only to an investment that is material to the member's wealth and spell out conditions that must be met for such an investment not to be considered a "joint investment in a closely held business" which would impair independence.[2] The four criteria are:

1. both parties must be passive investors,
2. the aggregate ownership of the member and his firm must be less than 20 percent,
3. the aggregate ownership of any investor client (and/or its directors, or principal stockholders) must be less than 20 percent, and
4. the aggregate ownership of the member and his firm and clients (and/or its officers, etc.) must be less than 50 percent.

If the member does not know, and could not be reasonably expected to know about the limited partnership/client relationship, independence would not be impaired.

The SEC has taken the position that *any* joint investment is unacceptable if the parties are aware of each other's investment and that a material investment would impair independence *even if the parties are not aware of each other.*

The term *member* has a technical definition in the independence rules of the SEC and AICPA. The rules differ slightly, but basically, an accountant is a member and subject to the independence rules if one is (1) a partner in the firm, (2) a manager located in the office that does a significant part of the audit, or (3) a professional employee who works on the audit.

The following hypotheses test the three basic dimensions upon which the joint investment independence rules are based. The three dimensions are (1) ownership percentage, (2) materiality, and (3) awareness. The CFO was chosen for use in the scenarios because it is the position referred to in both the AICPA and SEC rules which has the most direct contact with the auditor. The CPA firm partner was chosen for use in the scenarios because it is the highest ranking member of the firm that may have contact with the client.

Ownership Percentage

The dimension of ownership percentage is used specifically in the AICPA rules that designate acceptable ownership percentages, but is not used at all in the SEC rules.

Hypothesis 1. When a CPA firm partner and a client company CFO jointly invest in a limited partnership unrelated to the client company, the perceived risk of loss of independence does not increase as the percentage ownership of the partnership increases.

Materiality

The dimension of materiality is used in both the AICPA and SEC rules in differentiating acceptable joint investments. The SEC rules combine materiality with awareness, while the AICPA rules combine materiality with percentage ownership.

Hypothesis 2. When a CPA firm partner and a client company CFO jointly invest in a limited partnership unrelated to the client company, the perceived risk of loss of independence is is no greater when the investment is material to the individuals' wealth than when it is not.

Awareness

The dimension of awareness is used explicitly in the SEC rules when combined with materiality in defining acceptable investments, while the AICPA rules do not apply at all in cases where the CPA is unaware of the other party's involvement.

Hypothesis 3. When a CPA firm partner and a client company CFO jointly invest in a limited partnership unrelated to the client company, the perceived risk of loss of independence is is no greater when the individuals are aware of the other's investment than when they are not aware.

Interaction of Materiality and Awareness

The interaction of materiality and awareness is used in the SEC rules.

Hypothesis 4. When a CPA firm partner and a client company CFO jointly invest in a limited partnership unrelated to the client company, the perceived risk of loss of independence is no greater when both the investment is material and individuals are aware of the other's investment than when it is material and they are not aware or it is not material and they are aware.

Interaction of Materiality and Ownership Percentage

The interaction of materiality and percentage ownership is used in the AICPA rules.

Hypothesis 5. When a CPA firm partner and a client company CFO jointly invest in a limited partnership unrelated to the client company,

the perceived risk of loss of independence is no greater when both the investment is material and percentage ownership is larger than when it is material and the percentage ownership is smaller or it is not material and the percentage ownership is larger.

Comparison with Direct Investment Scenarios

The following hypotheses tests the difference in perception of risk of loss of independence between direct investment by the auditor in the client company and joint investment in an unrelated limited partnership.

Hypothesis 6. When a CPA firm partner and a client company CFO jointly invest in a limited partnership unrelated to the client company, there is no difference in the perceived risk of loss of independence between scenarios that meet both the SEC and/or AICPA independence rules and scenarios that involve direct investment by the CPA in the client company and meet neither the AICPA nor SEC independence rules.

Background Variables

The last two hypotheses involve background variables and specify interactions between (1) the respondent group and perceptions of risk of loss of independence and (2) the experience of the respondent and perceptions of risk of loss of independence.

Hypothesis 7. There is no difference between respondent groups' perception of risk of loss of independence.

Hypothesis 8. The perception of risk of loss of independence does not change with years of experience.

The rationale for these hypotheses is developed next.

Independent Variables

Given that the policymakers have agreed on the basic dimensions to the problem, the independent variables were chosen among them through consultation with the Chief Accountant and his staff. The following three variables about the two parties' relationship were chosen:

1. their percentage ownership of the partnership,
2. the materiality of monetary investment to the individuals' wealth, and
3. the awareness they may have of the other parties involvement.

Percentage Ownership

The ownership percentages chosen included two (1% and 5%) that are relatively small, but unacceptable under SEC rules. An ownership percentage of 18 percent was chosen because it is close to the AICPA maximum ownership percentage (20%), but still acceptable. Finally, an ownership percentage of 26 percent was chosen because that would represent a controlling interest by the CPA and CFO combined (52%). The 26 percent ownership is excluded from the scenarios where the parties are unaware of each other's investment because comments from the pilot study suggested that this situation is unlikely.[3]

The four ownership percentages chosen to be used in the direct ownership scenarios were: (1) less than one percent, (2) one percent, (3) five percent, and (4) ten percent. Four percentages were chosen to make the task comparable to that for the joint investment scenarios. Smaller percentages were used here than for were used in the limited partnerships because of the generally wider ownership of corporations.

Materiality

Materiality of the investment in the limited partnership is defined in terms of the individual's wealth. This is a critical dimension on which the SEC and AICPA policymakers differ. The AICPA rules apply only to "material investments" while the SEC rules apply to "all" investments where the parties are aware of each other. This difference indicates a difference in basic philosophy between the two policymakers. The SEC takes the stronger position that perceptions of risk of loss of independence are affected even by immaterial joint investments. Since the rules use a material/not material distinction, that same distinction is used in the study.

Awareness of Joint Involvement

The issue here is whether or not the CPA partner and client company's CFO are aware of the other party's involvement in the joint investment. The AICPA rules apply only if the parties are aware of each other, while the SEC takes the strong position that any material joint investment violates the independence rules *even if the parties are unaware that the other party is involved.* Again, this difference in rules indicates a basic difference in philosophy between the two policy setting bodies. This position by the SEC poses particular difficulties for CPAs who invest in widely traded limited partnerships where the identity of the other limited partners may not be readily apparent or available. The distinction used in the study is aware/not aware because that is the distinction used in the independence rules.

METHODOLOGY

This study analyzes the perceptions of risk of loss of independence of eight respondent groups to scenarios that manipulate three independent variables relating to joint investments. Factorial analysis of variance techniques are used to analyze the data.[4]

Subjects

Eight groups are included in the survey. One group represents auditors, one represents preparers of financial statements, and six represent financial statements users. A total of 1,996 questionnaires was sent in approximately equal numbers (250) to each group.

The auditor sample was chosen at random from the membership directory of the AICPA. Names were selected at random until 250 names were found with addresses that appeared to be public accounting firms. The preparer sample was comprised of chief financial officers who were selected randomly from a list of companies that file reports with the SEC. Individual names could not be identified, so the address was to "Chief Financial Officer." The six user groups were those identified by the Chief Accountant as being particularly significant. (1) bank loan officers were selected at random from the list of loan-officer members of Robert Morris Associates, (2) financial analysts were selected randomly from the membership of the Financial Analysts Federation, (3) institutional investors were selected randomly from the list of "Money Market Managers," and (4) individual investors were selected randomly from the membership of the National Association of Investors Corp. (NAIC). The two other user groups; (5) labor unions and (6) credit managers were not random samples from a universe. The labor union sample was addressed to the individual officer named in the list of 246 organizations in the "Labor Unions, Associations, and Federations" chapter of the *Encyclopedia of Associations*. The credit union group consisted of the five officer/members for each of the fifty state associations included in the National Association of Credit Management.

Completed responses to the questionnaire totaled 630 (117 from the second mailing), yielding a 31.5 percent response rate. Sixteen questionnaires were returned as undeliverable and 26 were returned blank by the respondents. The specific composition of the respondents by group is shown in Table 1.

There is a category of respondents labeled "other" made up of respondents who could not classify themselves into one of the eight groups. Because there were only twelve responses from labor unions, they were added to the "other" group for purposes of analysis.

Table 1. Respondents by Group

Group	*Number of Questionnaires* Sent	Received	*Response Percentage*	*Returned Undeliverable*	*Returned Blank*
CPAs	250	108	43	4	2
Individual Investors	250	55	22	0	0
Institutional Investors	250	47	19	1	5
Loan Officers	250	93	37	0	0
Financial Analysts	250	27	11	1	6
CFOs	250	148	59	6	0
Credit Managers	250	78	31	0	1
Labor Unions	246	12	5	2	4
Classified as "Other"	—	62	—		
Unknown				2	8
Total	1,996	630	32	16	26

Note: There were 246 questionnaires sent to labor union representatives, however, only 12 replies were received. Therefore, for purposes of the analysis, the labor union respondents were combined with the respondents who listed themselves as "Other."

Design of the Questionnaire

A sample scenario from the questionnaire is included in Appendix. Seven scenarios were constructed to manipulate the joint investment and direct investment variables. Following each of the scenarios the respondent is asked to respond on a five-point scale to the risk of loss of independence associated with various CPA ownership percentages. In five of the scenarios the CPA firm partner and client CFO are limited partners and in two of the scenarios the CPA invests directly in the client company. Four different orderings of the cases were used and no significant difference in responses was found based on the ordering. In the limited partnership scenarios the CPA partner and the client company CFO each own an equal interest in the same limited partnership and neither plays an active role. The CPA firm does not audit the limited partnership nor does the CPA partner perform any services for the CFO's company.

The fact that both parties are limited partners who do not play an active role in management differentiates the scenario from one in which both parties are engaged in operating a business together. If the CPA firm audited the limited partnership, then the scenario would involve direct ownership in a client company by a member of the audit firm. The statement that the partner does not perform any services for the client company is included to establish a minimal relationship between a partner of the CPA firm (a member) and a client CFO.

Table 2. Joint Investment:
Analysis of Variance for All Main Effects and First-Order Interaction Between Independent Variables and Groups

	Sum of Squares	*Degrees of Freedom*	*F Value*	*PR < F*
		MAIN EFFECTS		
P Percent Owned	1897.9	3	488.0	.000
A Awareness	838.3	1	646.6	.000
M Materiality	653.2	2	251.9	.000
G Group	317.1	7	34.9	.000
		INTERACTIONS		
PG	51.0	21	1.9	.009
AG	27.7	7	3.0	.003
MG	21.4	14	1.2	.286

In three of the five joint investment scenarios the parties are *aware* of each other's investment, but the level of materiality to each is changed (material to both, material to neither, and material to the CFO only). In each of these three scenarios the respondent is asked to respond to the risk of loss of independence for four levels of ownership (1%, 5%, 18%, and 26%).

The other two scenarios state that the CPA and CFO are *not aware* of each other's investment. In one scenario the investment is material to both the CPA and CFO and in the other it is material to neither. In these two scenarios the respondent is asked to respond to the risk of loss of independence for three levels of ownership (1%, 5%, and 18%).

The design allows the separation of materiality, awareness of the other party's investment, and level of investment. To conserve the respondents' time not all possible combinations of percentage ownership, materiality, and awareness were included.

The direct investment scenarios in the questionnaire involve an audit firm manager who owns stock in a company which he audits. In one scenario the investment is not material to his wealth, while in the other it is material. For both scenarios the ownership percentages listed are less-than-one percent, one percent, five percent, and ten percent.

RESULTS

Overall Analysis

The main effect and grouping factor/independent variable analysis of variance (ANOVA) results are reported in Table 2. The main effects correspond to the tests of hypotheses one, two, and three and to the test of the background variable in hypothesis seven. The interaction between the grouping factor and

Table 3. Joint Investment:
Significant Differences Between Group Means

Percent of Ownership	*Material to Neither CPA Nor CFO (%)*	*Material to CFO Only*	*Material to CPA Only*	*Material to Both CPA and CFO*
AWARE OF EACH OTHER'S INVESTMENT				
1	Not Significant	Not Significant	No Question	Not Significant
5	Not Significant	CPA/IIN CPA/CM	No Question	Not Significant
18	Not Significant	CPA/IIN CPA/CM	No Question	CPA/IIN CPA/CM
26	Not Significant	CPA/OTR	No Question	CPA/OTR
NOT AWARE OF EACH OTHER'S INVESTMENT				
1	Not Significant	No Question	No Question	Not Significant
5	Not Significant	No Question	No Question	Not Significant
18	Not Significant	No Question	No Question	Not Significant
26	No Question	No Question	No Question	No Question

Notes: The difference between the mean response for each group is significant at the .05 level.

CPA = Certified Public Accountant
IIN = Independent Investor
CM = Credit Manager
OTR = Others (includes labor unions)

No Question = There was no question on the questionnaire that addressed this issue.

the independent variables indicates any differences between the groups' response to the independent variables. The interactions between the independent variables are presented in Tables 5 and 6 and are discussed later.

The three main effects were significant at the .001 level, indicating that hypotheses one, two and three can be rejected. This shows that the respondents perceived a higher level of risk associated with (1) a larger percentage ownership by the parties, (2) awareness of the other parties investment, and (3) increased materiality of the investment to the individuals. The SEC uses awareness and materiality in its standards, while the AICPA uses percentage ownership, awareness, and materiality.

Looking more carefully at the results (reported in Table 3) indicates that the respondents perceived a greater difference between the 5 percent and 18 percent ownership levels (both of which are acceptable) than between the 18 percent (acceptable) and 26 percent (unacceptable) ownership levels.[5] One plausible explanation of this is that the magnitude of the percentage change in ownership is greater from 5 percent to 18 percent than from 19 percent to 26 percent. It also suggests that the issue of a controlling interest in the limited partnership by the parties may not make much difference (or that the issue of a controlling interest was not recognized in the questionnaire by the respondents).

The grouping factor was also significant, so hypothesis seven can be rejected. This suggests that the respondent groups perceived the risk of loss of independence in the scenarios differently. Looking at paired *t*-tests comparing the responses to each of the scenarios by group indicates that the significant differences across scenarios were between CPAs and (1) individual investors, (2) credit managers, and (3) "other" and that these differences existed for only three of the 18 responses to the joint investment scenarios. The lower assessment of risk of loss of independence by CPAs than other groups is consistent with the findings of others [Brilloff, 1966; Hartley and Ross, 1972; Lavin, 1976; Shockley, 1981], all of which found differences among groups.

A separate regression was run for each of the joint investment responses using years of experience as the independent variable and risk of loss of independence as the dependent variable. None of the regression equations was significant, so hypothesis eight could not be rejected. This indicates that experience did not affect respondents' assessment of risk of loss of independence due to joint investments.

Interactions Among Independent Variables

The analysis of interactions among the independent variables is complicated by the use of an incomplete design. The mean for each of the responses to the joint investment questions is shown in Table 4. That table has been laid out as a complete design with the words "NO QUESTION" (NQ) where there was no corresponding question in the questionnaire. To test the interactions, smaller complete designs must be created by dropping selected levels of the independent variables.

Two separate smaller complete designs were used. In the first, the interactions between all three independent variables (percent ownership, awareness, and materiality) were tested, but not for all levels. The "26%" ownership level and the "Material to CFO Only" materiality level were excluded from the analysis, yielding the first smaller, square design. The results of that analysis are shown in Table 5.

The interactions between awareness and materiality were significant. This result allows rejection of hypothesis four and is *consistent* with the SEC's use of the interaction between awareness and materiality in its standards. The interactions between ownership percentage and materiality were not significant. This result fails to reject hypothesis five and is *inconsistent* with the AICPA's use of the interaction between ownership percentage and materiality in its standards. The interactions between percentage ownership and awareness were significant, but are used in neither the SEC nor AICPA standard.

The second complete design provides a stronger test of Hypothesis 5 because it uses all four levels of the percent ownership independent variable and all

Table 4. Joint Investment:
Means of Responses to Independence Scenarios

	Percent of Ownership	Material to Neither CPA Nor CFO (%) Mean	SE of Mean	Material to CFO Only Mean	SE of Mean	Material to CPA Only Mean	SE of Mean	Material to Both CPA and CFO Mean	SE of Mean
Aware of each	1	1.46	0.88	1.71	1.08	NQ	NQ	1.99	1.22
other's	5	1.65	1.01	2.01	1.21	NQ	NQ	2.26	1.31
investment	18	2.17	1.20	2.53	1.33	NQ	NQ	2.83	1.39
	26	2.44	1.34	2.79	1.43	NQ	NQ	3.08	1.48
Not aware of	1	1.31	0.71	NQ	NQ	NQ	NQ	1.59	1.00
each other's	5	1.45	0.84	NQ	NQ	NQ	NQ	1.78	1.13
investment	18	1.73	1.06	NQ	NQ	NQ	NQ	2.11	1.30
	26	NQ	NQ	NQ	NQ	NQ	NQ	NQ	NQ

Notes: All means and standard errors of the mean are based upon between 625 and 630 responses on a 5-point scale where five represents the greatest risk of loss of independence.

NQ - No question on the questionnaire addressed this issue.

Table 5. Joint Investment:
Analysis of Variance for All Main Effects and First-Order Interactions
(Excluding "26%" Ownership Level and
"Material to CFO Only" Materiality Level)

	Sum of Squares	Degrees of Freedom	F Value	PR > F
		MAIN EFFECTS		
P Percent Owned	515.3	2	217.1	.000
A Awareness	292.4	1	246.4	.000
M Materiality	394.3	1	332.2	.000
G Group	137.2	7	16.5	.000
		INTERACTIONS		
PA	33.1	2	13.9	.000
PM	4.2	2	1.8	.169
PG	17.0	14	1.0	.426
AM	34.5	1	29.1	.000
AG	12.1	7	1.4	.180
MG	6.1	7	.7	.647

three levels of the materiality independent variable. To do so, however, the awareness variable must be excluded. Interactions between the percent ownership and materiality terms, including all levels of the variables, are made possible with this design. These results are shown in Table 6.

Table 6. Joint Investment:
Analysis of Variance for All Main Effects and First-Order Interaction
Excluding Aware/Unaware Variable

	Sum of Squares	*Degrees of Freedom*	*F Value*	*PR > F*
		MAIN EFFECTS		
P Percent Owned	1320.8	3	292.2	.000
M Materiality	459.5	2	152.4	.000
G Group	297.9	7	28.2	.000
		INTERACTIONS		
PM	4.5	6	.5	.809
PG	37.9	21	1.2	.242
MG	15.9	14	.8	.723

Even using all levels of the independent variables, the interaction between the percent ownership and materiality is not significant. This confirms that Hypothesis 5 cannot be rejected and that the respondents did not differentiate among the scenarios on the interaction of percent ownership and materiality together.

Analysis by Subject Group

The analysis by subject group (within group analysis) is consistent with the overall analysis for the main effects. All main effects are significant for all groups. The interaction terms are not significant for most of the cases, however. The one interaction term that is significant in many of the individual models is the materiality/awareness interaction.

Direct Investment

The direct investment scenarios have two independent variables with four levels for percentage ownership and two levels for materiality. The analysis of variance for these scenarios is presented in Table 7, while the means are presented in Table 8.

Both main effects and the interaction are significant. This suggests that respondents differentiated between the scenarios on both the dimensions of percentage ownership and materiality and on the combination of those two variables. Although any direct ownership by the auditor is precluded by the current standards it is still an important result to validate comparisons between the direct and joint investment scenarios.

The grouping factor is also significant indicating that the respondent groups differed in their assessment of the risk of loss of independence. The individual

Table 7. Joint Investment:
Analysis of Variance for All Main Effects and First-Order Interaction Between Independent Variables and Groups

	Sum of Squares	*Degrees of Freedom*	*F Value*	*PR > F*
		MAIN EFFECTS		
P Percent Owned	1298.1	3	287.5	.000
M Materiality	1123.9	1	746.8	.000
G Group	411.4	7	39.0	.000
		INTERACTIONS		
PM	42.0	3	9.3	.000
PG	21.3	21	.7	.864
MG	18.5	7	1.8	.092

Table 8. Direct Investment:
Means of Responses to Independence Scenarios

		Not Material to CPA		*Material to CPA*	
	Percent of Ownership	*Mean*	*SE of Mean*	*Mean*	*SE of Mean*
Less than	1	2.43	1.46	3.55	1.43
	1	2.67	1.46	3.77	1.31
	5	3.41	1.31	4.30	0.97
	10	3.93	1.19	4.60	0.78

Note: All means and standard errors of the mean are based upon between 625 and 630 responses on a 5-point scale where five represents the greatest risk of loss of independence.

differences of means indicate that CPAs viewed the risk of loss of independence as being greater than the other groups when there is a direct investment in the audited firm by the CPA. This result is shown in Table 9. There are eight responses to the direct investment scenarios and seven groups with which to compare CPA responses. Of the 56 (8 x 7) possible comparisons, 36 are significantly different at the .05 level of confidence or better and all indicate that the CPAs view the risk of loss of independence as higher than the other groups. There were no other significant differences between the groups. One may hypothesize that this difference is driven by the CPAs awareness of the AICPA rules which preclude such ownership, rather than some other factor. This hypothesis is supported by the facts that the only other significant differences between groups were between CPAs and others and that the CPAs were less conservative than other respondent groups in all of those other cases.

A separate regression was run for each of the direct investment responses using years of experience as the independent variable and the response to each specific question as the dependent variable. Six of the regressions had F-statistics

Table 9. Direct Investment:
T-tests of Differences Between Means

	Percent of Ownership	*Not Material to CPA*	*Material to CPA*
Less than	1	CPA/IIN CPA/BNK CPA/CFO CPA/CM CPA/OT	CPA/IIN CPA/INS CPA/BNK CPA/FA CPA/CFO CPA/CM CPA/OTR
	1	CPA/IIN CPA/BNK CPA/CFO CPA/CM CPA/OT	CPA/IIN CPA/BNK CPA/CFO CPA/CM CPA/OTR
	5	CPA/IIN CPA/CFO CPA/CM	CPA/IIN CPA/INS CPA/BNK CPA/CM CPA/OTR
	10	CPA/IIN CPA/CM CPA/OT	CPA/IIN CPA/BNK CPA/CM CPA/OTR

Notes: The difference between the mean response is significant at the .05 level. In all cases the CPA indicated higher risk of loss of independence.

CPA - Certified Public Accountant
CFO - Chief Financial Officer
IIN - Individual Investor
INS - Institutional Investor
BNK - Bank Loan Officer
FA - Financial Analyst
CM - Credit Manager
OTR - Other (includes labor unions)

significant at the .05 level and all six had a negative slope coefficient. This suggests that respondents with more experience were less concerned about loss of independence due to direct ownership of the client's stock.

Comparison of Joint and Direct Investment Scenarios

Beyond knowing that the respondents differentiate among the scenarios based upon the dimensions used in the independence rules, it is also interesting to compare the responses to the joint investment scenarios with the clearly precluded direct investment scenarios. This benchmark for comparison provides a broader perspective from which to view the results.

In five instances the respondents assessed the risk of loss of independence to be at least as high for joint investment as for the immaterial direct investment of less than 1 percent. Four of those instances are acceptable under the AICPA independence rules.

In three instances the respondents assessed the risk of loss of independence to be at least as high for joint investment as for the immaterial direct investment of 1 percent. Two of those instances are acceptable under the AICPA independence rules.

Why would the respondents assess a higher risk of loss of independence for some joint investments than direct investments? It may be that the materiality variable can help explain this result. In all five of the cases it is an *immaterial* direct investment that is being compared, and in four of the five cases the joint investment is *material* to at least one of the parties.

It is also interesting to note that the CPAs did not assess the risk of loss of independence to be higher for any of the joint investment scenarios than the direct investment scenarios.

POLICY IMPLICATIONS

The results support the first three hypotheses of the study, indicating that the respondents did differentiate between the scenarios based upon the dimensions of percentage ownership, awareness of the other parties' investment, and materiality of the investment to the individuals. Since these are the dimensions around which the current rules are written, this result supports the basis for the current rules. The fact that respondents perceived differences based upon percentage ownership conflicts with the SEC position that percentage ownership should not be part of the rules. The SEC should consider adding the dimension of percentage ownership of the limited partner interest to its rules.

The results of the interactions between the variables casts two of the finer distinctions in the AICPA rules into question. The AICPA uses the interaction of percentage ownership and materiality in its rules. Specifically, the percentage ownership rules apply only to material investments and not to immaterial investments. Because the results indicate that respondents do not differentiate on these dimensions combined, this distinction may be too fine.

The AICPA rules also include the interaction of percent ownership, awareness, and materiality in its rules. The percent ownership rules apply only to material investments where the CPA is aware of the client CFO's involvement. Because the results on the interaction of materiality and percentage ownership were not significant, neither were the results on this finer interaction. Again, the implication is that the AICPA rules, which add together the dimensions, may be to fine.

The results of the interaction between awareness and materiality are significant and support the use of those dimensions in the AICPA and SEC rules. Specifically, in the AICPA rules the materiality rules apply only to investments of which the parties are aware. In the SEC rules, all joint investments are precluded except immaterial investments of which the parties are not aware.

The interaction between awareness and percent ownership is significant. In other words, the level of awareness of the parties influences the respondents view about the risk posed by the level of ownership. The interaction of awareness and percentage ownership is used in the AICPA rules, but only in conjunction with materiality.

Looking at the results overall, it appears that the SEC independence rules on joint investments may be more restrictive than necessary for immaterial investments. These investments are precluded in the SEC rules where the parties

are aware of each another, but the means of the responses were relatively low for those scenarios. The SEC may also want to include the dimension of percentage ownership to its rules and allow small interests in large limited partnerships (like those that may exist in publicly traded limited partnerships) even where they are material to the parties.

The overall results suggest that the AICPA may wish to reassess its joint investment rules covering large ownership percentages in limited partnerships where the investment is not material to the CPA. The mean responses were relatively high when the CPA and CFO jointly controlled the investment. Mean responses were also relatively high when ownership percentages were high and the investment was material to the client CFO.[6]

SUMMARY AND CONCLUSIONS

The results of this study generally support the dimensions on which the SEC and AICPA rules governing joint investments are based. The results do show, however, an inconsistency between the respondents' perception of risk of loss of independence and the AICPA independence rules. Specifically, respondents are more concerned about certain joint investments, which are acceptable under AICPA rules, than they are about small percentage, financially immaterial direct investments which are unacceptable under AICPA rules. Interestingly, CPAs view the risk of loss of independence as greater than any other group when there is direct ownership of stock by the CPA.

The results also suggest that some of the SEC rules on joint investments may be too restrictive, particularly those involving immaterial investments and small percentage ownerships in large limited partnerships.

Additional evidence is needed about the level of risk of loss of audit independence that is acceptable to users of financial statements. Also, case studies that present independence problems in a broader context may provide a different perspective on the issues addressed here. Such studies are not efficient in the sense that not as many variables can be examined, but they may provide less obtrusive measures of this difficult issue.

APPENDIX

This study reports the responses to eight scenarios presented in a questionnaire. Each scenario lists three or four ownership percentages below it, so 30 individual responses are required.

For each scenario the respondent is asked the following question:

> In your mind, what is the level of risk that the auditing firm's independence would be impaired . . .

The sentence is then completed to introduce the specific ownership percentages in the particular scenario. For example, ". . . if each party's percentage ownership in the limited partnership is:" The respondent is then presented with four ownership percentages and asked to circle a number from one through five on a scale for each one as follows:

Very Low Risk	1	2	3	4	5	Very High Risk

This format was chosen instead of a "yes or no" format to allow the respondent more latitude and to make it more consistent with recent studies which use a multiple-point scale [Shockley, 1981; Knapp, 1985].

The first page of the questionnaire includes instructions, and an explanation of independence drawn from AICPA and SEC literature. The explanation of independence was included to provide a minimum understanding for all respondents. The investment section of the questionnaire is introduced by a brief paragraph describing the following scenarios. The order of the scenarios in the investment section was reversed in half of the questionnaires to determine if order made a difference in the responses.

The questionnaire was accompanied by a letter from the researcher stating that the Chief Accountant of the SEC had commissioned the project, indicating the group which they had been chosen to represent, and stating that approximately 30 minutes were required to complete the entire questionnaire. Also included in the packet were a postcard to request a copy of the results and a self-addressed, postage-paid return envelope. A second mailing, which followed three weeks after the first, was identical to the first except the shorter letter indicated that it was a second request and the questionnaire was a different color to differentiate responses from the second mailing.

A copy of the questionnaire is available to interested parties directly from the author. Inquiries about the availability of the data should also be directed to the author.

ACKNOWLEDGMENTS

The author would like to thank University of Southern California's SEC and Financial Reporting Institute and the Accounting Circle for financial assistance and Dr. Tora Bikson of the Rand Corporation survey research group and Dr. Eve Fielder of the UCLA Survey Research Center for their assistance in the questionnaire design. Robert West and members of the Chief Accountant's office also helped during the process of the study.

NOTES

1. An earlier report on this research appears in the proceedings of a meeting at DePaul University titled *A Profession in Transition: The Ethical and Legal Responsibilities of Accountants*, edited by B.E. Needles [1989, pp. 33-51].

2. The AICPA rules on a member and a client who are limited partners in a limited partnership are spelled out in Section 191, Ethics Ruling 62. The SEC guidelines on this issue come from Rule 201(b) of Regulation SX and from section 601.01g of the codification.

3. The 26 percent ownership level is omitted because it is unlikely that two individuals could own a controlling interest in a partnership and be unaware of one another. Comments from the pilot study confirmed this.

4. An analysis of variance methodology is used to deal with the categorical variables and interactions. Subjects made repeated judgments across the seven scenarios. The resulting experimental design is a repeated-measures block design with one grouping factor and three trial factors. There is one grouping factor with eight groups corresponding to the eight subject groups. The percentage ownership trial factor has four levels, the materiality trial factor has three levels, and the awareness trial factor has two levels.

Both overall and within subject group analyses were performed. The overall analysis included the three trial factors, the interactions between them, and the grouping factor. The results for each subject group were also analyzed separately.

5. Equivalent ANOVAs using regression equations with zero/one dummy variables were run and analyzed.

6. One final question that remains unanswered in this and all previous studies is the overall risk that respondents find acceptable. At the Chief Accountant's request, 26 follow-up telephone interviews were conducted. In these interviews six CPAs, seven CFOs, and thirteen users were asked what they would assess to be an acceptable risk of loss of independence on the scale they had used to answer the questionnaire. One refused to answer, one said "zero" (not on the scale), six gave a verbal description of range and the remaining respondents gave a specific answer. Treating the mean of the ranges as the response yielded a mean of 2.08 and a standard deviation of .69. This is a small sample and may not be representative of the respondents as a whole, but it is interesting nonetheless.

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PERSPECTIVES

REFLECTIONS ON THE FASB CONCEPTUAL FRAMEWORK

Eugene H. Flegm

In 1976, the Financial Accounting Standards Board (FASB) published a Discussion Memorandum titled "Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises," which proposed significant changes in the conceptual basis of accounting as it had been applied since the debates of the 1930s had settled upon an income statement orientation, for example, the matching of related costs with revenues being produced.

The proposed change was to shift the emphasis of accounting from an income statement orientation and the attest function to a balance sheet orientation intended to give prospective investors a more value-based view of an enterprise.

The Discussion Memorandum and subsequent public hearings resulted in considerable debate which is unresolved today. (The unprecedented two-year delay of the required implementation of Statement No. 96, Accounting for Income Taxes, in December 1989 by the Financial Accounting Standards Board is a direct outgrowth of that debate.)

The Committee on Corporate Reporting of the Financial Executives Institute, as well as several corporations (including General Motors Corporation) filed position papers and testified at the public hearings protesting the shift proposed in the Discussion Memorandum. Robert K. Mautz and Albert Koch, partners with Ernst & Ernst at that time, even went so far as to give a series of presentations

Research in Accounting Regulation, Volume 4, pages 153-168.
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ISBN: 1-55938-084-5

to the Committee on Corporate Reporting, various chapters of the FEI, and other interested groups pointing out the major shift being proposed.

As noted, the debate continues to this day. Much has been made of the disaffection the business community has with the standards-setting process with the assumption that the source of this disaffection is businesses "own ox being gored" syndrome. In fact, the now acknowledged shift (see "What Today's Balance Sheet Tilt Means," Ray Groves, *Financial Executive*, Sept./Oct. 1989, FEI, Morristown, NJ) of the FASB to the balance sheet, investor view as proposed in the 1976 Discussion Memorandum, is the cause of the basic disagreement.

Following the 1977 and 1978 public hearings, the FASB decided to meet with selected representatives of their constituencies (this was before they had adopted the "sunshine" rules) to attempt to thrash out the disagreement concerning the Discussion Memorandum. Thomas A. Murphy, who was Chairman of the Board for General Motors at that time and a former trustee of the Financial Accounting Foundation, was invited as one who held a representative view of business. Mr. Murphy was not able to attend and requested that I attend in his place. Attached is a memorandum of this meeting that I prepared for Mr. Murphy after the meeting.

As I re-read the memorandum today, I find that the issues are unchanged and unresolved.

— E. H. Flegm (December 12, 1989)

As the GM representative, I attended the July 26, 1978 meeting with the Financial Accounting Standards Board (FASB), held at the Stamford Board headquarters. The following were in attendance:

FASB

John March
Ralph Walters
Robert Sprouse
Donald Kirk
Oscar Gellein
David Mosso
Robert Morgan
Michael Alexander, Director of Research
Reed Storey, Director of the Conceptual Framework Project

Invited participants

Robert Anthony, Harvard Professor
Phillip Defliese, Retired Chairman of Coopers & Lybrand
Robert Espie, Vice President, Aetna Life Insurance
Robert Mautz, Partner, Ernst & Ernst
Robert Mays, Former Controller of Exxon and former FASB Board member
Arthur Wyatt, Partner, Arthur Andersen and Chairman of the AICPA AcSEC Committee
Eugene Flegm, General Motors Corporation

The purpose of the meeting was to discuss the exposure draft published in December 1976 titled "Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises." In this exposure draft, the FASB has adopted the so-called asset/liability view of the measurement of income which represents a major change from the matching of revenue/expense view used for the past 40 years in the accounting field. This change was made by the FASB in spite of overwhelming testimony and papers filed with the FASB in August 1977 and again in January 1978 in favor of the continuation of the matching concept. The purpose of the meeting was to attempt to dispel some of the adverse criticism which has arisen with the publication of the exposure draft and to assure people that the change to an asset/liability view does not represent the revolution in accounting that it has been presented to be.

The discussion centered around eight examples presented by Reed Storey (see Exhibit 1) in which the participants were asked to comment on whether or not they accepted the various alternatives under the asset/liability or revenue/expense view. Although I will expand in some detail on these exhibits and on my thoughts on the meeting, the following is a summary of the significant conclusions that I have drawn as a result of the meeting:

Item 1—The Board believes that the primary use of accounting data and financial statements is to serve the outside investor and, therefore, all of their thrust is toward providing *comparable* and *uniform* accounting data.

Item 2—While the Board believes that in the short term (10-15 years) historical cost will remain as the basis for financial statements, even though modified by such adjustments as LIFO, in the long run, accounting will at some point be valuation-based. Therefore, in viewing the conceptual framework of accounting today, the concepts must be based on an asset/liability view as opposed to a revenue/expense view because a valuation-based system cannot be supported under the revenue/expense view.

Item 3—The Board recognizes that the asset/liability view and revenue/expense view are not mutually exclusive. However, they are changing the fundamental base to the asset/liability view for the long-run move to a value base. So, should a question ever arise as to what should be favored—the income statement approach (revenue/expense) or balance sheet approach (asset/liability)—they would favor the balance sheet over the income statement.

Item 4—The Board is attempting to make the transition to an asset/liability view as painless as possible for business by defining elements of financial statements broadly enough to permit most of the existing accounting to continue, the most significant example being interperiod allocation of income taxes. (During the discussion, it came out that tax allocation would be permitted under the asset/liability view with the major shift being to construe the deferred taxes to be liabilities rather than deferred credits or assets rather than deferred charges.)

Item 5—The Board appears to be in a somewhat defensive position particularly with regard to oil and gas accounting, Statement ν19, foreign translations, Statement ν8, lease accounting, Statement ν13, contingency reserves, Statement ν5, and research and development, Statement ν2. It appears that, under the revenue/expense view, many of these statements can only be justified from a pragmatic approach rather than a theoretical approach, while under the asset/liability view there would be a more sound theoretical basis for these opinions. Therefore, the Board may also be moving to the asset/liability view in order to justify past statements.

Item 6—The Board, like all bureaucracies, is in a difficult face-saving position. Having moved this far down the road, they must come up with a definitive statement on conceptual framework. Furthermore, they must justify their existence and, thus, cannot agree that financial statements serve only an attestory function rather than a predictive function. Obviously, if they are construed as being predictive, they are of the utmost and critical importance for any user of financial data which, of course, enhances the prestige of the Board.

This seems to be a very real problem, particularly in view of their multi-million dollar budget. To put it another way: What should be the life work of the Board if not to lay the basis for an orderly capital market and the continuation of a free enterprise system in America which is how they construe their role.

Item 7—After listening and taking part in the discussion concerning the eight examples and the entire concept of the asset/liability and revenue/expense views, it seems clear to me that it is impossible to write definitive, workable definitions of any of those views, yet I am sure that Don Kirk at least, if not the entire Board, believes it can and must be done.

Before the review of the exhibits began at the start of the meeting, Don Kirk asked if each of the participants had any comments they wished to make as a type of opening statement. I reiterated several of the points we have made in our various position papers on the conceptual framework project, stating that we felt the Board had the "cart before the horse" and that they should determine the use of accounting before they attempted to determine how the elements of financial statements should be defined. I also stated that, we view the balance sheet not as a measure of value but as a measure of liquidity, that the income statement should remain as the paramount statement, and that, if anyone wants the balance sheet as a measure of value, this information should be presented as supplementary data outside the financial statements. I made the point again that management manages companies, not earnings, and that fluctuations in earnings are permissible, the big problem being not in the fluctuations but in the ability of management to forecast those fluctuations. I also pointed out that financial statements per se are no help in this and that the significant factors are: the state of the general economy, the specific state of the market in which you are selling, the consumer confidence, the acceptance of your product, government regulations and so on. I stated that it appears to us that analysts want to be able to forecast a company's earnings the same as management does and, thus, the actual financial data as published is the gauge by which the validity of the forecast system used by both the analyst and management is judged. I concluded by stating that we did not believe they could improve upon Paton and Littleton's work of 40 years ago.

Turning to the specific comments during the discussion, in his opening comments, Bob Mays stated that he felt the asset/liability versus revenue/expense question was a phony issue and a useless exercise; he felt that the real area of disagreement was not really too large and might just be the definition of the elements to financial statements. (I agree; however, I do not believe that the definition of the elements can ever really be effectively done.) He went on to state that paragraph 47 of the exposure draft says that assets must have future cash flows and that he felt the exposure draft should talk instead about the potential for future cash flows and also the evaluation of the certainty. We should keep in mind that conservatism is also a strong factor. We write down assets but we do not write them up. He did not believe that we wanted to change that yet. (An interesting point in his comments was that he cited Statement No. 5 as an example of conservatism!) I pointed out that we did not consider No. 5 to be a conservative statement.

Finally, Mr. Mays stated that, if you built the exposure draft on the basis of historical cost concept, you would write an entirely different draft than has been written. But, if the Board has already decided that some day a basis other than historical cost will be the valuation basis for financial statements, then you could agree with the basic conceptual approach of the exposure draft.

Bob Espie commented that, of course, from his standpoint, they (Aetna Life Insurance) was valuation-based for everything and thus all assets and liabilities should be discounted to their present value. He, of course, preferred the asset/liability approach and he feels that the whole issue of conceptual framework of accounting would not have arisen except for the loss of faith in historical cost because of inflation. He went on to comment that he felt Statement ν5 was deficient insofar as the accountants were beginning to deal with probabilities and they were not using the probability theories that actuaries use. He, as an actuary, did not regard anything as being certain and that if a person said that the probability was 20 percent, that might mean it was certain that it would be one in five, but that the accounting profession seems to have missed this point.

Phil Defliese made an interesting observation which illustrated the difficulty of preparing definitions. He felt that Price Waterhouse was inconsistent in their position on deferred taxes vis-à-vis their position in defense of historical cost. He also felt that Arthur Andersen could not defend their deferred tax allocation theory under the asset/liability viewthey have adopted. Art Wyatt, of course, disagreed with him which simply illustrated the point.

Throughout the day, Bob Anthony was most articulate in his defense of historical cost and revenue/expense view. His closing paper, in which he totally demolished the concepts of the exposure draft, was particularly effective. One comment he made concerning their definition of assets was that it should not bother anyone, because under that definition anything could be an asset. However, he did believe it was possible to define revenue/expense, although not everyone there agreed.

Bob Mautz was pretty quiet during most of the day—he seemed to be weary of the entire discussion. When asked for a position statement, he said he would file one later; he wanted to have some time to think about it and set his thoughts down. He did comment that one of the basic questions Paton and Littleton addressed themselves to was whether or not accounting should give recognition to economic values or just report transactional facts on a historical cost basis and let others get the economic effect of those. He, of course, does not feel that the conceptual framework can be approached from a definitional point of view.

Art Wyatt commented that one of the questions was whether accounting was a substrata of economics or a separate field. Certainly he felt that Paton and Littleton had tried to set up accounting as a separate "science" but that the concept is breaking down under the pressure of inflation, and thus, we are heading back to an economic view of earnings. He also commented on how much easier it is to get to a valuation or current-value, current-cost approach under asset/liability, but stated that he was certain that business would not accept this in the short term.

Oscar Gellein commented that the root of the problem is whether we are trying to convey a measure of earnings or of earnings power. It seems that, in the past, some people wanted to keep certain things out of earnings and to dump them into retained earnings directly. Then they went to a clean surplus theory and they started using extraordinary gains and losses, but this was abused and now some are trying to put the residue in the balance sheet.

Throughout the day, John March was one of the most articulate board members as he seems to have been in the various meetings that I have attended. He seems to have a practical common sense approach to the problems. Bob Sprouse was, of course, very articulate and very theoretical. Don Kirk impressed me as persistant in his "science of accounting" approach. One of his comments in particular was very disturbing. When we were discussing various accruals and the subject of the warranty accrual in the auto industry was raised, he asked me whether or not I thought that Chrysler should not accrue their reserve for warranty on *exactly* the same basis as General Motors so that they would be comparable. I told him that, if that was the Board's approach, then my analogy of a set of accounting rules that would rival the Internal Revenue Code was deficient, and instead these rules would greatly exceed any set of regulations that the Internal Revenue Service had ever provided and would entail specific point-by-point rule setting for all the companies in the United States, which would seem totally impossible.

Oscar Gellein, of course, was also very articulate. He seemed to be quite defensive concerning the discussion memorandum on conceptual framework. Bob Sprouse commented at one time that a bad debt expense would be handled in the same way under the asset/liability view as it would under the revenue/expense view. Bob Anthony immediately took exception to this. He said, if a bad debt occurs in the future, then under the asset/liability view you could not recognize it while you could under the matching of costs concept. Reed Storey, of course, took exception to this, stating that bad debts are not an expense under the asset/liability view but are reductions of revenues. This is an illustration of how they will split hairs to get the same answer under the asset/liability view as they have under revenue/expense view in order to defuse the arguments against the change.

Gellein then, after some discussion of matching, said "Well, why then not accrue for all costs such as all future contract settlements." Anthony responded that in setting the price of a product you should be trying to match future costs and certainly should take into effect labor contract increases, expected material increases, future warranty, and so on, so that in your pricing structure you would take into account future costs and that, to the account you sell a product involving those prices, you would match all future costs against that price. I agreed with Mr. Anthony although pricing is simply not a factor of the recovery of cost but may be more a factor of the market and consumer confidence.

John March questioned me as to what I felt earnings were. I responded that I felt earnings had to ultimately be translatable into cash either to be reinvested into the business or distributed as dividends. The point was that accounting was really only the arbitrary division of a long cycle of a business into 12-month periods and that the earnings of a business ultimately had to be returned to the investor as cash. Bob Morgan commented on this long-cycle approach, which was first expounded by George May nearly 50 years ago, and went on to explain that, if you chopped the one-year periods up perfectly and planned perfectly, you ended up with a perfect match of costs and revenues. Ralph Walters remarked that it sounds as if what you are really saying is that, in the long run, accounting is simply the long-term budget, which, if you prepare it perfectly and anticipate everything, would be budgeted earnings adjusted only for volume variances. Morgan responded that he thought perhaps we should also consider efficiencies. Walters said that conceptually efficiencies would have been included in the budget.

In our discussion of the exhibits, we started with the deferred investment tax credit (Exhibit 1). Conceptually, no one can defend the flow through method although it is the most widely used method in the accounting field today. The answer the participants and the Board generally agreed upon was that, under the asset/liability view, the deferred investment tax credit would not be recorded as a credit on the right had side of the balance sheet but rather as a reduction of the cost of the asset or as a valuation reserve. However, under the revenue/expense basis, you could match the deferred investment tax credit over the life of the credit which is of course similar to the existing method although not exactly the same, inasmuch as the investment credit now is amortized over the life of the asset.

The discussion covering the reserve for repairs (Exhibit 2), caused a great deal of confusion to everyone basically because Reed Storey did not indicate what had happened to the original first-time cost of the relining of the kiln. Assuming the original cost had been capitalized and the kiln had a life of 20 years, there would be no reserve established for relining the kiln anymore than there would be a reserve for the replacement of a roof of a building that had been originally capitalized. There was not much discussion on the asset/liability, revenue/expense concept inasmuch as this example seemed to be more of a question of how would you capitalize the cost of an asset.

The third example, reserve for self-insurance (Exhibit 3), Statement No. 5, produced some interesting comments. I, of course, argued for the reasonableness of a reserve stating that I felt it was no different than a bad debt reserve and, thus, so long as the reserve for self-insurance was based on some type of past experience, there was every bit of justification for accruing for it under the matching concept. I got support for this concept from Bob Anthony and surprisingly enough, I believe from John March also. March gave an example of workmen's compensation on a self-insured basis where

Exhibit 1. Deferred Investment Credit

X Co. acquired an asset for $1,000 and deducted an investment credit of $100 in its tax return for the year from a tax otherwise payable of $750.

Year of Acquisition		*In Each of 9 Remaining Years in 10-Year Life of Asset*	
		Method 1	
Income Tax Expense	650	Depreciation Expense	100
Income Tax Payable	650	Accumulated Depreciation	100
		Method 2	
Income Tax Expense	740	Deferred Investment Credit	10
Income Tax Payable	650	Income Tax Expense	10
Deferred Investment Credit	90		
Depreciation Expense	100	Depreciation Expense	100
Accumulated Depreciation	100	Accumulated Depreciation	100
		Method 3	
Income Tax Expense	750	Depreciation Expense	90
Income Tax Payable	650	Accumulated Depreciation	90
Asset	100		
Depreciation Expense	90		
Accumulated Depreciation	90		

Exhibit 2. Reserve for Repairs

Y Co. relines its kilns every eight years. The last relining cost $1,200 two years ago. The next relining is expected to cost $1,600.

Method 1

Estimated Relining Expense	200
Reserve for Relining Kilns	200

Method 2

Depreciation — Kiln Lining	150
Accumulated Depreciation — Kiln Lining	150

Method 3

No entry because entire relining cost of $1,200 was recorded as an expense two years ago.

a work-related fatality occurs every three years. He pointed out that this cost should be in the pricing structure so that you would not have a lower price for the two years in which there was no death. Bob Espie agreed, stating that that was basically the whole concept of life insurance. Some believed this to be an example of the Board's deep concern over management's smoothing

Exhibit 3. Reserve for Self-Insurance

A Co. and B Co. do not insure against casualty losses. During a 10-year period, A suffered loss from a fire, while B had no losses. Their income statements showed the following, each using two different methods of accounting for the losses:

	A Co.		*B Co.*	
	Expenses and Losses Using:		*Expenses and Losses Using:*	
Year	*Reserve*	*No Reserve*	*Reserve*	*No Reserve*
1	100	0	100	0
2	100	0	100	0
3	100	0	100	0
4	100	0	100	0
5	100	0	100	0
6	100	0	100	0
7	100	0	100	0
8	100	0	100	0
9	100	800	100	0
10	100	0	100	0

Exhibit 4. Deferred Debt Issue Cost

C Co. issued 20-year, 9½% notes to yield 10%, incurring an issue cost of $25 for each $1,000 bond. Interest is payable annually.

To Issue Notes		*To Accrue First Year's Interest*	
		Method 1	
Cash	932.42	Interest Expense	95.74
Bond Issue Costs	25.00	(10% x 957.42)	
Discount	42.58	Admin. Expense	1.25
Bonds Payable	1,000.00	(25.00 x 1/20)	
		Bond Issue Costs	1.25
		Discount	0.74
		Interest Payable	95.00
		Method 2	
Cash	932.42	Interest Expense	96.13
Discount and Issue Costs	67.58	(10.31% x 932.42)	
Bonds Payable	1,000.00	Discount and Issue Costs	1.13
		Interest Payable	95.00
		Method 3	
Cash	932.42	Interest Expense	95.74
Admin. Expense	25.00	Discount	0.74
Discount	42.58	Interest Payable	95.00
Bonds Payable	1,000.00		

earnings. Several times during the day I tried to make the point that this is overstated by the Board and that all of the abuses of accounting that I am aware of involved not accounting alternatives but outright fraud on the part of management or unbelievably poor judgment on the part of outside auditors and that in none of the cases of abuse would uniformity in accounting have resolved the problem.

We skipped the fourth example, deferred debt issue costs (Exhibit 4). Bob Sprouse commented in passing that he considered bond issue cost the same as the discount and he wanted to use the effective yield. The income effect is virtually the same either way.

The fifth example, deferred excess of acquired net assets over cost (negative goodwill resulting from a bargain purchase) was commented on briefly (Exhibit 5). Bob Mays stated that he did not feel there was any value talking about this because it could not possibly happen in real life. I pointed out that, when I was in public accounting 18 years ago, we actually had a client who bought a company, a savings and loan, for less than its book value. Negative goodwill was involved. It was a bargain purchase. We ascribed all of the goodwill possible to the fixed assets, which were really nominal, and could not write down the cash or receivables of the savings and loan. Thus we ended up with a deferred credit which we amortized on the basis that there was a risk factor involved in the purchase and, therefore, the supposed gain on the purchase should be matched against the future possible losses that the company might incur. Art Wyatt supported my comment stating that this certainly happened and that conceptually the only difference he had with our handling was that the credit should have gone directly to retained earnings. Under the asset/liability view, Art Wyatt's position would have been the accepted handling; of course, under the revenue/expense view, it was appropriate to defer it and match it against future expenses.

The sixth example, deferred credit to income tax expense (Exhibit 6), is an example of tax allocation when the tax and book depreciation differ. Originally, under the asset/liability view, many of us would have expected that tax allocation would not have been accepted and thus you would have had the difference between tax and book on an impact basis; that is, your tax expense would be the taxes payable, thus your tax rate could be quite low if you were claiming a lot of tax depreciation and not claiming it for book purposes. Or it could be well in excess of 48 percent if the reverse was true. Several of us were surprised to hear the Board and Reed Storey state that, under the asset liability view, they could accept interperiod tax allocation by taking the strict asset/liability view of tax allocation rather than the deferred charge/deferred credit view. This would involve the discounting of the present value of both the future liability and the future asset and thus there would be an income effect annually from tax allocation that would not occur under the existing system. However, this is a significant move from the Board's

Exhibit 5. Deferred Excess of Acquired Net Assets over Cost

M Co. acquired all of the outstanding stock of N Co. for $50 cash and recorded the fair values of assets acquired and liabilities assumed, leaving an excess of the fair value of the acquired net assets of $100:

Cash	20	
Accounts Receivable	30	
Inventory	50	
Marketable Securities (short-term)	20	
Property, Plant, & Equipment	80	
Marketable Securities (long-term)	10	
Current Liabilities		60
Cash		50
Excess of Fair Value over Cost		100

At Date of Acquisition		*Later*	
(1) To Apply Paragraph 91 and 92 of APB Opinion No. 16			
Excess of Fair Value over Cost	100	Deferred Credit	0.50
Prop., Plant, & Equip.	80	Gain	0.50
Deferred Credit	20	Depreciation Expense	0.00
		Accumulated Depreciation	0.00
(2) To Apply Paragraph 91 except for Recording a Deferred Credit			
Excess of Fair Value over Cost	100	Depreciation Expense	0.00
Prop., Plant, & Equip.	80	Accumulated Depreciation	0.00
Gain on Bargain Purchase	20		
(3) To Write Down other Assets in addition to Property, Plant, & Equipment			
Excess	20	Cash	75
Inventory	20	Inventory	30
		Gross Margin	45
Excess	20	Cash	30
Marketable Sec.	20	Marketable Securities	10
		Gain on Sale	20
(4) To Record All Assets Acquired and Liabilities Assumed at their Fair Values			
Excess of Fair Value over Cost	100	Gain on Bargain Purchase	100

(5) Excerpt from APB Opinion No. 16

Excess of Acquired Net Assets over Cost

91. The value assigned to net assets acquired should not exceed the cost of an acquired company because the general presumption in historical-cost based accounting is that net assets acquired should be recorded at not more than cost. The total market or appraisal values of identifiable assets acquired less liabilities assumed in a few business combinations may exceed the cost of the acquired company. An excess over cost should be allocated to reduce proportionately the values assigned to noncurrent assets (except long-term investments in marketable securities) in determining their fair values (Paragraph 87). If the allocation reduces the noncurrent assets to zero value, the remainder of the excess over cost should be classified as a deferred credit and should be amortized systematically to income over the period estimated to be benefited but not in excess of 40 years. The method and period of amortization should be disclosed.

92. No part of the excess of acquired net assets over cost should be added directly to stockholders' equity at the date of acquisition.

Exhibit 6. Deferred Credit to Income Tax Expense

The cost of $600 for a machine with an estimated life of two years is depreciated on the straight-line basis in the accounts and the sum-of-the-year's-digits basis in the tax returns (48% tax rate):

	Year 1	*Year 2*
Depreciation in Tax Returns	$400	$200
Depreciation in Accounts	300	300
Amount of Timing Difference	100	(100)
Tax effect of Timing Difference @ 48%	48	(48)
Taxes otherwise payable for period	336	336
Taxes payable for period	288	384

Year 1		*Year 2*	
	(1a) Record Tax Expense for Year		
Income Tax Expense	336	Income Tax Expense	336
Income Tax Payable	288	Deferred Credit	48
Deferred Credit	48	Income Tax Payable	384
	(1b) Pay Tax for Year		
Income Tax Payable	288	Income Tax Payable	384
Cash	288	Cash	384
	(2a) Record Tax Expense for Year		
Income Tax Expense	336	Income Tax Expense	336
Income Tax Payable	288	Income Tax Payable	336
Income Tax Payable in future years	48		
	(2b) Pay Tax for Year		
Income Tax Payable	288	Income Tax Payable	336
Cash	288	Income Tax Payable in future years	48
		Cash	384
	(3a) Record Tax Expense for Year		
Income Tax Expense	288	Income Tax Expense	384
Depreciation Expense	48	Accumulated Depreciation	48
Accumulated Depreciation	48	Depreciation Expense	48
Income Tax Payable	288	Income Tax Payable	384
	(3b) Pay Tax for Year		
Income Tax Payable	288	Income Tax Payable	384
Cash	288	Cash	384

position of last August when it appeared that tax allocation would disappear completely under the asset/liability view.

Exhibit 7. Deferred Moving Costs

D Co. moved its corporate headquarters from New York City to Greenwich, Ct. because it estimated it would save about $200 each year for at least 10 years. The move cost $1,000 in cash outlays in addition to $300 in employees' time:

	At Time of Move		*Each Year for 10 Years*	
(1)	Deferred Moving Costs	1,000	Administrative Expenses	100
	Cash	1,000	Deferred Moving Costs	100
(2)	Deferred Moving Costs	1,300	Admin. Expenses	130
	Cash	1,000	Deferred Moving Costs	130
	Admin. Expenses	300		
(3)	Moving Expense	1,000		
	Cash	1,000		

The seventh example, deferred moving cost (Exhibit 7), was an interesting one because as it illustrated the importance of judgment. Bob Mays commented that, if we could measure satisfactorily the future benefits of the move, he would vote for any one of the three, picking number three (direct expense) on the basis of conservatism only. I agreed with Mays stating that I am sure method three would be the more acceptable method simply on the basis that you cannot evaluate with any certainty the future benefits to be derived. Art Wyatt, however, surprised some of us by voting for method three. He stated that he felt the future benefits could not be quantified, therefore, he would write them off, which illustrates the judgment involved in any definition of asset/liability or revenue/expense. Bob Sprouse voted for neither of the first two methods because these deferred charges would not represent a future economic resource. Bob Anthony said he could accept any one of the three methods under either view. Sprouse made an interesting comment when he said that, while moving costs to some may not be considered an asset, if you included them as part of a cost of a lease, then you might agree that it might be capitalized. He went on to draw the comparison to a dry hole that would not be an asset per se but if you considered it part of the cost of obtaining a good oil well then it could be capitalized. Everyone agreed that under the present exposure draft any of the three methods would be acceptable.

We then came to the eighth example, deferred costs of a development stage company (Exhibit 8). I found this one to be the most interesting examples because it gave four alternatives for accounting and reporting the financial results of this company. I made the point that this was illustrative of the need for judgment in accounting and pointed out the difficulty of defining exactly how to account for a transaction. I said I could develop a rationale for using any one of the four methods of presentation depending on the degree of "hardness" of the assumptions made in the example and the degree of conservatism that management had. In the first of four sets of financial

Exhibit 8. Deferred Costs of Development Stage Company

E Co. was formed at the beginning of the year to develop, manufacture, and sell a new product. During the year it spent $400 on developing the product, $250 on manufacuring units ready for sale, $100 on advertising of the product, and $200 on general and administrative activities. It is ready to begin selling the product during the first month of the next year, and all indications are that the market will exceed the company's manufacturing capacity, at least in the beginning. The company prepared four sets of financial statements:

	Set 1	*Set 2*	*Set 3*	*Set 4*
Balance Sheet				
Inventory	$250	$250	$250	$250
Deferred Development Cost	400	400		
Prepaid Advertising	100	100	100	
Deferred General & Admin. Cost	200	—	—	—
	950	750	350	250
Capital Stock	950	950	950	950
Deficit	-0-	(200)	(600)	(700)
	950	750	350	250
Income Statements				
Revenues	-0-	-0-	-0-	-0-
Development Expense			400	400
Advertising Expense				100
General and Admin. Expense	—	200	200	200
Net Loss	-0-	(200)	(600)	(700)

statements, the inventory costs, the deferred development costs, the prepaid advertising and the general and administrative costs all were deferred in a development stage company to be matched against a firm contract to be delivered after year end. This was acceptable depending on how firm the sales contract was. Moving then to the second set, the G&A, as the least specific cost that was identifiable to revenue, it would be expensed. In the third set, the next least specific identifiable item, the research and development costs, would be expensed. Finally, in the last set, the only item capitalized would be the $250 inventory cost of the product with prepaid advertising being written-off strictly on a conservative basis. Bob Anthony agreed, stating that if we had fixed an absolute contract for $1,000 we would have to defer the whole $950 to match against it. Bob Sprouse agreed even though he is a current-value man. Oscar asked, "Is the point that the $950 is deferred as an asset because it has future value or is it deferred because of the need to match?" I told him it seemed to me that this was heads and tails of the same coin and I thought both statements were true. Phil Defliese agreed that he did not see

these as different views. Most revenue/expense people would agree that any assets that are deferred must have future benefit to be matching. Mautz commented that matching is not a guideline, it is a goal and that when it becomes too "soft" we arbitrarily write off the expense.

As I mentioned earlier, all of the discussion only confirmed for me the impossibility of specific identifications of terms.

HOPKINS V. PRICE WATERHOUSE: PERSONNEL POLICY IMPLICATIONS OF A SUPREME COURT RULING

Ross Quarles and Michael J. Tucker

ABSTRACT

This paper examines the details of the recent Supreme Court ruling which specifically applied standards of Title VII of the Civil Rights Act of 1964 to promotion practices in a public accounting firm. The case involved an allegation of sexual discrimination in the partner selection process of a national accounting firm. The ruling recognizes the legal relevance of sex stereotyping in the promotion process and clearly identifies such a practice as prohibited by the statute. The Court affirmed that the existence of sex stereotyping transfers the legal burden of proof in Title VII actions from the employee to the employer with regard to the legal defendability of the final employment decision. The ruling also establishes the preponderance of the evidence test in Title VII cases as the required defense for promotion decisions. This article discusses the implications for both accounting firms and the accounting profession, resulting from the judicially created standards set by this case.

Research in Accounting Regulation, Volume 4, pages 169-179.
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ISBN: 1-55938-084-5

INTRODUCTION

The recent decision of the U. S. Supreme Court in *Price Waterhouse v. Hopkins* (1989)[1] has specifically applied judicially created standards under Title VII of the Civil Rights Act of 1964[2] (Title VII or Act) to the promotion practices of accounting firms. These standards have an immense impact on the promotion practices of all professional groups but particularly on accounting firms since the promotion practices of one of the "Big 8" firms were specifically being scrutinized in this case with respect to their compliance or noncompliance under the Act. In *Hopkins*, the Supreme Court of the United States has emphasized that accounting firms are subject to specific regulatory standards in their hiring and promotion practices.

Practitioners and academics alike need to review this case and its implications for both immediate and long-term considerations. As an immediate concern, accounting firms must review their promotion practices for compliance with the standards established by the Supreme Court in *Hopkins*. From a long-term perspective, the profession must address the issues raised in the case because of the continuing increase in the number of women in the profession.

The case itself involved an allegation of sexual discrimination by Price Waterhouse against a female partner candidate. The impact of the Court's decision, however, is applicable to a wide variety of employees who fall under the protection of the Act. The Act specifically establishes sex, color, race, religion, and national origin as protected categories which may not be used in the hiring or promotion process.

BACKGROUND

The case initially arose in 1982 when Ann Hopkins, a senior manager[3] in Price Waterhouse, was proposed for partnership by her local office. At that time, Ms. Hopkins was the only woman candidate out of a total of eighty-eight partner candidates proposed nationwide for admission to the Price Waterhouse partnership. The selection process asked all of the Price Waterhouse partners to rank partner candidates on a list of relevant neutral criteria and then to make one of three recommendations: (1) to admit to partnership, (2) to deny admission to partnership, or (3) to defer consideration. In Ms. Hopkins' case, 32 partners submitted evaluations, 13 recommended admission, 8 recommended denial, three recommended deferral, and 8 indicated they had no basis with which to make an evaluation.

Many of the comments concerning Ms. Hopkins' partner qualifications concerned problems arising from her strained interactions with lower ranking Price Waterhouse staff members. A final decision on her admission to the

partnership was deferred in 1982. In order to give Ms. Hopkins an opportunity to improve her chances of making partner the following year Ms. Hopkins underwent a "quality control review." This was an internal Price Waterhouse procedure in which Ms. Hopkins was given advice concerning ways to repair any deficiencies she may have evidenced at her initial screening for admission to the partnership. Apparently Ms. Hopkins successfully completed the quality control review, but shortly thereafter the Price Waterhouse partnership decided not to repropose her for admission to the partnership because of the strong opposition of several partners. When Ms. Hopkins was advised of this decision, she realized that her admission to the partnership was very unlikely and resigned in January, 1984.

Ms. Hopkins filed an action under the Act charging that Price Waterhouse had discriminated against her on the basis of sex in the decision denying her admission to the partnership. Title VII forbids an employer to "fail or refuse to hire, or to discharge any individual or otherwise to discriminate with respect to his compensation, terms, conditions, or privilege of employment."[4] The Act also forbids employers to:

> limit, segregate, or classify his employees or applicants for employment in any ways which would deprive or tend to deprive any individual's employment opportunities or otherwise adversely affect his status as an employee because of such individual's race, color, religion, sex, or national origin.[5]

The case was originally tried in the District Court for the District of Columbia and won by the plaintiff.[6] Price Waterhouse appealed but the District Court decision was affirmed by the Court of Appeals for the District of Columbia Circuit.[7] Price Waterhouse then appealed to the Supreme Court of the United States and the Court agreed to hear the case.

MS. HOPKINS' POSITION

At trial, Ms. Hopkins introduced evidence as to her professional competence and accomplishments. For example, she introduced a statement prepared by several Price Waterhouse partners showcasing her successful two-year effort to secure a $25 million contract with the Department of State. This report labeled her work as "an outstanding performance" carried out "virtually at the partner level." The trial judge cited the plaintiff's instrumental role in securing the Department of State contract and noted that none of the other of that year's partnership candidates had a similar record in regard to securing multimillion dollar contracts for the firm. Additional testimony from supporting partners described the plaintiff as "an outstanding professional" with a "deft touch" and "strong character, independence, and integrity." One of the plaintiff's witnesses described Ms. Hopkins as "extremely competent, intelligent, strong and forthright, very productive, energetic, and creative."[8]

In addition to such laudatory comments, Ms. Hopkins introduced evidence at trial which she used to demonstrate that the Price Waterhouse partner selection process was tainted with sexual bias and thus violative of the Act. For example, one partner described her as "macho." Another partner suggested that Ms. Hopkins "overcompensated for being a woman" while the third advised that she should "take a course in charm school." Several of the partners singled out her use of profanity as being incompatible with feminine characteristics. The trial judge was particularly moved by remarks made by the Price Waterhouse partner charged with sponsoring her candidacy for the partnership. This male partner advised Ms. Hopkins to "walk more femininely, talk more femininely, dress more femininely, wear make up, have her hair styled, and wear jewelry."[9] Ms. Hopkins produced testimony from a social psychologist to the effect that the Price Waterhouse partnership selection process was probably influenced by sexual stereotyping. This witness examined both the overtly sex-based comments of some of the partners and also certain very personal, emotional comments made by other partners who had almost no contact either personally or professionally with Ms. Hopkins.[10]

THE RULINGS OF THE LOWER COURTS

Throughout all three judicial proceedings Price Waterhouse argued that the Act is violated only if *decisive* consideration is given in an employment decision to the employee's gender, race, national origin, or religion. Price Waterhouse emphasized its belief that Ms. Hopkins' poor interpersonal skills were the reason for her inadmission to the partnership. Evidence was introduced that even before the partnership issue arose, Ms. Hopkins was often counseled about her strained relations with lower ranking staff members. The trial judge believed Price Waterhouse's contention that Ms. Hopkins' career history did involve numerous clashes with lower ranking staff members. The trial judge noted that Ms. Hopkins was "sometimes overly aggressive, unduly harsh, difficult to work with, and impatient with staff."[11] The District Court held that Price Waterhouse legitimately used interpersonal skills as a standard in its partnership selection process and did not give decisive emphasis to such traits only because Ms. Hopkins was a woman.

On the same point, however, the trial court held that Price Waterhouse had unlawfully discriminated against Ms. Hopkins on the basis of sex by consciously giving credence and effect to partners' comments that resulted from sex stereotyping. The trial court noted that Price Waterhouse could have rebutted evidence of sexual discrimination and avoided any equitable relief to the plaintiff by presenting clear and convincing evidence that it would have denied Hopkins' candidacy even absent the sexual discrimination. The trial court indicated, however, that Price Waterhouse had not presented such evidence.

The District of Columbia Court of Appeals affirmed the trial court's decision and held that the defendant, Price Waterhouse, would not be liable if it could prove by clear and convincing evidence that it would have made the same decision regarding Ms. Hopkins in the absence of sexual discrimination. Thus under the Court of Appeals' approach there is no violation of the Act if Price Waterhouse could prove by clear and convincing evidence that it would have made the same decision denying Ms. Hopkins' partnership candidacy in the absence of an impermissible sexual bias against her.

THE SUPREME COURT RULING

The Supreme Court of the United States heard *Hopkins* in order to resolve a conflict among the various Courts of Appeals involving the respective burdens of proof required of plaintiff and of defendant in Title VII cases where employment decisions involving discrimination were based on a mixture of legitimate and illegitimate motives.[12] The Supreme Court affirmed the Court of Appeals in that it held that the standard for liability under Title VII is whether the employer would have made the same decision in the absence of an impermissible motive. However, the Supreme Court disagreed with both the District Court and the Court of Appeals because both of these courts required the employer to make its proof by clear and convincing evidence rather than by a preponderance of the evidence. The Supreme Court adopted preponderance of the evidence as the evidentiary standard which will relieve employers of liability in the presence of impermissible motives in an employment decision.

The burden of proof that the Supreme Court adopted, preponderance of evidence, places an evidentiary burden on both the plaintiff and the defendant. The plaintiff must demonstrate that an impermissible motive played a part in an adverse employment decision. Once this showing has been made the defendant must show by a preponderance of the evidence that it would have made the same decision even if the impermissible motive had not been present. The trial court finding for the plaintiff must effectively conclude that an illegitimate motive was a "but for" cause of the employment decision. As stated by the Supreme Court the critical inquiry "is whether gender was a factor in the employment decision at the moment it was made."[13]

Although legal authorities and courts differ as to the meaning of "preponderance of the evidence" and "clear and convincing evidence" most legal authorities believe "preponderance of the evidence" is a lower standard of proof than is "clear and convincing evidence." Generally, preponderance of the evidence is a standard that leads the trier of fact, the judge or the jury, to find that the existence of the contested fact is more probable than its nonexistence. Clear and convincing evidence is a higher burden of proof and

generally means that the trier of fact is persuaded that the contention is "highly probable."[14]

The Supreme Court began its analysis of the Act by looking at its legislative history. This history reveals that Congress intended that the standards for the selection, evaluation, and compensation of employees should not include sex, race, religion, and/or national origin. Therefore the purpose of the Act is to eliminate these factors as bases for distinguishing among employees while otherwise preserving the freedom of choice that the employer has to select or to reward employees or potential employees. Hence any analysis of the Act always reflects a tension between the impermissible categories explicitly named and a decision making process which is otherwise free and open. The Supreme Court stated that the "balance between employee rights and employer prerogatives turns out to be decisive"[15] in *Hopkins*. The Supreme Court indicated that in light of the legislative history of the Act the first standard to be used in applying the statute is to determine whether gender was a factor in the employment decision at the moment of the decision. The Supreme Court held that:

> When, therefore, an employer considers both gender and legitimate factors at the time of making a decision, that decision was "because of" sex and the other legitimate considerations—even if we may say later in the context of litigation that the decision would have been the same if gender had not been taken into account.[16]

The Supreme Court stated that the Act was intended to condemn even those decisions based on a mixture of legitimate and illegitimate considerations. However, the Supreme Court also stated that even though the Act forbids an employer to take gender into account in an employment decision, another important aspect of the statute is the preservation of the remaining freedom of choice to which an employer is entitled in such decisions. Although gender cannot be taken into account by an employer in an employment decision, the employer is free to decide against a woman for other reasons. The Act "does not purport to limit the other qualities and characteristics that employers *may* take into account in making employment decisions."[17] The Supreme Court concluded that the preservation of the employer's freedom means that an employer shall not be liable if it can prove that, even if it had not taken gender into account, it would have come to the same decision regarding a particular person.

In addressing Ms. Hopkins' argument that she had been the victim of sex stereotyping, the Supreme Court recognized the legal relevance of sex stereotyping. The Supreme Court stated that "we are beyond the day when an employer could evaluate employees by assuming or insisting that they match the stereotype associated with their group."[18] An employer who objects to aggressiveness in women but "whose positions require this trait places women

in an intolerable and impermissible Catch-22: out of a job if they behave aggressively and out of a job if they don't. Title VII lifts women out of this bind."[19]

In addressing evidence of the existence of sex stereotyping, the Supreme Court reasoned that remarks in the workplace which are based on sexual stereotypes do not inevitably prove that gender is a relevant factor in a given employment decision. The Court did observe that in *Hopkins* there were indications of more than simply stray remarks regarding stereotypes of the ideal woman. The promotion process at Price Waterhouse relied very heavily on the partners' evaluations. The Court believed that some of the partners' comments in these evaluations were the product of stereotyping, and Price Waterhouse did not disclaim reliance on these sex-linked evaluations. The Court described as inevitable its conclusion that Price Waterhouse did take into consideration all the partners' comments including those that were tainted by stereotypical notions about women's proper conduct and deportment.[20]

In addressing the Price Waterhouse argument that Ms. Hopkins' poor interpersonal skills doomed her partnership opportunities, the Supreme Court stated that the firm appears to take the position that in order to find for Hopkins, the trial court would have to find that she is "kind and considerate and patient" rather than "overbearing and aggressive and curt." The Supreme Court, however, stated that Hopkins' actual temperament was not at issue. What was at issue was that the partners who were evaluating her, as evidenced by their comments, were scrutinizing Hopkins as a *woman* manager and reacted negatively to her personality because she is a woman. Therefore, Price Waterhouse was guilty of sexual stereotyping in its promotion processes.

In evaluating the comments made by partners regarding Hopkins, the Court took the position that it takes no special training or skill to discern sex stereotyping in a description of an aggressive female employee as requiring "a course at charm school." Similarly, no expertise in psychology is required to determine that if an employer believes that an employee's "flawed 'interpersonal skills' can be corrected by a soft-hued suit or a new shade of lipstick, perhaps it is the employee's sex and not her interpersonal skills that has drawn the criticism."[21]

The Supreme Court appears to take a "common sense" approach to the evaluation of sex stereotyping based on a facts and circumstances test. Where comments or actions that evidence prohibited category stereotyping or bias are clearly present in the promotion process, then the process is tainted under the Act.

The existence of sex stereotyping transfers the legal burden of proof in a Title VII action from the plaintiff to the defendant with regard to the legal defendability of the final employment decision. The Supreme Court cited numerous prior rulings which demonstrated that if an employer allows gender to affect its decisionmaking process, then the employer must carry the burden

of justifying its ultimate decision.[22] Thus Price Waterhouse must demonstrate that because gender (through sexual stereotyping) had affected its decisionmaking process, the result in Ms. Hopkins' case would have been the same absent that taint of sexual discrimination. On this point the Supreme Court remanded the case to the District Court to determine if Price Waterhouse could prove by a preponderance of the evidence that the same decision would have been made had not the sexual stereotyping occurred. On May 14, 1990, the District Court ordered Price Waterhouse to make Ms. Hopkins a partner and pay her approximately $350,000 for earnings she lost as the result of illegal sexual stereotyping. The District Court judge concluded that Price Waterhouse's arguments amounted to advocacy rather than proof under the preponderance of evidence test.

IMPLICATIONS OF THE RULING FOR FIRMS AND FOR THE PROFESSION

The immediate implications of *Hopkins* for accounting firms involve (1) implementing the preponderance of evidence test in Title VII actions and (2) changing the promotion practices of the firm to comply with the provisions of this decision. The long- term implication of *Hopkins* is to change the subjective management environment because the Supreme Court found evidence of sexual discrimination in the promotion practices of an accounting firm which believed that its promotion practices were based only upon ability and performance. This decision is particularly noteworthy to a profession which values so highly its reputation for integrity. In fact, the profession's Code of Ethics forbids not only actual misdeeds but even the appearance of misdoings. Sexual discrimination in promotion practices is not only objectively unjust and unfair, but hardly comports with the reputation for integrity that the accounting profession brandishes as its badge of respect.

Prior to *Hopkins* a promotion decision based on both permitted and illegitimate factors would violate Title VII if the plaintiff proved (1) the presence of a prohibited factor in the decision-making process and (2) the decision to be invalid based on the factors which are permitted as promotion criteria under Title VII. The plaintiff had the burden of proof that the decision was wrong not simply because of the presence of illegitimate factors, but wrong in light of the legitimate factors that were considered. However, under *Hopkins* a plaintiff must only prove that the decision was based on a mixture of legitimate and illegitimate factors. Once the presence of an illegitimate factor in the decision is established by the plaintiff, the burden of proof shifts to the defendant to prove by a preponderance of the evidence that the decision would have been the same even if the improper factor had not been present. This shifting of the burden of proof is especially critical owing to the Court's position

that in cases where a decision is made based on a combination of legitimate and illegitimate factors there is the presumption that the decision is based solely on the illegitimate factors. Prior to *Hopkins*, a partner in a firm making a promotion decision may have had the attitude that if he or she improperly or inadvertently included prohibited factors in such a decision it would be the offended employee's problem to prove that the decision was improper and discriminatory. However, *Hopkins* has established that a *prima facie* showing of discrimination under Title VII places the burden of rebutting the presumption of discrimination on the defendant, and the defendant must prove that the decision was indeed proper given the factors which are not prohibited by Title VII. Where the inclusion of prohibited factors in an employment decision is established, the firm is no longer considered "innocent" but must prove that "innocence."

The procedural changes which may be necessary to the promotion systems of accounting firms due to *Hopkins* are based primarily on the concept of sexual stereotyping described in the ruling. Firms must ensure that their promotion systems neither establish nor tolerate stereotypes of what an ideal *woman* partner or employee would be. For example, if excellent interpersonal skills are a necessary and desirable trait for a certain position in the firm, then care must be taken in the evaluation process not to introduce differing sets of definitions of excellence based on a male/female dichotomy. The Court indicates that the explicit inclusion of stereotypical comments in the evaluation process is sufficient evidence of sexual stereotyping and is prohibited. Firms should, therefore, examine their processes for gathering comments regarding individuals being considered in employment decisions. Individuals in responsible positions within the firm should be sensitive to sexually stereotypical comments submitted as part of the process and reject evaluations including such comments. Bringing the illegitimacy of such stereotyping to light helps ensure compliance with the "letter" of the law under the regulations of Title VII. However, the process of identifying such stereotyping may help individuals to be aware of a potentially unconscious act on their part. For example, an individual may not be consciously aware that he or she is evaluating a person in light of being a "woman" partner rather than as a partner. Forced compliance with the law in this case may bring a greater sensitivity to the issue of gender in the profession and contribute to the elimination of sexual stereotyping.

As for the long-term implications for the profession involved in the issues addressed in *Hopkins*, the fact is that (1) the profession must face the issue of gender due to its changing nature and (2) the evidence of illegal and unjust practices in the profession potentially diminishes the integrity and reputation of the profession. The fact of history is that the profession has been primarily composed of male members. This is evident in the *Hopkins* case from the fact that Ms. Hopkins was the only woman out of 88 partnership candidates in

1982. The situation has, however, been rapidly changing in recent years. On college campuses the number of female accounting graduates has increased to the point that there is approximate parity of the sexes. Accounting firms are recruiting a larger number of women than in the past, and more women are pursuing careers in the profession than ever before. These factors enhance the importance of the "spirit" of the law as considered in *Hopkins*. The profession cannot have a double standard for this growing segment of its membership.

The result of this decision is that Price Waterhouse has been found to be guilty of sexual discrimination in violation of public law. Without overly criticizing that one particular firm, one must pose the question concerning just how does such a finding agree with the supposed high degree of integrity and ethical behavior which forms the cornerstone of the practice of public accounting. The accounting profession is based on the trust that integrity and ethical behavior produce. That the profession may be guilty of sexual discrimination impinges upon that integrity and indicates a possible degree of hypocrisy which is not in keeping with the standards set by the profession. Presumably this case involved the presence of unconscious factors such as sexual stereotyping in a promotion decision. If such is the case, then sensitizing the members of the profession to such a presence will help to remedy the situation. If the possibility is considered that such discrimination is based on a conscious effort to enforce a double standard in the profession, then the profession is faced with some hard questions concerning the outcome of such a practice. A double standard would potentially lead to: the elimination of any claim to integrity on the part of the profession, increased regulatory intervention in relation to the practices and policies related to the individuals who practice accounting, and a highly disharmonious relationship between the male and female members of the profession. All of these possible outcomes will adversely affect not only the profession but also its individual members. The accounting profession has made great efforts to retain the highest degree of self-regulation where accounting concepts, principles, procedures, and so on are concerned. The profession takes careful note for the need for equity and fairness in its reporting processes and mechanisms. The potential signal provided by *Hopkins* is that such self-regulation and due care for equity and fairness may be applicable to the policies and procedures which govern and direct the individuals who practice public accounting as well as to the procedures which govern that practice. Given the need for integrity and ethical behavior required by the accounting profession, the issues of equity, fairness, and opportunity for accounting professionals should be faced by the profession from within as opposed to being demanded by outside regulatory and judicial bodies.

NOTES AND REFERENCES

1. 109 S.Ct. 1775 (1989).
2. 78 Stat. 253 as amended, 42 U.S.C. Section 2000e et seq.
3. Senior manager is a position within Price Waterhouse next to partner in the firm's hierarchy.
4. 42 U.S.C. Sections 2000e-2(a)(1),(2).
5. 42 U.S.C. Section 2000e-2(a).
6. 618 F.Supp. 1109.
7. 825 F.2d 458.
8. 618 F.Supp. at 1112-1113.
9. 618 F.Supp. at 1117.
10. Note 1, *supra.* at 1783.
11. 618 F.Supp. at 1113.
12. Several of the circuits have held that a plaintiff challenging an adverse employment decision must show that but for her gender or race or religion or national origin the decision would have been in her favor. See *Bellissimo v. Westinghouse Elec. Corp.*, 764 F.2d 175 (CA 3, 1985) *cert. denied.* 475 U.S. 1035, 106 S.Ct. 1244, 89 L.Ed. 2d 353 (1986); *Ross v. Communications Satellite Corp.* 759 F.2d 355 (CA 4, 1985); *Peters v. City of Shreveport*, 818 F.2d 1148 (CA 7, 1987). Other circuits have held that once the plaintiff has shown that a discriminatory motive was a substantial or motivating factor in an employment decision, the employer may avoid liability by proving that it would have made the same decision even in the absence of discrimination. *Fields v. Clark University*, 817 F.2d 931 (CA 1, 1987); *Berl v. Westchester County*, 849 F.2d 717 (CA 2, 1988); *Terbovitz v. Fiscal Court of Adair County, Ky.*, 825 F.2d 111 (CA 6, 1987); *Bell v. Birmingham Linen Service*, 715 F.2d 1552 (CA 11, 1983).
13. Note 1, *supra.* at 1785.
14. Cleary et al., *McCormick on Evidence*, 3rd ed. [West].
15. Note 1, *supra.* at 1785.
16. Ibid.
17. Note 1, *supra.* at 1784.
18. Note 1, *supra.* at 1791.
19. Ibid.
20. Note 1, *supra.* at 1794.
21. Note 1, *supra.* at 1793.
22. *Dothard v. Rawlinson*, 433 U.S. 321, 97 S.Ct. 2720, 53 L. Ed. 2d 786 (1977) and *Corning Glass Works v. Brennan*, 417 U.S. 188, 94 S.Ct. 2223, 41 L.Ed. 2d 1 (1974).

THE EMERGING ISSUES TASK FORCE: AN EXAMINATION OF ACTIVITIES AND IMPLICATIONS FOR PRACTICE

Paul R. Bahnson and Andrew J. Rosman

ABSTRACT

Although the Emerging Issues Task Force (EITF) was established in 1984 to advise the FASB on emerging issues, the EITF has evolved into a "de facto" standard setting body for publicly held companies since it's conclusions on accounting practice enjoy the full support of the SEC. Without similar support by the FASB and AICPA, however, nonpublic companies are not compelled to follow EITF guidance. The opportunity, therefore, exists for inconsistent accounting recognition practices to develop between public and nonpublic companies, which may seriously impair the EITF's credibility in the long run. In turn, the FASB could be forced to reassume the direct burden of providing practice with comprehensive timely guidance. This paper proposes two steps to eliminate the opportunity for nonpublic companies to ignore EITF conclusions. First, the EITF should be recognized by the profession as a standard-setting body subject to FASB oversight. Second, a new hierarchy establishing the sources of authoritative guidance should be established to raise the present "official" status of the EITF as a GAAP source of last resort to an equivalent level of authority

Research in Accounting Regulation, Volume 4, pages 181-193.
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ISBN: 1-55938-084-5

with FASB Statements and Technical Bulletins. In addition, the paper raises other issues concerning the EITF that should be addressed by the profession to make the standard-setting process more efficient and effective.

INTRODUCTION

The Emerging Issues Task Force (EITF) was established in 1984 to make standard setting more efficient by identifying emerging issues on which the FASB should take action. Although intended primarily to advise the FASB on agenda matters, the EITF has gone beyond this charge by reaching conclusions on accounting practices. Neither its track record of issue resolution nor the SEC's commitment to enforce its decisions has influenced the private sector, which deemphasizes the EITF in two important ways. First, the AICPA designates the EITF as a source of generally accepted accounting principles (GAAP) of last resort by placing the EITF in the lowest level of the GAAP hierarchy. Second, the FASB breaks a long-standing practice of discussing task force deliberations in its basis for conclusions to Statements by ignoring relevant EITF discussions.

Because the EITF's authority comes from the SEC rather than from the AICPA or the FASB, nonpublic companies are not compelled to follow EITF guidance. Permitting companies to ignore EITF consensuses because their shares are not publicly traded extends the dichotomy between public and nonpublic companies far beyond presently accepted differences in disclosure rules. The dichotomy is significant because it breeds the opportunity for inconsistent accounting recognition practices to develop among similar companies and may seriously impair the EITF's credibility in the long run. Thus, ironically, the posture of the FASB and AICPA toward the EITF may minimize the EITF's ability to provide practice with timely guidance on narrow issues, which in turn could cause the direct burden of providing timely guidance to revert to the FASB.

To eliminate the opportunity for nonpublic companies to ignore EITF conclusions, this paper proposes that (1) the EITF be recognized as a standard-setting body subject to FASB oversight and (2) a new hierarchy for establishing sources of accounting guidance be established.[1] To lay the foundation for both proposals, the next section examines the inconsistencies between the EITF's stated mission of advisement and evidence of standard-setting gathered over six years of EITF activity. The following section examines the current GAAP hierarchy's incompatibility with the EITF's standard-setting role and proposes an alternative hierarchy. The concluding section is a summary of the principal arguments presented in the paper and a discussion of other observations about

the EITF that, although tangentially related to the issues addressed in this paper, nonetheless are important concerns for practice.

EITF: ADVISER OR STANDARD SETTER?

As a result of its review of the FASB in 1982, the Financial Accounting Foundation recommended that "more timely guidance on implementation questions and emerging issues is needed" [FAF, 1982, p.21]. The FASB responded by expanding the scope of Technical Bulletins so that they could be used to address certain emerging issues and by creating the EITF to "identify financial reporting problems as they develop . . . [and to] attempt to define the scope of the problems, focusing on the problems' pervasiveness and relationship to the existing authoritative literature" [FASB, 1983, para. 15]. Although the EITF was to serve primarily as an adviser, the FASB recognized that EITF deliberations

> might clarify the nature of the problem and create a consensus on a solution before diverse accounting practices become established. If some problems could be resolved through a discussion of the issues by the advisory group, the need for formal guidance by the FASB in a Statement, Interpretation, or Technical Bulletin could be avoided [FASB, 1983, para. 16].

In contrast to initial expectations, the EITF has been heavily engaged in issue resolution. In fact, in the words of one author, the EITF has attained "de facto" standard-setting status because its decisions, which are endorsed by the SEC, are made with only the indirect involvement of the FASB [Dyckman, 1988].

Overview of EITF Deliberation Process and Meaning of "Consensus"

As of December 1989, the EITF consisted of four individuals from industry, nine individuals from public accounting (all of the "Big Six" were represented), and the FASB Director of Research and Technical Activities who is the EITF Chairman. The Chief Accountant of the SEC and the Chairman of the AICPA's Accounting Standards Executive Committee (AcSEC) participate without the right to vote. Each participant is knowledgeable in accounting and financial reporting and is in a position to be aware of emerging issues.

EITF meetings are held approximately once every four to six weeks. Although the meetings are open to the public, the EITF does not formally solicit comments from interested parties as is done by the FASB to satisfy "due process." However, the EITF's process is more open than the previous process of resolving narrow issues, which consisted of "private conferences that may have involved only an auditor and a client, and perhaps the Chief Accountant of the SEC" [Miller and Redding, 1988, p. 147].

Issues discussed at EITF meetings are problems that represent prior events for which practice may have reached tentative conclusions or events that are being planned. EITF issues typically are either too narrow to be added to the Board's agenda or so timely that they can not wait for final resolution by the Board as part of a major agenda project. An issue summary, which describes the issue and the related accounting and reporting literature, is prepared by the EITF member who asks to add the issue to the agenda. The issue summary provides the basis for discussion. Issue summaries and minutes of EITF meetings are available from the FASB at a cost.

For each issue addressed by the EITF, the outcome is: a consensus (i.e., if no more than two members disagree with a position), an informative discussion with no consensus attempted, or the inability to reach a consensus. A consensus is: an agreement that a particular problem is not pervasive and need not be addressed further, an agreement that a problem warrants attention by the FASB, or an agreement that the existing literature provides adequate guidance for resolving the issue.

The FASB is the primary beneficiary of the first two types of consensus and must determine how to use the consensus in its deliberations (i.e., whether to take action). For example, the consensus reached in Issue 84-16, *Earnings-per-Share Cash-Yield Test for Zero Coupon Bonds*, was that the FASB should amend APB Opinion 15, *Earnings per Share.* The Board responded to this and other input by issuing FASB Statement No. 85, *Determining Whether a Convertible Security Is a Common Stock Equivalent.*

In contrast to its advisory role in the first two types of consensus, the EITF resolves issues when it arrives at the third type of consensus (Type-3 consensus). A Type-3 consensus, which may result from either the direct application of GAAP to an issue or the interpretation of GAAP by consulting for guidance the authoritative literature that exists for an event similar in substance (i.e., an analogy), is more than merely advisement because either an acceptable practice is specified or the set of acceptable practices is narrowed.

Oversight of EITF Activities

Regardless of the specific issue or type of activity in which the EITF is involved (e.g., informative discussion), EITF deliberations are closely monitored by the FASB, SEC, and AcSEC. As indicated earlier, the FASB Director of Research and Technical Activities is the EITF Chairman. In addition, FASB staff members are assigned to participate in discussing and evaluating each issue and FASB Board members attend each meeting to observe and participate in discussions. Oversight by the SEC and AICPA is achieved by the participation of the Chief Accountant and the Chairman of AcSEC, respectively. FASB, SEC, and AcSEC reactions to EITF activity are recorded in EITF minutes.

Further evidence of oversight activity is provided in FASB Technical Bulletins and Statements, SEC Staff Accounting Bulletins, and AcSEC Statements of Position, which may be issued to support or overturn EITF positions. FASB follow-up, however, is not always easily identified because FASB pronouncements do not discuss relevant EITF deliberations. This omission is unusual because FASB pronouncements typically refer to the activities of other FASB task forces.

An example of follow-up activity overturning an EITF consensus is the action taken by the FASB staff on EITF Issue 84-38, *Identical Common Shares for a Pooling of Interests*. In its consensus, the EITF stated that the issuance in a business combination, of shares that are identical to other outstanding common shares except for the right of first refusal, would not preclude the issuer from accounting for the business combination as a pooling. The FASB staff disagreed with the EITF's interpretation of GAAP and overturned the EITF consensus in Technical Bulletin 85-5, *Issues Relating to Accounting for Business Combinations*.

Disagreement with an EITF consensus, however, does not always result in immediate action by the FASB, SEC, or AICPA. For example, FASB staff concerns about the consensuses reached in Issue 86-24, *Third-Party Establishment of Collateralized Mortgage Obligations*, and Issue 86-36, *Invasion of a Defeasance Trust*, have been deferred until the Board addresses these and other related issues in its major agenda project on financial instruments.

Analysis of EITF Deliberations and FASB, SEC, and AICPA Oversight

The 207 issues discussed by the EITF from its inception in July 1984 through December 1989, may be grouped broadly as follows: financial instruments (52), financial institutions (32), business combinations (23), income taxes (22), pensions/employee benefits (19), inventory/fixed assets/leases (18), off-balance-sheet financing (12), real estate (9), and other (20) [FASB, 1989]. Of the 207 issues, 170 (82%) pertained to emerging issues for which the FASB did not currently have a project on its agenda. The remaining 37 issues (18%) were related to major agenda projects (Table 1).

Many of the issues addressed by the EITF are a series of questions for which separate votes are taken. Thus, the relevant number of actions taken by the EITF during the study period is 358 (see Table 1). Although the average number of questions addressed per issue increased from 1.23 in 1984 to 2.32 in 1987, the average declined to 2.21 and 1.53 in 1988 and 1989, respectively (Table 1). Table 2 shows that 264 (74%) questions resulted in a consensus, 22 (6%) were the basis for informative discussions, and 72 (20%) were questions for which the EITF was unsuccessful in reaching a consensus.

Table 1. Summary of Issues and Questions by Year

	1984		*1985*		*1986*		*1987*		*1988*		*1989*		*Total*	
	N	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)
Issues														
Emerging Issue	30	(70)	36	(80)	35	(78)	28	(90)	22	(92)	19	(100)	170	(82)
Major Board Project	13	(30)	9	(20)	10	(22)	3	(10)	2	(8)	0	—	37	(18)
Total	43		45		45		31		24		19		207	
Questions														
Total	53		63		88		72		53		29		358	
Average per issue	1.23		1.40		1.96		2.32		2.21		1.53		1.73	

Table 2. Type of EITF Deliberation by Year

	1984		*1985*		*1986*		*1987*		*1988*		*1989*		*Total*	
Type of Deliberation	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)
Consensus (Direct and Analogy)	21	(40)	34	(54)	78	(89)	65	(90)	42	(81)	24	(83)	264	(74)
Discussion	5	(9)	10	(16)	0	(0)	3	(4)	1	(2)	3	(10)	22	(6)
Unable to Reach a Consensus	27	(51)	19	(30)	10	(11)	4	(6)	10	(18)	2	(7)	72	(20)
Total Number of Questions*	53		63		88		72		53		29		358	

Note: * Total is taken from Table 1.

The learning curve appears to have been steep for the Task Force members in 1984, which was the EITF's first year of operation. Only in 1984, for example, was the EITF unable to reach a consensus more frequently than it was able to reach a consensus (Table 2). Furthermore, 1984 was the year in which the smallest percentage of total questions addressed by the EITF resulted in a consensus. The 40 percent consensus rate in 1984 was more than doubled in each year after 1985, when a consensus was reached for 89 percent, 90 percent, 81 percent, and 83 percent of the questions addressed, respectively (Table 2).

The FASB, SEC and AICPA resolved a number of the issues in 1984 for which the EITF was unable to reach a consensus. Documents were prepared by the FASB, SEC, and AICPA for 53 percent of the questions addressed by the EITF in 1984, compared to 27 percent, 22 percent, 18 percent, 0 percent, and 0 percent over the next five years (Table 3). Fourteen of the 28 follow-up actions in 1984 (50%) pertained to issues for which the EITF was unable to reach a consensus (Table 3). Subsequent to 1984, the EITF activity on which follow-up action was most heavily concentrated was on questions that resulted in consensus. Although the FASB, SEC, and AICPA followed up on a smaller

Table 3. Follow-Up Action on EITF Deliberation

Type of Deliberation	*Follow-Up*		*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*Total*
Consensus	FASB		6	8	14	10	0	0	38
	SEC		2	1	3	0	0	0	6
	AcSEC		2	1	0	1	0	0	4
	Total:	*N*	10	10	17	11	0	0	48
		(%)	(36)	(59)	(89)	(85)	—	—	(62)
Discussion	FASB		3	2	0	0	0	0	5
	SEC		1	0	0	0	0	0	1
	AcSEC		0	0	0	0	0	0	0
	Total:	*N*	4	2	0	0	0	0	6
		(%)	(14)	(12)	(0)	(0)	—	—	(8)
Unable to Reach a Concensus	FASB		9	5	1	2	0	0	17
	SEC		3	0	1	0	0	0	4
	AcSEC		2	0	0	0	0	0	2
	Total:	*N*	14	5	2	2	0	0	23
		(%)	(50)	(29)	(11)	(15)	—	—	(30)
Total Follow-up	FASB		18	15	15	12	0	0	60
	SEC		6	1	4	0	0	0	11
	AcSEC		4	1	0	1	0	0	6
			28	17	19	13	0	0	77
Total Questions (from Table 2)			53	63	88	72	53	29	358
(Percentage of Total Questions that were Followed Up)			(53)	(27)	(22)	(18)	—	—	(22)

Table 4. Result of Follow-Up Action on Consensus Deliberation

	1984		*1985*		*1986*		*1987*		*1988*		*1989*		*Total*	
Follow-Up Activity	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)	*N*	(%)
Nullify/Change	5	(50)	6	(60)	11	(65)	9	(82)	0	—	0	—	31	(65)
Support	2	(20)	4	(40)	6	(35)	2	(18)	0	—	0	—	14	(29)
No Position	3	(30)	0	—	0	—	0	—	0	—	0	—	3	(6)
Total (from Table 3)	10		10		17		11		0		0		48	

percentage of EITF actions from 1985-1987, the level of disagreement with EITF consensus positions, principally by the FASB, was relatively high. As shown in Table 4, EITF consensuses were nullified in at least 50 percent of the cases that involved FASB, SEC, or AICPA follow up. Much of the activity in 1987, in which 82 percent of the followed-up EITF consensuses were nullified, reflected changes prescribed by FASB Statement No. 96, *Accounting for Income Taxes*. No follow-up activity, however, was reported in 1988 and 1989.

Implications of a Consensus for Practice

Once a Type-3 consensus is reached it becomes a "source of established accounting principles," unless the FASB or SEC disagrees with the consensus and overturns it by issuing a document of its own. An EITF consensus is an example of "other accounting literature" in the GAAP hierarchy (i.e., the lowest of four levels of sources of accounting principles [AICPA, 1988]). This paper argues that classifying an EITF consensus as a level-4 source of accounting principles misrepresents its relative importance to users and preparers of financial information for two reasons. First, of all the different types of level-4 accounting principles such as APB Statements, AICPA Issues Papers, and accounting textbooks, only changes in accounting principles that result from implementing an EITF consensus are subject to cumulative catch-up requirements of APB Opinion No. 20, *Accounting Changes* (FASB, 1989, p. 4953). Second, the only level-4 accounting principles that the SEC will strictly enforce are EITF consensuses. According to the Chief Accountant, "A Task Force consensus will set the tone for future accounting, and [the chief accountant's office] will question SEC registrant's accounting practices that differ from a Task Force consensus" [FASB, 1984].

The application of APB Opinion 20 when adopting EITF consensuses and the SEC's enforcement policy send an important message to financial statement preparers and users. That is, although the FASB is the sole body designated to establish accounting principles to be observed by members of the AICPA for purposes of expressing an opinion on financial statements (i.e., level-1 accounting principles [AICPA, 1988]), decisions reached by the FASB and EITF have substantially the same impact on the accounting and reporting policies of publicly traded companies. For a public company, deviating from an EITF consensus is no more an option than is deviating from an FASB Statement. Thus, in practical terms, the EITF's guidance is equivalent to the guidance in FASB standards, with the only difference being that due process is absent in the former. In fact, the absence of due process is the principal factor that precludes considering an EITF consensus as a second level source of accounting guidance (i.e., pronouncements of bodies composed of expert accountants that follow a due process procedure). Furthermore, due process, coupled with AICPA Rule 203's designation of the FASB as the only "officially" recognized standard setter, precludes level-1 status for EITF consensuses in the present hierarchy.

COMPATIBILITY OF GAAP HIERARCHY AND EITF'S STANDARD-SETTING ROLE

The present GAAP hierarchy [AICPA, 1988], which was referred to in the previous section, is portrayed in Figure 1. Level 1 includes all FASB Statements

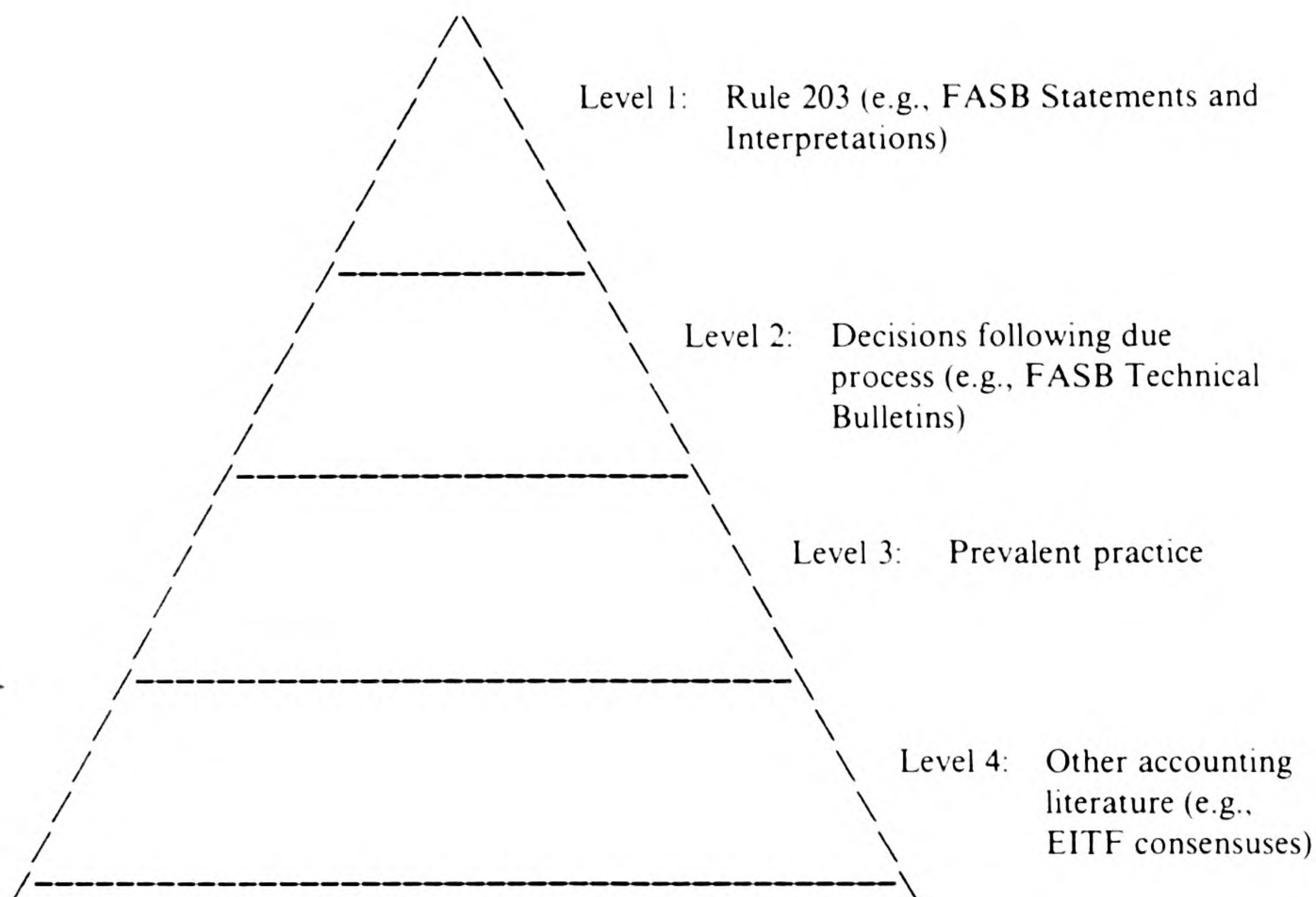

Figure 1. Present GAAP Hierarchy

Source: Statement on Auditing Standards No. 52, *Omnibus Statement on Auditing Standards–1987* (April 1988).

and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins. Level 2 includes guidance provided by knowledgeable professionals whose decisions follow due process (e.g., AICPA Industry Audit Guides and FASB Technical Bulletins). Level 3 is prevalent practice. Level 4 is other accounting literature (e.g., textbooks). The dominant characteristic upon which the present GAAP hierarchy is organized is the "authoritativeness" of the pronouncement (i.e., official designation). Because the FASB is the only body designated by the AICPA to establish accounting principles, its Statements and Interpretations are level-1 GAAP. All documents other than APB Opinions and AICPA Accounting Research Bulletins, including AICPA Audit Guides and EITF consensuses, are relegated to lower levels (see Figure 1).

Dimensions other than authoritativeness, such as narrowness of issue and due process, also influence the present GAAP hierarchy. FASB Technical Bulletins, for example, are included in level 2 because they are narrow in scope (i.e., Technical Bulletins are not expected to cause a major change in accounting for a significant number of companies) and are subject to less due process than FASB Statements (e.g., there typically are no public hearings, discussion memorandum-type documents, or Board vote). However, narrowness is not consistently applied across all levels of the hierarchy. For example, certain FASB Statements are as narrow in scope as Technical Bulletins in terms of

the number of Board constituents affected, but, nevertheless, are included in level 1 (e.g., FASB Statement No. 40, *Financial Reporting and Changing Prices: Specialized Assets–Timberlands and Growing Timber*).

As a result of the authoritative structure of the GAAP hierarchy, accounting users and preparers may conclude that EITF consensuses are inferior to (i.e., less authoritative than) FASB Statements, FASB Technical Bulletins, and AICPA Audit Guides. However, relying on the hierarchy to identify authoritative GAAP is misleading since EITF consensuses are as authoritative for public companies as are FASB Statements. The principal difference in the authoritativeness of FASB Statements and EITF consensuses for practitioners is that the assignment of authority for FASB Statements comes from the AICPA whereas EITF consensuses derive their authority from the SEC. This paper argues that the different postures taken by the SEC and the profession toward the EITF may lead to a decline in the EITF's credibility and, thus, reduce its effectiveness.

To help ensure that the EITF remains a credible source of accounting guidance, this paper recommends to the profession that it reconstruct the GAAP hierarchy. As portrayed in Figure 2, the revised level 1 includes all pronouncements of the FASB, except Concepts Statements (which are not intended to be authoritative), APB Opinions, AICPA Accounting Research Bulletins, and documents of bodies which the FASB directly controls through oversight (i.e., the FASB staff and the EITF). Levels 2, 3, and 4 remain unchanged except for moving FASB Technical Bulletins and EITF consensuses to level 1.

The proposed GAAP hierarchy recognizes that due process must sometimes be traded off for timely guidance without affecting the authoritativeness of the guidance (see level 1 of Figure 2). Because the appropriate combination of due process and timely guidance essentially is determined by the FASB through its decision to add a project to its agenda, to direct its staff to address an issue through a Technical Bulletin, or to oversee the EITF's deliberations, standard setting is reaffirmed to be officially under the purview of the FASB.

The proposed hierarchy defines FASB activities more broadly than does the present hierarchy. By including activities of the Board and its "controlled" operations (i.e., staff and EITF), level 1 of the proposed hierarchy more "faithfully represents" the reality of standard setting much as FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, faithfully represents the results of operations and the financial position of a parent company and its controlled subsidiaries. That is, as FASB Statement No. 94 makes the form of financial statements conform to the substance of the underlying control structure of the firm, the revised hierarchy makes the "official" accounting literature conform to practice.

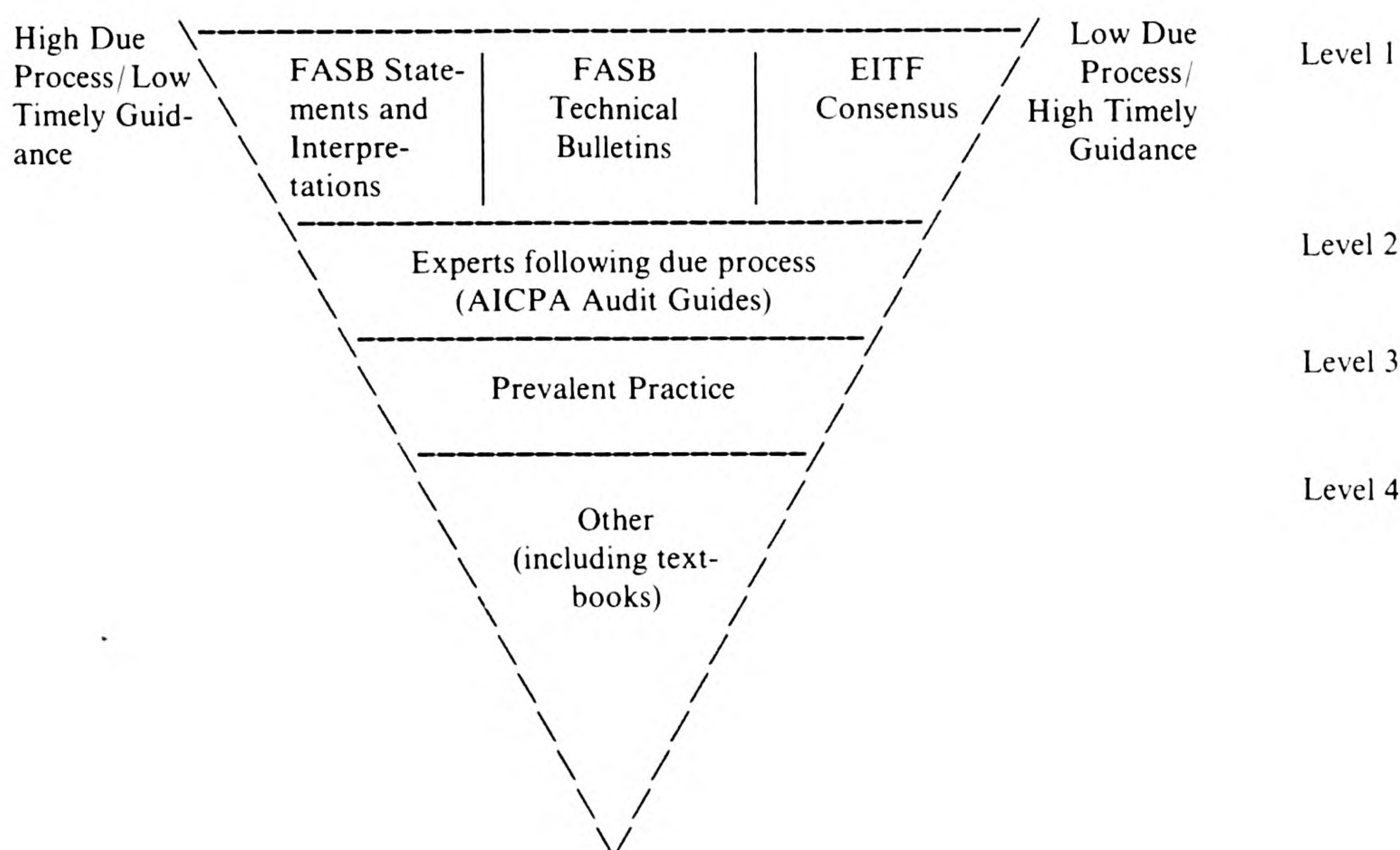

Figure 2. Proposed GAAP Hierarchy

SUMMARY AND OTHER ISSUES

This paper argues that the EITF is a standard-setting body subject to FASB oversight rather than an advisory committee. The EITF has resolved issues brought to its attention by specifying an acceptable practice or narrowing the set of acceptable practices. The SEC has stated its position of strictly enforcing EITF consensuses and APB Opinion 20 treatment for changes in accounting principles is applicable for changes in practice brought about by EITF activities.

The current GAAP hierarchy relegates EITF consensuses to the lowest level of sources of accounting principles, which this paper argues does not faithfully represent the growing volume of important EITF consensuses. Furthermore, this paper argues that to deny the vital role which the EITF plays in providing guidance will, ultimately, decrease its credibility and effectiveness. Thus, this paper proposes a new hierarchy that elevates the status of the EITF by including it as a standard-setting body subject to FASB control through oversight.

Even if the proposed hierarchy is adopted, other issues will need further attention. First, what are the implications of permitting an EITF consensus to guide practice after the FASB or its staff has expressed reservations with that guidance (e.g., Issue 86-24, *Third-Party Establishment of Collateralized Mortgage Obligations* and Issue 86-36, *Invasion of a Defeasance Trust*)? Is

the FASB compelled to issue guidance of its own or should it direct the EITF to retract the consensus? Furthermore, if the FASB eventually nullifies an EITF consensus in a Statement or an Interpretation, or the staff takes a different position in a Technical Bulletin, what guidance should be provided to financial statement preparers in the intervening period and what are the implications for consistent reporting both on an interim and an annual basis?

The second issue concerns the FASB's responsibility to provide complete disclosure in a new Statement of all affected pronouncements and all important considerations in the basis for conclusions. To date, no FASB Statement has disclosed related EITF discussions nor has a superseding FASB Statement even mentioned that an EITF consensus has been nullified. Thus, users and preparers must rely on *EITF Abstracts*, which is an annual FASB publication, to determine which EITF consensuses are still in force, rather than obtain that information from FASB Statements.

The third issue concerns an administrative procedure followed by the EITF. Many issues, particularly those that remain unresolved, are revisited by the EITF, which may at that later date reach a consensus. Rather than be assigned a new issue number, the abstract for the old issue is simply rewritten. Thus, a practitioner who believes that he is following an acceptable practice based on the first version of the EITF abstract may unknowingly be violating the "revised" guidance. Thus, the question is how should the EITF handle the numbering of its issue abstracts in light of revisions to previous positions?

The fourth issue concerns the EITF's activity on major agenda projects, which represents 18 percent of the issues discussed by the EITF (Table 1). Is it appropriate for the EITF to provide "interim" guidance on issues which are under consideration by the FASB? This question is particularly important given that the high level of follow-up activity nullifying EITF consensuses in 1987 was accomplished through FASB Statement No. 96.

The final issue concerns the explanation for the lack of follow-up activity by the FASB, SEC, and AICPA in 1988 and 1989 (Tables 3 and 4). Does the lack of follow-up suggest that the bodies charged with oversight were in total agreement with the EITF during 1988 and 1989 or that oversight activities were relaxed during those years? It may be naive to believe that the lack of follow-up though official pronouncements reflects greater autonomy for the EITF. Perhaps the more likely explanation is that the oversight bodies have begun to shape EITF actions early in the deliberation process. If the latter is true, then the FASB in particular may have found an alternative outlet for setting standards.

ACKNOWLEDGMENT

The authors thank Jean Bedard, Mohamed Hussein, Paul B.W. Miller, and Rudolph W. Schattke for their suggestions and comments.

NOTES

1. The term "standard-setting body" has a precise meaning in the literature in that only the FASB is officially designated to establish accounting standards. In this paper, "standard-setting body" is used more liberally to mean any body of knowledgeable people in the accounting profession whose collective judgment represents an important source of accounting guidance.

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THE CONTROVERSY OVER THE RECEIPT OF COMMISSIONS AND CONTINGENT FEES

Alan T. Lord and David G. Jaeger

ABSTRACT

The recent agreement between the Federal Trade Commission (FTC) and the American Institute of Certified Public Accountants (AICPA) (subject to final FTC approval) would cause substantive changes in the restrictions that the AICPA places on its members regarding the receipt of commissions and contingent fees. The impact of the changes contained in the agreement is questioned in light of the state action doctrine, which provides an exemption from federal antitrust law. We argue that the result of the FTC's actions may be an increase in regulatory diversity for the profession of accountancy.

Research in Accounting Regulation, Volume 4, pages 195-204.
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ISBN: 1-55938-084-5

In 1985, the Federal Trade Commission (FTC) began an evaluation of the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct[1] (Code) [AICPA, 1988]. This was done to determine the compliance of the Code with The Federal Trade Commission Act (FTC Act) and to determine any anticompetitive effect that the rules of the Code might have upon the practice of accountancy in the United States. The FTC is concerned with restrictions that the AICPA places upon its members regarding advertising, solicitation, trade names, referral fees, and most significantly, the receipt of compensation in the form of commissions or contingent fees. To settle these concerns, the FTC staff and the AICPA recently entered into an agreement which will cause the AICPA to make substantive changes in these rules. At the time of this writing, the agreement had been signed by the AICPA and had received preliminary approval from the FTC. The public comment period ended in June 1989, but the FTC had not yet issued its final approval.

This paper presents a historical background to the FTC's current investigation and reviews the events which led to the current agreement. Because the most controversial issues in the agreement relate to an accountant's receipt of commissions and contingent fees, these issues are the focus of this article.

The FTC's action against the AICPA potentially has broad implications for the regulatory environment of the practice of accountancy. Historically, the AICPA has set the de facto standards for the practice of public accountancy, even though the actual licensing function and regulatory powers belong to the states and territories. Until this time, the rules of the individual licensing bodies have substantially been in harmony with those promulgated by the AICPA. Since the most recent conflict between the FTC and the AICPA, there has been a reduction in the consistency of the laws within the licensing bodies. We suggest that this is a result of a shifting of the de facto regulatory authority from the AICPA to the various state and territorial licensing boards which could lead to a lack of uniformity in the regulation of the practice of accountancy.

The article begins with the background events leading up to the consent agreement and the agreement itself. Next, the legal precedents to allow state action in these areas to be exempt from federal antitrust law are explored. Evidence is presented that demonstrates the current uniformity of the states regarding treatment of commissions and contingent fees which may be eroding as a result of the current antitrust attack on the AICPA's Code. Finally, the article concludes by showing that the series of antitrust challenges to the AICPA's Code of Professional Conduct is causing a shift in who is in fact regulating the accounting profession.

BACKGROUND TO THE CONSENT AGREEMENT

The AICPA's Code of Professional Conduct was first adopted in its current form in 1973, though it is the result of a long history of standards and opinions

developed by the Institute and its predecessor organizations [Lowe, 1987]. On several occasions, the rules of conduct governing the accounting profession have been the subject of antitrust challenges for alleged violations of both the Sherman Act and the Federal Trade Commission Act [Bialkin, 1987]. In the mid 1960s, the AICPA was informed by the Antitrust Division of the Department of Justice (DOJ) that the DOJ had concluded that the AICPA rule banning competitive bidding was a conspiracy in restraint of trade and violated the Sherman Act. After the AICPA membership refused to voluntarily abolish the rule, a law suit was filed by the DOJ. In 1972, the AICPA dropped its ban on competitive bidding to settle this suit. In 1977, these rules again came under fire when the government challenged Rule 502 of the Code which provided for a total ban on advertising and solicitation by members. A membership ballot in 1978 amended the rule to permit advertising that was not false, misleading or deceptive while retaining a ban on direct uninvited solicitation. Amended Rule 502 was then challenged by the DOJ because of the continued prohibition of such solicitations. As the result of another membership ballot in early 1979, Rule 502 was further changed to permit solicitation as long as it was not false, misleading or deceptive [Bialkin, 1987].

In 1981, the AICPA professional ethics division began a review of the Code in order to determine areas of concern regarding compliance with antitrust law. This review recommended changes to the rules regarding the acceptance of contingent fees and, modifications to the interpretations of the commission rules to make them less susceptible to an antitrust challenge and to make them more clearly enforceable. The proposals that were developed were presented to a special committee (the Anderson Committee) established in 1983 to make recommendations regarding all professional standards. These proposals were subsequently rejected by the AICPA council [Bialkin, 1987].

In January 1985, the FTC staff began an investigation of the consistency of a number of the AICPA's rules of conduct with the FTC Act. A major portion of the investigation eventually focused upon the AICPA's rules regarding commissions and contingent fees which are contained in rules 503 and 302 of the Code. Rule 503 regarding commissions prohibits members from accepting payments "for the referral of products or services of others to a client" and also prohibits a member from making payments in order to obtain a client. Rule 302 prohibits members from charging contingent fees by stating that "Professional services shall not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is attained, or where the fee is otherwise contingent upon the finding or results of such services." Both of these prohibitions have a long history with a ban on commissions dating back to 1905 and a ban on contingent fees first adopted in 1919 [Lowe, 1987].

The FTC staff took the position that the AICPA's prohibition of commissions and contingent fees was a violation of the FTC Act. The rationale for

this interpretation was expressed in a letter sent from the FTC Director, Bureau of Competition to the National Association of State Boards of Accountancy (NASBA) commenting on the May 1987 Exposure Draft of NASBA's Model Code of Professional Conduct. The Exposure Draft proposed changing from a total ban on all commissions and contingent fees for attest and non-attest services to a prohibition only on the receipt of commissions and contingent fees with respect to clients for whom the accountant also provides attest services. (Attest services are audits, reviews, and compilations of financial statements where it is reasonably expected that a third party will rely on the financial statements. Examples of non-attest services include tax planning and return preparation, management advisory services and financial planning services.) The position expressed by the FTC was that the proposed change was still too restrictive and that NASBA's rules should be amended to allow accountants to accept commissions and contingent fees for non-attest services even if they were providing attest services to the same client.

The Director argued in the letter that the ban on commissions and contingent fees was harmful to consumers because it restrained price competition among accountants. He argued that the restrictions prevent consumers from selecting payment methods under which accountants bear a portion of the risk by having their compensation depend on their performance on the engagement. Allowing an accountant to receive commissions would also provide consumers with the option of one-stop shopping for financial planning services. A client could have the accountant prepare and implement a financial plan rather than have the accountant prepare a plan for a fixed or hourly fee that must be implemented by others, such as stockbrokers.

THE CONSENT AGREEMENT

In mid-1987, the FTC proposed changes to the AICPA's Code in order to resolve their antitrust concerns. The proposed change to the rule regarding commissions suggested that the AICPA require members to disclose receipt of commissions for an initial five-year period after which no disclosure could be required. Also, the FTC suggested that the AICPA no longer prohibit the receipt of commissions. Regarding contingent fees, the proposed changes suggested that the AICPA only prohibit members from taking contingent fee payments for attest engagements. Thus contingent fees could be charged to attest clients for any non-attest services. These proposed changes were rejected by the AICPA's Board of Directors.

Subsequent negotiations between the AICPA and the FTC resulted in a consent agreement whereby the AICPA can retain rules that prohibit its members from taking commissions or contingent fees from any engagement for a client for whom attest services are performed. These fee structures can

be utilized whenever the member provides only non-attest services for a client. The AICPA can, however, require members to disclose that they are receiving commissions for products or services that are recommended to the client.

With regard to commissions and contingent fees, the agreement differs from the FTC's original proposal in two specific ways. First, the agreement provides for a broader ban on contingent fees and commissions than the FTC had originally proposed. Instead of only banning contingent fees for attest services, they can be banned for *all* services provided to a client which also receives attest services. The receipt of commissions from clients who receive attest services can also be banned. Second, it imposes no time limitation on the AICPA's power to require disclosure for the receipt of commissions from clients who do not receive any attest services.

On August 30, 1988, the Institute's Council voted 191 to 5 to approve a recommendation of the Board of Directors to enter into this agreement with the FTC. The FTC then voted four to one to publish the consent agreement for a 60 day public comment period. This comment period began when the agreement was published in the *Federal Register* on April 4, 1989. Even though the public comment period expired on June 5, 1989, at the time of this writing the FTC had not yet adopted the agreement as a final settlement of the issues regarding the rules it covers.

STATE ACTION DOCTRINE

The recent actions of the FTC may not achieve their ultimate objective. Although the FTC has initiated actions that may cause the AICPA to modify the Code, these actions may not result in the FTC's desired changes in fee arrangements for *all* CPAs. This section of the paper presents the background to support these conclusions.

A question exists regarding the impact of the changes contained in the consent agreement in light of an exemption to antitrust law recognized by the Supreme Court. Until the mid-1970s, there was some question regarding whether or not antitrust law was applicable to professional associations such as the AICPA. This uncertainty resulted from a feeling that the professions were different from trade associations and that the rules of professional associations should therefore be exempt from antitrust challenges.

This blanket exemption for the professions was rejected by the United States Supreme Court in its decision in *Goldfarb v. Virginia State Bar* [1975]. In this case, the Court held that a minimum fee schedule published by a county bar association was illegal price fixing in violation of federal antitrust law. In reaching this conclusion, the Court rejected the argument that Congress never intended to include the learned professions within the term "trade or commerce" in Section 1 of the Sherman Act. According to the decision, the

nature of an occupation alone does not provide an exclusion from antitrust regulation. This judicial rejection of a blanket antitrust exemption for the professions has been restated by the Supreme Court in such other decisions as *Bates v. State Bar of Arizona* [1977] and *National Society of Professional Engineers v. United States* [1978]. Thus, there is no real legal question as to the applicability of federal antitrust law to professional rules of conduct issued by a private association, such as the AICPA's Code. As a result, the FTC's attack on the Institute's rules regarding commissions and contingent fees is based on solid legal precedent.

However, in the case of *Parker v. Brown* [1943], the Court held that a state-created program for marketing the 1940 California raisin crop was not subject to an antitrust challenge. This case created an exemption to the Sherman Act that has become known as the state action doctrine. The court noted that in our dual system of government, states are sovereign only as long as Congress has not enacted legislation which supersedes the states' authority. Nothing in the language of the Sherman Act suggests that its purpose is to restrain a state from activities directed by its legislature. The Act was intended to regulate private practices and not to prohibit a state from imposing a legislative restraint as an act of government.

The relationship of this state action doctrine to state regulation of the professions was also addressed by the Supreme Court in its decision in *Goldfarb*. Here, the Court further restricted the scope of the state action exemption by rejecting the bar association's argument that its anticompetitive conduct in adopting minimum fee schedules was outside the scope of the Sherman Act since it was "prompted" by state action. According to the Court, anticompetitive activities must be compelled by direction of the state acting as a sovereign in order to fall within the state action doctrine. In this case, the bar association's activities were not compelled by direction of the state since there was no state statute requiring their activities or referring in any way to fee schedules.

The Court recognized that states have an interest in the practice of professions within their boundaries. As part of a state's power to protect the public, it has broad power to establish standards for licensing and regulating the practice of professions. The *Goldfarb* decision was not intended to diminish the authority of a state to regulate its professions. The holding that the bar association's minimum fee schedule was in violation of the Sherman Act was therefore based on the conclusion that the fee schedule was not mandated by the state legislature.

As a result of this series of Supreme Court decisions, it is clear that the AICPA, a private professional membership association, is subject to the federal antitrust laws. Its rules banning commission and contingent fees are therefore subject to challenge as unreasonably restraining trade in violation of federal antitrust law.

The objective of the FTC in attacking the AICPA's rules is clearly to create a situation in which accountants can receive commissions and perform services on a contingent fee basis. However, since the ultimate rule-making bodies for the practice of accountancy are the state and territorial licensing boards, the existence of the state action doctrine creates a question as to the impact that the agreed changes in the AICPA's rules will have. The real impact of the consent agreement may be a shift from the relative uniformity in these areas, which was initiated by the AICPA's rules, to a state by state determination as to whether accountants should be allowed to accept commissions and contingent fees.

CURRENT STATE RULES

As of October 1989, a NASBA survey of the positions of boards of accountancy of the states and territories regarding commissions and contingent fees (see Table 1) indicates that 50 boards banned commissions while 51 banned contingent fees. Only four had no ban on commissions and only three had no ban on contingent fees. This relative uniformity of regulation is the result of many boards tying their codes of ethics to the AICPA's Code. But while the rule changes contained in the consent agreement will loosen the restrictions on the receipt of commissions and contingent fees by AICPA members, it will cause no direct change in state law or the rules of the various boards. Thus, accountants who accept commissions or contingent fees based on AICPA rules of conduct could be in violation of state law or the rules of their particular board of accountancy [Leopold, 1988].

As Table 1 indicates, only six states currently prohibit commissions and contingent fees by state statute. In these states, the bans are probably immune from any antitrust challenge based on the state action doctrine. This exemption would apply because in these particular states, the bans are the result of direct regulation of the accounting profession by the state legislative body.

In contrast, the vast majority of states that ban commissions and contingent fees currently do not do so by statute but by rules promulgated by their boards of accountancy. This type of ban is more susceptible to an antitrust challenge because it would not likely fall within the parameters of the state action doctrine. Nine of these states are currently considering legislation that would ban commissions and contingent fees. If any of these legislative efforts are successful, the number of states in which the bans would be free from any antitrust challenge would increase. It appears that a trend is developing in which a number of states will adopt legislation prohibiting accountants from accepting commissions and/or contingent fees despite any change in the AICPA's Code.

Table 1. State Boards of Accountantcy Positions on Commissions and Contigent Fees in October 1989

	Ban on Commissions	*Ban on Contingent Fees*	*Legislation Considered or in Progress to Prohibit*
Alabama	Yes	Yes	Yes
Alaska	Yes	Yes	No
Arizona	Yes	Yes	No
Arkansas	Yes	Yes	No
California*	Yes	Yes	—
Colorado	Yes	Yes	No
Connecticut	Yes	Yes	No
Delaware	Yes	Yes	No
Dist. of Col	Yes	Yes	No
Florida*	Yes	Yes	—
Georgia	Yes	Yes	No
Guam	Yes	Yes	No
Hawaii	Yes	Yes	Yes
Idaho	Yes	Yes	No
Illinois	Yes	Yes	No
Indiana	Yes	Yes	No
Iowa*	Yes	Yes	—
Kansas	Yes	Yes	No
Kentucky	Yes	Yes	Yes
Louisiana	Yes	Yes	No
Maine	Yes	Yes	No
Maryland	No	No	No
Massachusetts	Yes	Yes	Yes
Michigan	Yes	Yes	No
Minnesota	Yes	Yes	Yes
Mississippi	Yes	Yes	No
Missouri	Yes	Yes	No
Montana	Yes	Yes	No
Nebraska	Yes	Yes	No
Nevada*	Yes	Yes	—
New Hamphshire	Yes	Yes	No
New Jersey	Yes	Yes	No
New Mexico	Yes	Yes	No
New York	Yes	Yes	Yes
N. Carolina	Yes	Yes	No
N. Dakota	Yes	Yes	No
Ohio	Yes	Yes	No
Oklahoma	No	No	No
Oregon*	Yes	Yes	—
Pennsylvania	Yes	Yes	No
Puerto Rico	Yes	Yes	No
Rhode Island	Yes	Yes	No
S. Carolina	Yes	Yes	No

(*continued*)

Table 1. Continued

	Ban on Commissions	*Ban on Contingent Fees*	*Legislation Considered or in Progress to Prohibit*
S. Dakota	No	No	No
Tennessee	Yes	Yes	Yes
Texas	No	Yes	Not Approved
Utah	Yes	Yes	Yes
Vermont*	Yes	Yes	—
Virginia	Yes	Yes	No
Virgin Islands	Yes	Yes	No
Washington	Yes	Yes	Yes
West Virginia	Yes	Yes	No
Wisconsin	Yes	Yes	No
Wyoming	Yes	Yes	No
Totals	Y-50 N-4	Y-51 N-3	Y-9 N-38

Note: * Prohibition is statutory.

Source: The table is constructed from material available at the 82nd Annual Meeting of the National Association of State Boards of Accountancy, Inc., held Ocober 16-18, 1989.

The modification of the AICPA's rules prohibiting commissions and contingent fees may become a catalyst for increased regulatory diversity at the state level. This result could occur as some states elect to bring their rules in line with the changes expressed in the consent agreement and other states decide to retain more strict prohibitions on accountants accepting commissions and contingent fees. Concern has been expressed that the practice of accountancy will vary from state to state as a CPA in one state will be allowed to accept commissions and a CPA in another state will not. A CPA licensed in both states will theoretically be able to accept commissions in one state but not in the other [Crane, 1989].

CONCLUSION

Assuming the FTC gives final approval to the consent agreement entered with the AICPA, it remains to be seen what ultimate impact the changes regarding commissions and contingent fees will have on regulation of the accounting profession. The potential for change is already creating a shift in the regulatory focus of these issues to the state level as demonstrated by the legislative actions in a number of states. These legislative actions may create a result not intended by the FTC—the continuation of the ban on these payment arrangements in such a manner as to be free from antitrust challenges based on the state action doctrine.

Another possible outcome is that the consent agreement may lead to state by state regulation that will erode the present uniformity indirectly imposed as a result of the current AICPA rules. This could occur as some states enact legislation to take advantage of the state action exemption and other states amend their rules to conform to the revised AICPA rules.

In either case, the FTC's attack on the AICPA's Code of Professional Conduct is causing a shift in the manner in which the profession is being regulated. Rather than uniform compliance to the AICPA Code, the focus is shifting toward a state by state determination as to how accountants may be compensated for their services.

ACKNOWLEDGMENT

We would like to acknowledge the comments of an anonymous reviewer and the editors, and we would like to thank Michele Matherly for her research assistance.

NOTE

1. Over the years, the document describing the rules of conduct and ethics required of members of the AICPA has had several titles. We have referenced the most current version.

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BOOK REVIEWS

The Logic of Tax: Federal Tax Theory and Policy

by Joseph M. Dodge
(West Publishing, 1989, 343 pages; $17.95)

Reviewed by **Michael L. Roberts**

This book is intended as a supplement for traditional tax textbooks for the introductory tax course or, alternatively, as a primer for a tax policy course. The author's premise is that much of the substantial body of tax rules can be understood as flowing from several "logics" of tax policy. Further, the author hypothesizes that students will be able to learn tax rules by reference to the model of tax doctrine that he describes, in lieu of rote memorization or looking up answers in the Code. For tax educators, like myself, who are constantly looking for ways to give our students a theoretical foundation that will explain the myriad of tax rules, these premises are inviting, and this book thus deserves to be considered for adoption.

The author constructs his model of tax around five logics: (1) the definition of income, (2) fairness, (3) accounting, (4) financial concepts, and (5) economics. These logics also serve as the organizing structure for the five chapters following the introduction. This review will examine the author's treatment of each of these logics.

The introductory chapter contains an outline of the individual tax and may be the most helpful chapter for the introductory tax student. The introduction includes a discussion of tax rates, including the implications of marginal, average, effective, progressive, regressive, and flat rates, and the phase out provisions of the 15 percent tax rate for individuals. Other basics are also discussed, including calendar and fiscal tax years, the definition of gross income, deductions for personal versus income producing items, capital expenditures, basis, mixed-use assets, and indexing. There is also a brief explanation of the time value of money and present value concepts.

Research in Accounting Regulation, Volume 4, pages 207-221.
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ISBN: 1-55938-084-5

In Chapter One, titled "The Internal Logic of Tax," the author distinguishes between internal and external logics as follows: external logics are derived chiefly from disciplines, such as accounting, economics, and distributive justice, that have established principles that are not necessarily tax-related. In the author's opinion, the internal logic of tax is associated with the principle that the same dollars should not be taxed to, nor deducted by, the same taxpayer twice. After a very brief introduction to this principle, the remainder of Chapter One deals with the concept of basis and its various applications.

I found the placement of this material and the detail of applications in this chapter to be somewhat awkward given the purposes of this book. I would expect that a book addressing the logic(s) underlying the federal income tax would begin by exploring the choice of income as a tax base or the historical development of the federal income tax. This is especially true because the book is intended to supplement existing introductory tax texts, which uniformly are organized by discussions of income followed by discussions of deductions. Indeed, the author acknowledges in the Preface that his use of the five logics made organization of the book difficult. He explains that because there is no master logic, and because each chapter is self-contained, the reader can start anywhere. In fact, I like his suggestion that the beginning material in each chapter be read first as an overview, and then the more detailed discussions within each chapter be assigned on a topical basis. Potential adopters should be advised, however, that this will necessarily result in a good deal of "jumping around" when making assignments. This is not a book that ordinarily will be assigned in a chronological fashion. To the contrary, its potential as a text supplement will be better served if it is treated more like a reference book. Fortunately, there are several reference tables—cases, code sections, regulations, and rulings—included in the front of the book.

Chapter Two discusses the fairness logic. The author defines fairness solely in terms of the tax base and eschews any consideration of tax rates or distributive justice. Brief discussions of sacrifice theory, benefit theory, and ability to pay are included. The remainder of the chapter presents certain applications of the fairness logic, for example, the treatment of gifts, bequests, death benefits, recoveries for personal injuries, various personal deductions, and the deferral of certain types of income based on ability to pay.

Chapter Three focuses on the logic of accounting, including capitalization, realization, depreciation, inventories, debt, and cash versus accrual accounting. This chapter is the shortest in the book, and the bulk of it centers on the latter two topics. In contrast, the discussion of accounting concepts is limited to definitions and explanations. The discussion of depreciation, for example, ignores the policy aspects of accelerated depreciation.

Chapter Four, on the financial logic of tax, continues the discussion of several topics previously addressed, including the time value of money, capitalization, and the realization principle. Applications related to income

measurement for debt obligations, carve out provisions (related to items such as leases, production payments, and advance rentals), and issues of substance versus form (sale versus lease, debt versus equity) make up the remainder of the chapter.

Chapter Five explores the logic of economics. Attention is given to the principle of neutrality, the concept and illustration of tax expenditures, and the implications of utility theory for progressive tax rates. Applications include employee fringe benefits, owner-occupied housing, taxing unrealized appreciation, and the distinction between human and investment capital.

The author has done an admirable job of pulling together many specific tax rules under the umbrellas of his various tax logics. The overviews in each chapter provide introductions to the policies underlying significant amounts of the Code. The strength of the book, however, may be the treatment of a significant number of tax applications, that is, the organization of particular topics within the various logics. The sheer number and detail of these applications make the book somewhat overwhelming to read through sequentially; however, this detail increases the worth of the book as a reference source for supplementing existing tax textbooks. The reference tables add to the flexibility of the book by enabling the reader to understand how particular Code sections have been influenced by a given logic.

International Accounting and Auditing Trends

by Vinod B. Bavishi

(Center for International Financial Analysis and Research, Inc., 601 Ewing Street, Princeton, NJ 08540; 1989; 2 Volumes, 1, 332 pages; $2.95)

Reviewed by **Walter J. Kennamer**

Some books cry out for description in physical terms. This intimidating two-volume set of statistics on the international practice of accounting weighs in at six pounds, takes up roughly 3.5 inches of shelf space and contains about 2,000 pages. Clearly there is more to know about this subject than one might expect.

The result of a four-year project, *International Accounting and Auditing Trends* (IAAT) was published early in 1989 by the Center for International Financial Analysis and Research (CIFAR), an independent research group supported by universities, multinational corporations, financial organizations, and the international accounting firms.

ORGANIZATION AND COVERAGE

IAAT is a diverse collection of research findings on international accounting and auditing issues. It is divided approximately equally between accounting

and auditing issues. The accounting section is largely devoted to cataloging differences in accounting standards and financial reporting among countries. The auditing section focuses on the international organization of the 16 largest accounting firms. It is difficult to summarize a work of this scope in a sentence or two; therefore I have extracted the major headings from the table of contents to provide a general overview of the book.

The accounting section covers these topics:

Research Design
Accounting Standards for Industrial Companies
Financial Reporting Practices for Industrial Companies
Financial Statements for Banks and Insurance Companies
Interim Financial Statements
Analyzing International Financial Statements

The auditing section discusses:

Research Design
The Organization Network of Sixteen International Accounting Firms
Clients Audited by Leading Accounting Firms
Audit Fees
Comparison of Auditors' Reports in 24 Countries
Competitive Analysis Among International Accounting Firms

Each of these major chapters is organized as follows:

Introduction
Research Objectives
Research Design
Findings
Summary and Conclusions

The entire work is organized this way, and this consistency makes it much easier to use. In spite of its bulk, *IAAT* is easy to navigate and its extensive tables are easy to locate and well-presented. As you would expect in a statistical compendium, most of the information in *IAAT* is presented in tables and there is relatively little narrative interpretation of the findings.

The tables in *IAAT* focus on 24 countries, including the United States, Canada, the industrialized countries in western Europe, and South Africa. The Pacific Rim is represented by Japan, Australia, South Korea, Hong Kong, and Malaysia and Singapore.

Different databases are used for different analyses in IAAT. The schedules for industrial companies are prepared from a database of 2,778 companies in a variety of industries. The banking analyses are based on 294 large banks, and the insurance analyses are derived from a database of 155 companies. The client database includes about 16,600 entries.

ACCOUNTING

The focus of the accounting section is on comparative international accounting and financial reporting practices, though *IAAT* also includes some information on comparative accounting standards.

Due to its wide range, *IAAT* is a difficult book to summarize in general terms. Perhaps the best way to convey the flavor of the book is to sample a few of the tables and show the range of information they contain.
Some samples:

- Japan and South Korea are the only countries in the sample where accelerated depreciation predominates. The other countries use straight-line, except for West Germany, where mixed depreciation methods are common.
- The financial reporting chapter includes a comparative analysis of audit reports. I found it interesting that 4 percent of United States audit reports are qualified, while 48 percent of Australian and 35 percent of Canadian reports are qualified.
- About half of U.K. companies use a December 31 fiscal year end, compared to 66 percent in the United States. Only 9 percent of New Zealand companies have a December 31 year end.

The chapter on accounting standards analyzes 36 accounting issues by country. These issues include such items as financial statement cost basis, consolidation practices, intercompany accounts, accounting for treasury stock, earnings per share, inventory valuation methods, and so forth.

The financial reporting analyses are organized similarly to the accounting standards section, though they are somewhat more extensive, covering 78 topics. Examples include such items as the language of the financial statements, presentation of inflation-adjusted data, and disclosure of research and development costs. Bank and insurance company reporting is summarized in a similar way.

The interim reporting chapter highlights major differences from one country to another. As a general rule, the United States, Canada and Japan provide the most interim information and Commonwealth countries the least.

The chapter on analyzing international financial statements is aimed at people who use financial statements from several countries. It briefly summarizes the major areas of inconsistency in international financial reporting and indicates which differences have the greatest impact on earnings.

In addition, the accounting portion of *IAAT* contains three appendices with guides for preparing financial statements and annual reports for industrial

companies, banks and insurance companies in each of the countries covered by the report. Another appendix contains an accounting lexicon in eight languages.

AUDITING

The auditing section of *IAAT* focuses principally on the business of the profession and does not include much material on auditing standards or theory. Most tables are organized around the 16 largest international accounting firms at the time of publication. Unfortunately, this four-year project was completed within a few weeks of the wave of accounting firm mergers earlier this year. The tables thus do not reflect the mergers of Ernst & Whinney and Arthur Young or of Deloitte Haskins and Sells and Touche Ross, which limits their usefulness. However, CIFAR has promised an update in late 1990.

A sampling of the information presented in this section:

- By country, the percentage of the 2,778 sample companies audited by the 16 largest international firms ranged from 56 percent in Switzerland to 100 percent in the United States.
- The five cities with the most partners from the top 16 firms are New York (1448), London (1434), Chicago (839), Toronto (757) and Los Angeles (521). Paris, Sydney, Montreal, Tokyo, and Washington round out the top ten. The one to watch is Tokyo, where the number of partners more than doubled between 1982 and 1988.
- Audit reports in most countries are addressed to shareholders or to the board of directors. In France and Belgium, they are addressed to "ladies and gentlemen."
- Audit reports for large companies on average are dated about 40 days past the year-end date in the United States and Spain, and about 100 days past year end in France and Italy.

The analysis of the organizational structures of the large firms centers around statistics on the number of offices and the number of partners by country, and seems to have been derived mainly from the firms' directories. It also includes information on the name under which the firms practice in each country. One table summarizes the network of correspondent firms that have affiliations with several of the 166 largest firms.

The main database for the client analysis chapter contains information on about 16,600 clients of the 16 largest firms. Analyses include market share by firm, by client type (e.g., consumer goods, capital goods, utility/transportation,

financial), and by geographical area. Additional tables break the statistics down by industrial and developing countries and by client size. One particularly interesting set of tables in this chapter shows the percentage of sales or assets that each firms' clients contributed to the country total. So, for example, you can explore not only which firms audit the most clients, but which firms audit the most large ones. An update reflecting the recent mergers would be especially welcome in this chapter.

The chapter on audit fees is intriguing, but is limited since only nine countries disclose fee information. Interestingly, for those countries reporting such data. fees as a percentage of sales or assets have been decreasing since 1982.

The comparison of audit reports is based on a sample of 3,892 reports and includes such information as who the report was addresssed to, where it was located in the annual report, which financial statements it referred to, and its timeliness in relation to the company's year end. In my view, the most interesting part of this chapter was the analysis of the most frequent reasons for issuing a qualified report in each of the countries studied.

The section on competitive analysis of large firms contains a questionnaire for public accounting firms to use in their own internal competitive analyses, but does not include any competitive assessments itself.

In addition, there are four audit-related appendices:(1) a listing of accounting partners by city in each of the sixteen largest firms; (2) a global list of clients by firms; (3) a list of audit fees by country; and (4) summary profiles of each of the largest firms.

SUMMARY

IAAT would be a useful reference for international financial analysts, researchers in comparative financial reporting, managers responsible for reporting financial results in other countries, and for anyone studying the public accounting profession.

Values in The Marketplace: The American Stock Market Under Federal Securities Law

by James Burk
(New York: de Gruyter, 1988; $34.95)

Reviewed by **Jimmy W. Martin**

The primary purpose of James Burk's *Values in the Market Place* is to show the effects of federal securities regulation on the moral or normative order of the stock market and the subsequent institutional development of the stock market in the United States. The first half of the book focuses on the impact

that securities regulation had on reconstructing the market's regulation efforts. The author concludes his study by drawing important inferences as to why market regulation may yield unintended results, and when, or under what conditions, market regulation could lead to a weakening of social control. Finally, he states his conclusions on the prospects for market regulation in a democratic society.

The introduction of the book defines the period of focus as a 40-year period that approximately encompasses the years from 1930 to 1970. Thus, researchers must look elsewhere if they are researching issues or phenomena that have arisen in the last two decades. For example, current questions of interest, such as the desirability of program trading and whether the SEC should possess the power to close the stock markets, are not considered in this text. While this does not detract from the merits of Burk's work, it does point out the need for an expanded second edition which would address the current issues affecting the stock market.

The author begins his discussion by delving into sociological theories of markets, including his own views. A central topic of his book, the moral order concept, is defined as follows: the condition of action that specify how individuals ought to trade and who is allowed to trade. Much of the book focuses on these rules before and after the securities legislation in the 1930s.

The primary theme of the book is to analyze how federal regulations changed the moral order of the stock market and altered its future course of development. Despite a huge impact on the stock market, Burk denies that federal regulation has been effective at strengthening market control.

Chapter Two examines key events and personalities that led to the passage of the Securities Acts. Burk cites the market failures that occurred in the late 1920s and early 1930s, but discards the popularly-held view that market failures led directly to the passage of the Securities Acts. Instead, he argues that the initial impetus for congressional investigations was based on political motives of President Herbert Hoover. President Hoover alledgedly was convinced that stock speculators sympathetic to the Democratic Party were trying to drive down stock prices in an effort to prevent his re-election. The subsequent investigation created a public perception that markets had failed in ways that required a public response.

Congress responded by passing the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Glass-Steagall Act. The author summarizes the highlights of the Acts as follows: required that businessses and investment bankers disclose information about the conditions of firms whose securities were sold to the public; prohibited commercial bankers and security dealers from associating with one another to distribute new securities issues; barred stock traders from using techniques, such as matched order that aided in manipulating stock prices; and finally, created the Securities and Exchange Commission to ensure the enforcement of these new policies.

Chapter 3 seeks to describe the effects which the federal legislation had on the stock market. Before 1933, a materialist theory primarily was used to justify the price of a given stock. Knowledge about property values (value of a firm's net assets) was at the core of this pricing theory. The greater the value of the assets behind a stock, the more stable the stock and the less volatile would be the change in the stock's price. Of course, anyone knowing the true value of a firm's assets was in a position of advantage. If values were great, the trader knew that the stock represented a sound investment. If values were small, one knew the price movement would be volatile and subject to manipulation. Here, the trader might borrow to sell short in hopes of driving the price down. However, for this to work, all traders could not have equal knowledge. Without adequeate disclosures by companies about their financial condition, uncertainties would abound, and the trader with superior knowledge could turn a profit.

The author states that the passage of the federal securities laws in 1933 and 1934 undermined the materialist approach by banning manipulative stock trading and by requiring publicly-held companies to disclose information about their assets and liabilities. Moreover, securities regulation caused a reorganization of trading based on pragmatic beliefs that stock prices are determined by the present value of a firms's future earnings. The test provides an interesting overview of the evolution of pragmatists views in the 1930s, ranging from the ideas of Charles Dow to those of John B. Williams.

One must question part of the author's arguments. While federal legislation no doubt curbed several abusive, manipulative trading practices they were not completely eliminated. Even today, manipulative practices such as free riding, parking, and churning of security prices exist even though they are all prohibited by security laws. Since manipulative trading practices remained, one wonders about the accuracy of his statement that "Federal securities laws . . . by prohibiting manipulative trading practices . . . made it impossible to continue acting on materialist beliefs."

Whereas Chapter 3 focuses on the change in investment decision norms, Chapter 4 deals with the question of who should have access to the stock market. The author states that the Securities Acts caused individual investors to be replaced, in part, by institutional investors.

State laws had largely prohibited trustees of personal or corporate funds from making investments in the stock market. This prohibition resulted from the general attitude that such investments were unsafe and amounted to little more than speculation with someone else's money. The security laws increased the belief that speculative activities would be controlled and the perception grew that investments in equity securities could be a relatively safe investment alternative. In addition, financial institutions, seeking higher yields, lobbied for more flexible investment alternatives. The two forces together gave rise to a new institutional investor.

Burk traces the origins of the attitude decrying trustee stock investments back to our English heritage and particularly the South Sea Bubble in 1720. He describes the state legislative efforts in the United States to prevent trustees from investing in equity securities and concludes that these efforts were very effective.

The attitude toward stock investments changed partly because their main alternative, bonds, becames less safe as some companies defaulted on their bonds during the 1930s. Also, as trust funds grew, acceptable investment alternatives became harder to find. This shortage of investment opportunities placed upward pressure on the prices of those securities that were permitted, thereby reducing investment yields. Thus, institutional financial leaders lobbied for an expansion of investment alternatives in hopes of earning higher yields.

The author does not attribute the growth of institutional investing in the stock market solely to federal security legislation. However, he does conclude that, without the securities laws, it would have been impossible for trustees of institutional funds to lose their fear of the hazards of investing in equity securities. Thus, it would have been unlikely that state politicians could have loosened restrictions on institutional investments which had prevailed for over 200 years.

Chapter 5 focuses on the impact of institutional trading on the stock market. As large institutions with their huge resources entered the trading scene, competitive conditions in the markets changed. Small individual transactions were replaced by large block transactions of the institutions. The ability of brokers and exchanges to procure these large transactions would determine their revenues, prestige and power. The environment became intensely competitive, and traditional market rules broke down, leading to discord among broker-dealers and exchanges.

Prior to the 1930s, stock transactions had been divided among brokers, investors, and exchanges on the basis of three guiding principles: (1) to maintian a market based on mediated exchange (buyers and sellers would meet only through brokers); (2) to restrict off-board trading (exchange-listed stocks could not be traded over the counter); and (3) to eliminate direct price competition among brokers by charging fixed commission rates.

According to the first rule, institutional investors could not join exchanges or bypass brokers and their commissions, thus protecting the revenue of the brokers. The second rule created a monpoly for the New York Stock Exchange in the trading of securities listed on that exchange. The third rule prevented any price competition among brokers who were members of the same exchange. All of these rules lessened competition in one form or another.

The author relates how these principles were challenged in the 1960s with the growth of institutional investing and their huge volume of trades. This increased the chance for large profits by broker-dealers who could charge fixed commission rates. To beat the competition and obtain the large trades, brokers

would cut their commission rates. The other rules began to unravel as brokers fought each other for the lucrative institutional business.

Another problem was the lack of physical capacity of some broker-dealers to handle the huge volume of trades. This incapacity resulted in an increase in unsettled trades, placing financial strains on firms with weak capital positions.

Burk asserts that the SEC failed to provide adquate leadership during the 1960s. He attributes this largely to the fact that the Commission had been weakened during the 1950s by inadequate funding and had relied too much on the exchanges to police themselves. The SEC saw that the old market structure was breaking down and urged exchange leaders to act, but the Commission was in a weakened position and could not or would not force changes on the industry. As a result, during 1969-1970, over 100 brokerage firms failed and Congress was forced to step into the leadership breach. In effect, Congress provided a bailout. With the passage of the Securities Investor Protection Act, $1 billion of federal money was pledged to protect customers of failed brokerage firms from losing money.

Chapter 6 focuses on the goals of Congress in reforming the market structure and the limitations of regulatory reform. Congress was convinced that the market's anticompetitive practices and the failure of the markets to adjust to a changing competitive environment had brought on the above problems. The Securities Reform Act of 1975 was aimed at eliminating these anticompetitive principles and to promote a more flexible, self-adjusting market structure.

The SEC was charged with the responsibility of eliminating all competitive restraints contained in market exchange rules or its own rules, unless those rules were plainly justified by the purposes of the Reform Act. This meant eliminating off-board trading restrictions, among other things, and steering towards a national market system. To accomplish these goals, the Reform Act increased the regulatory power of the SEC. While the Securities and Exchange Act of 1934 gave the SEC the power to review rules of stock exchanges, the SEC's power to initiate changes or to abort exchange rules was in question. The Reform Act gave the SEC explicit power to approve all exchange rules before they went into effect. Further, the SEC was given the power to amend or revoke any exchange rules. According to Burk, Congress wanted to embolden the Commission to act forcefully to eliminate anticompetitive barriers.

How well did the SEC respond to this challenge? The author critiques the agency's effort and, at best, gives it a mediocre grade. The SEC's successes were summarized as follows: eliminated fixed commission rates which reduced transaction costs; pressured market exchanges to automate the processing of transactions; encouraged the NYSE in the development of an "intermarket trading system" designed to link the trading floors of various exchanges in order that brokers could direct their trades to the market offering the best price.

The SEC's chief failure was in the area of off-board trading restrictions. The SEC eliminated off-board restrictions that had prevented exchange members from trading in the third market as brokers (trading as agents for their customers). However, restictions prohibiting exchange members from trading as dealers (trading for their own accounts) were not removed. Since the largest broker-dealers are members of the NYSE and American Stock Exchange, preventing them from trading for themselves was a significant failure. In effect, this protected the major exchanges from competition from third markets.

Why did the SEC fail to eliminate this critical anticompetitive barrier? Burk provides three primary reasons. First, the NYSE argued that to allow exchange members to trade in third markets as dealers would transform the stock market from an agency, auction market mediated by brokers into a dealer market, something the Reform Act had urged the SEC to avoid. A second argument was that allowing dealer trading in third markets would fragment trading, reducing market liquidity and reducing the efficiency of the capital markets. The author denies the validity of these arguments and charges the NYSE with obfuscating the real issue with these technical arguments.

Yet, Burk does not conclude that the SEC is the pawn of industry leaders. In his third argument, he implies that, had the composition of the Commissioners of the early 1970s remained intact, they would have successfully achieved the goal of eliminating all vestiges of anticompetitive practices. However, two new commissioners were appointed who did not share the views of their predecessors. For example, the new chairmain, Harold Williams, was afraid of disrupting the nation's capital markets by precipitous actions.

While admitting that the stock markets in the 1980s have functioned fairly efficiently, the author concludes Chapter 6 by asking whether our system of regulatory control is effective. Burk asks, "Can we by regulation create an authority structure in which leaders might take initiative to limit the pursuit of self-interest, to modify their market rules, and to adjust the operation of their particular organizations to serve the minimal collective interest of institutional survival?"

In Chapter 7, the author summarizes his primary findings about the effects of federal legislation on the stock market. He concludes that since this legislation was largely a response to pressing political issues at the time, the long-term effects were neither foreseen nor intended. He believes that federal regulation of securities has been ineffective because it has not effectively linked the pursuit of private interests to a public goal. Linking the two "requires a regulatory structure which supplies inducement to market leaders to act on behalf of the market as a whole rather than as committed representatives of partial market interests." In addition, he describes the need for a consensus among market participants about what goals they want the market to achieve. Of course, this is unlikely in a fragmented market where leadership is divided among national and regional exchanges as well as the over-the-counter market.

Burk concludes his work by examining the prospects for market regulation in a democratic society. He concludes that conflicts of interest among leaders of a fragmented market, along with a weak SEC, are structural products of political compromise embedded in the federal securities laws and are unlikely to be altered in the future. He sees the challenge facing market regulators as being able to devise a governance structure that promotes rapid adaptation of market rules to the new circumstances of competition in an international market. Burk believes that, in a democratic society where people are free to choose their own objective, the moral order of the institutions they create is always changing and the consequences for institutional development are difficult to predict. In this dynamic environment, any attempt at market regulation is likely to be far from perfect. The goal is to minimize the degree of imperfection.

As stated earlier, the main goal of this book is to show how federal securities regulation has affected the development of the stock market. Burk successfully accomplishes this misssion and in a manner that captures and retains the attention of the reader. Anyone interested in the SEC will find the book enjoyable. Burk provides plausible arguments to support his theories, and they are presented in a well-organized, insightful fashion. His style of introducing a new topic by posing critical questions arouses one's curiosity and assists the reader in following his presentation.

As mentioned earlier, the book primarily analyzes events occuring between 1930 and 1970. Thus, recent regulatory issues are not adequately considered. Another disappointment is that the author never sets forth a concrete plan for dealing with the problems that he uncovers. The book provides excellent, thought-provoking insights that lie behind the problems and their causes, but it would have been an even more valuable contribution to the literature on market regulation if specific, practical solutions were offered. For example, what can be done to stengthen the SEC? Specifically, how can we structure a more viable, self-adjusting market system?

Despite these drawbacks, the book is a valuable contribution in that it clarifies many regulatory issues affecting the stock markets during this century. Lessons can be learned from our past mistakes, and the book should be studied by anyone with an interest in market regulatory problems.

The Wall Street Journal on Accouunting

by Lee Berton and Jonathan B. Schiff

(Homewood, IL: Dow Jones-Irwin, 1990; 471 pages; $39.95)

Reviewed by **Thomas R. Robinson**

This book is a collection of selected articles concerning accounting which appeared in *The Wall Street Journal* in the past five years. Virtually all of the articles included were written by Lee Berton. The book's overleaf states that:

> This quick reference will help you decipher annual reports and find out what is really happening to your investments. Plus, you'll learn how the professionals who set the standards in accounting and auditing are issuing rules that could affect your pension, medical costs, financial instruments, and taxes.

In reality, the book does a poor job of the former but a fairly decent job of the latter. Overall, the book provides an excellent discussion of the key issues involving financial acounting and CPAs in recent years. Accountants and nonaccountants would both benefit from this overview of issues, however, the nonaccountant should not expect the book to be an accounting primer. Very little benefit, if any, could be gleaned from the book in terms of analyzing financial statements. I recommend reading the book in the not too distant future because its nature guarantees that it will quickly become dated. In fact, as noted in the following discussion some portions are already dated.

The book consists of 20 chapters classified into five parts, as follows:

Part 1. The New World of Accounting
Part 2. The Impact of the Financial Accounting Standards Board
Part 3. Taxes and Government Accounting
Part 4. Industry-Specific Reporting
Part 5. Humor in Accounting

This review addresses each part separately.

The book gets off to a disappointing start with the first chapter of Part 1. This chapter purports to name the "key players" in accounting today; however, the articles simply make note of some recent changes in leadership at the FASB, the SEC, and several national accounting firms. Articles describing the structure of the FASB and the SEC and identifying the major national accounting firms would have been much more appropriate here. Even though the book was published in 1990, this chapter is already dated in that it comes on the heels of several major accounting firm mergers. Information on these mergers apparently did not become available by press time, and some of the firms listed as being "key players" no longer exist in the form listed by the book. The balance of Part 1, which covers about 40 percent of the book, discusses the regulation of the accounting profession and recent occurrences of financial fraud (Chapters 2,3,6, and 7). These chapters should be required reading for nonaccountants and new graduates entering the profession. Chapter 4, The Marketing of Accounting Firms' Services, addresses changes in the contingent fee area, but not in advertising, and therefore appears inappropriately titled. Chapter 5 provides a good discussion of the increased role of consulting at CPA firms and the potential conflict of interest when such services are provided.

Part 2 is the most interesting section, particularly for nonaccountants or accountants not practicing in the financial accounting area. This section devotes a chapter apiece to the major financial accounting issues of our time: Accounting for Income Taxes, Accounting for Post-Employment Benefits other than Pensions, Pension Accounting, Statement of Cash Flows, and Early Extinguishment of Long-Term Debt. The articles selected for these chapters' provide an excellent summary of the chronological events leading up to recent pronouncements, including pressures placed on the FASB by business and governmental agencies. Although articles discuss both the pros and cons of these rulings, for the most part they tend to lean toward criticism of the FASB.

Part 3 discusses tax and governmental issues. The treatment of governmental issues is brief but very informative for those not practicing in the area. The tax area addresses only a few of the recent major tax changes and could have been expanded. In particular *The Wall Street Journal* coverage of the Tax Reform Act of 1986 was extensive and should have been included here.

Part 4 addresses accounting issues in three particular industries: Financial Services, Oil and Gas, and Utilities. Like Part 2, this section does an excellent job of highlighting and discussing key issues in these industries.

Part 5, titled "Humor in Accounting," is the briefest. This is fortunate in that most of the articles laugh "at" rather than "with" the accountants. Some are humorous, however, and provide an appropriate ending to the book.

In putting these articles together, it seems that some were classified in the wrong chapters or that some chapters were not appropriately titled. Overall, however, the authors performed well at bringing together articles of a common topic into a single source. The articles make for fairly light reading for both accountants and nonaccountants.

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Volume 1, 1987, 235 pp. $63.50
ISBN 0-89232-849-5

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Volume 2, 1988, 245 pp. $63.50
ISBN: 0-89232-941-6

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Volume 3, 1989, 248 pp. $63.50
ISBN 0-89232-998-X

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ISBN: 1-55938-084-5