RESEARCH IN ACCOUNTING REGULATION

Editor: GARY JOHN PREVITS
Associate Editors: LARRY M. PARKER
ROBERT ESKEW

Volume 7 • 1993

P
Gary Previts
3420 Bradfords Gate
Rocky River, OH 44116

RESEARCH IN ACCOUNTING REGULATION

Volume 7 • 1993

RESEARCH IN ACCOUNTING REGULATION

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

ROBERT ESKEW
Krannert School of Management
Purdue University

VOLUME 7 • 1993

JAI PRESS INC.

Greenwich, Connecticut *London, England*

Copyright © 1993 JAI PRESS INC.
55 Old Post Road, No. 2
Greenwich, Connecticut 06836

JAI PRESS LTD.
The Courtyard
28 High Street
Hampton Hill,
Middlesex TW12 1PD
England

All rights reserved. No part of this publication may be reproduced, stored on a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, filming, recording or otherwise without prior permission in writing from the publisher.

ISBN: 1-55938-692-4

Manufactured in the United States of America

CONTENTS

LIST OF CONTRIBUTORS ix

EDITORIAL BOARD xi

INVITED REFEREES FOR VOLUME 7 xiii

THE NEW AGENTS OF MANAGERIAL CAPITALISM
Larry M. Parker and Gary John Previts xv

MAIN PAPERS

A CRITICAL ASSESSMENT OF THE LITERATURE ON POLITICAL ACTIVITY AND ACCOUNTING REGULATION
Robert G. Walker and Peter Robinson 3

LOCAL GOVERNMENT AUDIT QUALITY AND THE ANALYST REACTION TO BOND RATING CHANGES
Arthur C. Allen 41

THE STANDARD OF CARE FOR INDEPENDENT PUBLIC ACCOUNTANTS: INSIGHTS FOR SELF-REGULATION AND STANDARD SETTING
Ramona L. Paetzold and H. Fenwick Huss 61

AN ANALYSIS OF STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES NO. 1
Albert D. Spalding 81

THE DISTRIBUTION OF MANAGEMENT ADVISORY SERVICES: THE CASE OF ACTUARIAL SERVICES
Noel Addy, Alan Friedberg, and Alan Mayper 95

RESEARCH REPORTS

EXTENDED ADOPTION WINDOWS BY THE FINANCIAL ACCOUNTING STANDARDS BOARD: THE CASE OF *SFAS 87*
John A. Brozovsky, Dennis Murray, and Frank H. Selto 119

ACCOUNTANT LIABILITY: A PERSPECTIVE ON SECTION 10(b)(5) AIDING AND ABETTING
Mark A. Segal 137

SOME FACTORS RELATED TO THE FAILURE OF SAVINGS AND LOANS
James H. Thompson 151

PERSPECTIVES

THE ACCOUNTING PROFESSION AND FINANCIAL REPORTING: WHY SHOULD ANYONE BELIEVE US?
David P. Tweedie 161

A CALL FOR CHANGE: COMMENTS BY A. MARVIN STRAIT, 1992 AICPA GOLD MEDAL RECIPIENT, AT THE 1992 ANNUAL MEETING OF THE AICPA
A. Marvin Strait 183

ACCOUNTANCY AND CAPITAL MARKET REGULATIONS IN TURKEY
Yüksel Koc Yalkin 187

STATEMENT ON SENATE BILL 165 ON THE 150-SEMESTER-HOUR REQUIREMENT FOR PRACTICE AS A CERTIFIED PUBLIC ACCOUNTANT BEFORE THE SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE OF THE STATE OF OHIO, NOVEMBER 13, 1991
Robert K. Elliott 199

BOOK REVIEWS

UNACCOUNTABLE CONGRESS: IT DOESN'T ADD UP
By Joseph J. DioGuardi
Reviewed by Alfred R. Michenzi 211

BUSINESS BEHAVIOR AND INFORMATION
By Yuji Ijiri and Isao Nakano
Reviewed by Nandini Chandar 212

CHANGING FORTUNES
By Paul Volcker and Toyoo Gyohten
Reviewed by Barbara Uliss 215

PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION. SEC STAFF REPORT 1504
Reviewed by Gary John Previts 218

POWERSHIFT
By Alvin Toffler
Reviewed by Stephen J. Young 220

LIST OF CONTRIBUTORS

Noel Addy School of Accountancy
Mississippi State University

Arthur C. Allen School of Accountancy
University of Nebraska-Lincoln

John A. Brozovsky Department of Accounting
Virginia Polytechnic Institute and State University

Nandini Chandar Department of Accountancy
Case Western Reserve University

Robert K. Elliott Partner, KPMG Peat Marwick
New York, New York

Alan Friedberg School of Accounting
Florida Atlantic University

H. Fenwick Huss School of Accountancy
Georgia State University

Alan Mayper Department of Accounting
University of North Texas

Alfred R. Michenzi Department of Accounting
Loyolla College in Maryland

Dennis Murray Accounting Department
University of Colorado at Denver

Ramona L. Paetzold Department of Management
Texas A&M University

Larry M. Parker Department of Accountancy
Case Western Reserve University

Gary John Previts Department of Accountancy
Case Western Reserve University

Peter Robinson	Department of Accounting and Finance University of Western Australia
Mark A. Segal	Department of Accounting University of South Alabama
Frank H. Selto	Accounting Faculty University of Colorado at Boulder
Albert D. Spalding	Department of Accounting Wayne State University
A. Marvin Strait	Partner and Chairman Strait, Kushinsky and Company Colorado Springs, Colorado
James H. Thompson	Meinders School of Business Oklahoma City University
David P. Tweedie	Chairman United Kingdom Accounting Standards Board London, England
Barbara Uliss	School of Accounting Florida International University
Robert G. Walker	School of Accountancy University of New South Wales
Yüksel Koc Yalkin	Department of Accounting and Finance University of Ankara, Turkey Head, Commission of Accounting Standards, Turkey
Stephen J. Young	Department of Finance Case Western Reserve University

EDITOR-IN-CHIEF

Gary John Previts
Weatherhead School of Management
Department of Accountancy
Case Western Reserve University

ASSOCIATE EDITORS

Larry M. Parker
Case Western Reserve University

Robert Eskew
Purdue University

EDITORIAL BOARD

Jerry L. Arnold
University of Southern California

Michael Barrett
Attorney at Law, Washington, D.C.

George Benston
Emory University

Victor Bernard
University of Michigan

James Don Edwards
University of Georgia

Eugene Flegm
General Motors Corporation

Robert Ingram
University of Alabama

Rifaat Ahmed Abdel Karim
Financial Accounting Organization for Islamic Banks and Financial Institutions

Michael Chris Knapp
University of Oklahoma

David L. Landsittel
Arthur Andersen & Co., S.C.

Harold Q. Langenderfer
University of North Caralina

Harry T. Magill
Arizona State University

Barbara D. Merino
University of North Texas

Paul B.W. Miller
University of Colorado
at Colorado Springs

Robert W. (Rob) Parry, Jr.
Indiana University

Robert Sack
University of Virginia—
Graduate School

E. Kent St. Pierre
James Madison University

Ray Stephens
Kent State University

Jerry Sullivan
Executive Director
Public Oversight Board

Michael J. Tucker
George Mason University

Wanda Wallace
College of William and Mary

O. Ray Whittington
San Diego State University

Arthur Wyatt
Arthur Andersen & Co., S.C.

Yüksel Koc Yalkin
University of Ankara
Head, Commission of Accounting
Standards, Turkey

Research in Accounting Regulation, Volume 7

INVITED REFEREES

Jacob Birnberg
University of Pittsburg

Robert Bricker
Case Western Reserve University

Richard Dieter
Arthur Andersen & Co., S.C.

Philip Drake
Southern Methodist University

Michael Dugan
University of Alabama

Timothy Fogarty
Case Western Reserve University

William Hall
Arthur Andersen & Co., S.C.
Retired

Harvey Hendrickson
Florida International University

William Hillison
Florida State University

David Jaeger
Case Western Reserve University

Don Neebes
Ernst & Young

Terrence O'Keefe
University of Oregon

Paul Pacter
University of Connecticut

R.H. Parker
University of Exeter

David Pearson
Ernst & Young

Lawrence Ponemon
Babson College

Thomas Robinson
University of Miami

Robert Rouse
College of Charleston

John Sennetti
Florida Internaitonal
University

Gerald Searfoss
Deloitte & Touche

Henry Stabler
Georgia State University

Mary Stone
University of Alabama

Stephen Tomczyk
Suffolk University

David P. Tweedie
Chairman, United Kingdom
Accounting Standards Board

Arthur Wilson
Case Western Reserve
University

Alan J. Winter
American Institute of
Certified Public Accountants

Peter Woodlock
Case Western Reserve
University

Joni Young
University of New Mexico

Linda Zucca
Kent State University

THE NEW AGENTS OF MANAGERIAL CAPITALISM

Larry M. Parker and Gary John Previts

In modern times privately owned businesses are generally operated by hierarchies of managers who have little or no ownership in the businesses—managerial capatalism (Chandler and Tedlow 1985, 396; Chandler 1990, 621). These managers act as agents for the owners in operating the business, in contrast to the owner management of enterprises which was common until the twentieth century. The managers of major enterprises have been described as "the visible hand" (Chandler 1977) influencing corporations. However, a new group of managers, the managers of large investment funds, have begun to exert more and different influence than before. These are the new agents of managerial capitalism. Does current regulatory policy adequately consider these new agents? How does regulatory policy related to the managers of large investment funds serve the needs of the individual owner/investor of a pension or an investment fund?

The majority of corporate equity ownership in this country is directed by institutional investors (Previts 1992, 207), and the trend toward greater equity ownership by institutional investors is continuing (McGough 1993). There are over 2,300 mutual funds listed on the New York Exchange alone (*Clevland Plain Dealer,* January 30, 1993, 5D).

The power of these investor institutions is increasing because of the rush by small investors who are seeking alternatives to money market funds whose recent low returns are deemed unsatisfactory.

In addition, the ways in which the new agents exercise their stewardship of funds is changing. Traditionally, institutional investors exercised their influence by moving their funds when they felt it was appropriate. However, these investors now balance two options. They can still be "punters" (move their funds), but they can also act as "proprietors" (*The Economist* May 5, 1990). As proprietors, managers of institutional funds now attempt to directly influence the professional managers of businesses in their investment fund portfolios (e.g., Gordon 1993; Pulliam 1993). That is, investment fund managers now often exercise the responsibility of overseeing corporate managers, creating a new type (or layer) of agents for corporate owners (individual investors) in addition to the corporate managers. In many ways the new agents have the potential to benefit individual investors and society. But there are several potential problems.

Some of the institutional investors need to make sure their own houses are in order (e.g., Anders 1993). While it can be beneficial for the fund investors to influence corporations to be more efficient and effective, who will help ensure the institutional investors are also properly managing their businesses? There is a need for better disclosure of fund performance. Currently, it can be difficult to determine if a fund is performing well (e.g., is the fund "outperforming the market"), and performance measures should be established. Also, many funds invest in companies in other countries, which is natural in a global economy (e.g., Clements 1993; Hardy 1993). Unfortunately, many other countries have regulatory models and financial disclosure requirements which may not be adequate for the current business environment.

There will be pressure on the new agents from other institutions, such as governments. Politicians can see the accumulated wealth in investment funds. President Clinton, for example, has suggested increasing the social investment requirements of pension funds. This may involve requirements similar to those that already exist in some states, such as a stipulation that a portion of state teacher retirement funds be invested in road construction bonds or other social infrastructure projects. If this reduces the yield of the overall fund, such requirements amount to a tax on those who have money in these

funds, and makes governments allocators of such funds. The possible impact of this kind of requirement also needs to be examined.

The diverse individual investors are "distant beneficiaries" of their investments (Previts 1992, 203). These individuals have neither the knowledge or power to influence the institutions which control their investments—governments, "nationlike" large corporations, and institutional investment groups. For the most part, individuals must rely on the institutions and the institutional system of checks and balances (regulation) for the management of their investments. At this time, it appears that the regulatory model does not sufficiently deal with investment fund institutions—the new agents of managerial capitalism—to properly protect the individual investors. A recent staff study by the Securities and Exchange Commission (May 1992) seems to support a "deregulatory" or free market approach to developing the global aspects of such funds.

There is a role for professional accountants in an improved disclosure model. Accountants can assist in the establishment of performance standards and help to determine the efficiency and effectiveness of investment funds. The accounting profession is a logical part of the disclosure system that can help protect the investing public from some of the potential problems described in this paper.

REFERENCES

Anders, G. 1993. Restless natives. *The Wall Street Journal* (January 29): A1, A6.

Chandler, A.D. 1977. *The Visible Hand: The Managerial Revolution in American Business*. Cambridge, MA: Harvard Belknap.

________. 1990. *Scale and Scope: The Dynamics of Industrial Capitalism*. Cambridge, MA: Harvard Belknap.

Chandler, A.D., and A.S. Tedlow, 1985. *The Coming of Managerial Capitalism*. Irwin.

Clements, J. 1993. Fund managers are looking overseas to catch the next running of the bulls. *The Wall Street Journal* (February 4): C1, C16.

Editor. 1990. Capitalism: In triumph, in flux. *The Economist* (May 5): 5-20.

Gordon, L. 1993. New deal for shareholders. *The Wall Street Journal* (February 4): A18.

Hardy, Q. 1993. Pension money flows to Japan. *The Wall Street Journal* (February 4): C1, C18.

McGough, R. 1993. Investors ran to stock funds during January. *The Wall Street Journal* (February 2): C1, C27.

Previts, G.J. 1992. Financial reporting in an investor fund economy: Regulation and reports to portfolio investors. In *Research in Accounting Regulation,* Vol. 6, ed. G.J. Previts. Greeenwich, CT: JAI Press.

Pulliam, S. 1993. Big investors, even money managers, join activists' ranks for better bottom lines. *The Wall Street Journal* (February 5): C1, C6.

Securities Exchange Commission. 1992. *Protecting Investors: A Half Century of Investment Company Regulation,* SEC Staff Report 1504. Commerce Clearing House, Federal Security Law Reports, May 29.

MAIN PAPERS

A CRITICAL ASSESSMENT OF THE LITERATURE ON POLITICAL ACTIVITY AND ACCOUNTING REGULATION

Robert G. Walker and Peter Robinson

ABSTRACT

Most studies of the rule-making process in accounting have focused on political activity undertaken through written submissions to profession-sponsored boards developing accounting standards. This form of lobbying activity represents a late, and relatively insignificant part of the overall political process surrounding rule-development. Earlier stages in the rule-making process involve contests over the powers of regulatory agencies, the composition of boards, and the overall structure of regulatory arrangements. Government- and private-sector agencies may seek jurisdiction over particular types of disclosure, or particular forms of financial reporting. Within a particular agency, there may be contests over what items gain

Research in Accounting Regulation, Volume 7, pages 3-40.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

admittance to the formal agenda, and how those issues will be addressed. In many cases these phases in the rule-making process may have a greater impact on regulatory outcomes than written submissions on discussion memoranda or exposure drafts. Yet few studies have examined these earlier phases. Gaps in the research literature are identified, and suggestions are offered about possible research opportunities.

POLITICAL ACTIVITY AND ACCOUNTING REGULATION

Accounting rules[1] are the outcome of political processes. Rule-making bodies are not solely concerned with the resolution of technical issues; they may not place much weight on the findings of academic researchers; nor may they show much interest in promoting research that will shed light on contentious issues. Rather, rule-making can be viewed as a form of political activity, and as such can be examined from varying perspectives.

First, an examination can be undertaken of the behavior of rule-making bodies in dealing with particular issues. This can involve an examination of voting behavior of members of rule-making bodies, or on the link between decisions of a body and different forms of lobbying activity. This approach focuses on concrete decisions being made by a rule-making body—on items that have found their way on to the formal agenda of those bodies.

Second, one can examine the way in which certain issues attain prominence and gain admission to the formal agenda of a regulatory body—while other issues are disregarded or suppressed, and are denied agenda entrance. This approach examines political activity as occurring in terms of a set of existing rule-making processes and organizational structures.

Third, one can examine the factors which lead to the creation of a particular set of arrangements for rule-making activity, or which enable the maintenance of those arrangements, or which lead to change. Efforts to explain rule-making in accounting in these terms will involve analysis of the effects of rule-making on various interests and the incentives facing those interests.

These three approaches to describing rule-making activity in accounting echo more general descriptions of political activity found in the social sciences—notably analyses of various conceptions of "power" (see Bachrach and Baratz 1962; Lukes 1974; Clegg 1989). Within the accounting literature, most research has reflected the first perspective—through a preoccupation with the decisions of rule-making bodies, and the pattern and influence of lobbying. Most of these lobbying studies have viewed the processes surrounding rule-making in terms of the pluralist model of political behavior, in the tradition of early writings in political science, notably Dahl (1957, 1958, and 1961). The pluralist model—characterized as a "one dimensional view of power" (Lukes 1974)—focuses on behavior in the making of decisions, and seeks to draw conclusions about the influence of major interest groups on that process. Consistent with this model, lobbying studies in accounting have examined whether power is concentrated in the hands of an elite, or is more widely distributed. The dominant theme has been a concern with whether the decisions of rule-making bodies have been influenced by the lobbying activities of elites (such as Big 8 accounting firms, or large corporations).

The second section of this paper reviews the lobbying literature in accounting, and the third section points to the limited range of issues that have been addressed in empirical analyses of formal, written submissions to rule-making bodies. While researchers have often employed sophisticated quantitative analytical techniques to examine this form of lobbying, the evidence (and the methods used to analyze it) only concerns a late and relatively insignificant phase of the overall political process surrounding rule-development in accounting. The fourth section reviews a series of U.S. studies of intraboard political activity, and cautions against simple interpretations of this evidence in terms of a naive pluralist model, while disregarding the incentives facing individual board members or employees, or ignoring the place of an individual agency in an overall framework of regulation. The fifth section examines political activity regarding the design of such overall arrangements for regulation within a community. The sixth section summarizes the way that prior research has contributed little to an understanding of the overall political process affecting rule making in accounting, while the final section suggests some directions for future research.

STUDIES OF POLITICAL ACTIVITY IN RULE-MAKING

The last two decades have witnessed a heightened interest in the accounting rule-making process. Most early studies were institutional histories, or descriptions of regulatory processes by former participants (e.g., Zeff 1972; Carey 1969, 1970; Horngren 1972; Moonitz 1974). More recently there has been a burgeoning literature concerned with the behavior of rule-making bodies. Yet much of this literature has been undertaken in terms of the first perspective—and then dwelt mainly on lobbying activity (and factors that may motivate "lobbying").

In excess of 20 studies dealing with rule-making activity in accounting have been published since 1980. Most were quantitative analyses of lobbying activity, evidenced by written submissions that were available to the public. The major studies of this genre are summarized in the Appendix.

Most of these studies have been concerned with submissions made to profession-sponsored standard-setting bodies: only Deegan, Morris and Stokes (1990) and Gorton (1991) dealt with efforts to influence government agencies. This preoccupation with the profession's standard setting activities ignores the fact that government agencies—such as the Securities and Exchange Commission (SEC) in the United States or Australia's National Companies and Securities Commission (NCSC)—have been active in the development of accounting rules, and the rules they have developed are generally more authoritative than those produced by private-sector bodies. Further, the stock exchanges in North America, United Kingdom, and Australia have undertaken major initiatives affecting financial reporting, often well in advance of the accounting profession's involvement with certain issues.

More generally, the activities of profession-sponsored rule-making bodies have often been strongly influenced by government agencies—a matter well-documented in institutional histories (see Kirk 1981; Sampson 1983; Moran and Previts 1984). It appears that the reverse may also be true: government agencies may have been influenced by the profession's rule-making initiatives.

Since the empirical literature has focused on standard setting by the profession, it may be useful to recall the formal steps commonly used by those bodies in the course of developing a standard. Table 1

Table 1. Elements of the Profession-Sponsored Rule-Making Process

Stage of Rule Making	*Elements*	*Modes of Lobbying*	*Evidence*
Agenda Entrance	1. Issue emerges and gains admission to agenda	Discussions with members of regulatory bodies, politicians, and so on; pressure through media reports, campaigns	Surveys, government reports; newspaper and other media comment
Formal Consideration of Agenda Items	2. Discussion memorandum or paper drafted and released	Written submissions informal discussion	Written submission
	3. Exposure draft(s) prepared and released	Written submissions informal discussions	Written submissions media releases
	4. Open hearings and working parties	Representations to a regulatory body	Transcripts of testimony
	5. Standard prepared, approved and issued	Press releases; meetings of professional bodies; contact with regulators and politicians	Text of standards/ policy notes
Post-Enactment Review	6. Assessment of impact of approved standard	Press releases; meetings with various progessional and government bodies; noncompliance with accunting standards	Review letters; reporting practices

outlines six elements of the rule-making process that are common to the procedures adopted by standard-setting organizations in the United States (FASB), the United Kingdom (Accounting Standards Committee [ASC]), and in Australia (Accounting Standards Review Board [ASRB]) and government bodies such as the SEC and NCSC.

In general, published empirical studies have addressed only elements 2 or 3 of Table 1. That is, researchers have examined written submissions that have been prepared in response to discussion memoranda (e.g., Watts and Zimmerman 1978; Brown 1981; McKee, Bell, and Boatsman 1984), exposure drafts (e.g., Haring 1979; Hussein and Ketz 1980; Dhaliwal 1982; Hope and Briggs 1982; Hope and Gray 1982; Puro 1984 and 1985; Coombes and Stokes 1985; Morris 1986; Feroz 1987; Sutton 1988; MacArthur 1988a, 1988b; Feroz and Hagerman 1990) or both (e.g., Deakin 1989).

Many of these studies might be regarded as seeking evidence consistent with the pluralist model, for example, by considering

whether a rule-making body such as the FASB was "responsive" to the submissions made from a variety of interested parties; whether it was "dominated" by particular interest groups (elites); whether the submissions of major accounting firms promoted the interests of their clients. Other studies considered what motivated corporations or accounting firms to engage in lobbying activity, and how those motives affect the preferences communicated to a rule-making body.

Findings include claims that rule-making bodies are indeed responsive to [written] submissions made by interested parties (e.g., Gibson 1981; Hope and Briggs 1982; Coombes and Stokes 1985) and that no one group of respondents has its policy preferences consistently adopted by the rule-making body (Hussein and Ketz 1980; Puro 1985; Coombes and Stokes 1985). While major accounting firms and the financial sponsors of a private-sector rule-making body may collectively influence the decisions of that agency (Haring 1979), the views presented by major accounting firms to a rule-making body are not dominated by the preferences of their clients (Haring 1979; Brown 1981; Puro 1984, 1985; MacArthur 1988b). While there may be some alignment between decisions of a rule-making body and the preferences of organized interest groups, rule-making bodies "either [attempt]...to compromise among diverse constituents' preferences, or...simply [ignore] many constituents' preferences" (Brown 1981, 245). As for the motivation of those who lobby through formal written submissions, it has been suggested that the views presented by corporate lobbyists are consistent with the self interests of the respondent (e.g., Watts and Zimmerman 1978; Dhaliwal 1982; Griffin 1983; Deakin 1989; Feroz and Hagerman 1990).

Not surprisingly, these findings have been cited as evidence of the independence of rule-making bodies, and as refuting allegations of domination (Haring 1979, 508; Hussein and Ketz 1980, 364-5; Brown 1981, 246; Puro 1985, 174). They have also been interpreted as demonstrating the responsiveness of those bodies to interested parties (Hope and Briggs 1982, 95; Coombes and Stokes 1985, 44), and as questioning the case for government intervention in the rule-making process (Coombes and Stokes 1985, 44; Hussein and Ketz 1980).

LIMITATIONS OF LOBBYING STUDIES

Despite the number of lobbying studies, there remain significant gaps in descriptions of the political processes surrounding the development of accounting rules. These gaps arise since:

1. the issues examined by the researchers have been limited to items already on the formal agenda of rule-making bodies;
2. the studies have only examined written submissions, which provide limited insights into the nature of political activity surrounding accounting rule development.

Moreover, the studies have interpreted written submissions as "votes"—thus ignoring the substance of the submissions and the context in which they were made. This approach casts doubt on the validity of both the results and the inferences drawn from those studies. Each of these concerns will be considered in turn below.

Restriction to Issues Already on the Formal Agenda

Lobbying activity can occur at many points in the life cycle of an accounting issue (see Table 1). However, the concentration by researchers on written submissions in response to discussion memoranda or exposure drafts narrows the research focus to only one aspect of the "political" process of rule development. It ignores the way in which some accounting issues are admitted to the formal agenda of a rule-making body, while others are not.

Hence the studies are looking at a late stage of the rule-making process on particular issues—the stage that may be the least-contested. The answers to important questions such as How do issues gain admission to the agenda of a rule-making body?, How are some issues removed from the agenda or from active consideration?, What prompts the rule-making body to review or enact an accounting rule?, and Who are the gatekeepers that control the rule-making agenda? may reveal the existence of more significant lobbying behavior than that evident in written submissions to discussion memoranda or exposure drafts.[2] To date, as noted by Hope and Gray (1982, 536), there has been little attention directed to such questions.

In effect, the lobbying studies have only examined issues that have emerged from political processes to attain agenda entrance.

Accordingly, reservations must be held about claims that the process employed by an individual rule-making body is "responsive" to the views of "interested parties," or that the rule-making process can be described as "pluralistic" (e.g., Coombes and Stokes 1985).

Even after a topic has been placed on the agenda of a rule-making body, the way issues are described and presented in discussion memoranda and exposure drafts may have a significant influence on the way others respond to those proposals. Some issues may be highlighted while others are given little attention. Potential respondents may be guided towards some positions, and away from others. The staff and members of a rule-making body may be key players in this process. Again, studies that only examine responses to certain issues may be disregarding more interesting questions about why and how those issues were identified and what came of them following the release of the accounting rule.

Reliance on Written Submissions

There are grounds for skepticism as to whether reliance on evidence in the form of written submissions adequately reflects the lobbying process. An illustration of the inadequacy of relying on this evidence was provided by Hope and Gray's (1982) analysis of the UK ASC's deliberations on the treatment of research and development expenditure. The ASC publicly acknowledged that representations from the electronics industry influenced the final decision taken on the treatment of research and development costs in *SSAP 13*. Yet these representations were not revealed in any publicly-available written submissions.

Some researchers who have relied on analyses of written submissions have acknowledged that they are relying on evidence that may be incomplete (Coombes and Stokes 1985, 34; Feroz 1987, 419; MacArthur 1988a, 214), unreliable (Hope and Gray 1982, 553), or that may not allow regularities in lobbying behavior to be easily determined (Puro 1984, 624). But a more significant caveat may be that members of rule-making bodies have themselves not seen those submissions, or have relied on them in making their decisions. Instead, it is common for members of profession-sponsored rule-making bodies to rely on summaries and analyses prepared by staff. Reliance on "staff-generated analyses" has been acknowledged by one former FASB staffer, who claimed that it would be "unrealistic to assume that every member reads each letter in detail" (Brown 1982, 283).

Of course, while written submissions may have relatively little direct impact on members of a rule-making body, they may have greater influence on staff. Questions may also be raised about other aspects of the political process: what roles do the staff of regulatory bodies play in shaping the agenda of those bodies? How does the drafting of discussion memoranda and exposure drafts affect the direction of debate? How do they affect the weighting and interpretation placed on individual written submissions? To date, no published studies have addressed these questions.

There has been very little effort to look beyond political activity as it is reflected in written submissions. Of course, evidence about such activities may be difficult to obtain. For instance, oral lobbying of members or staff of regulatory bodies may be undertaken on the telephone, or during social interaction.[3] Corporations and major accounting firms may seek to influence rule-making bodies through issuing press releases, writing articles for publication in professional accounting journals (Nobes 1990), and other public relations activities. The role and activities of staff of regulatory bodies may be examined through case studies and reliance on interviews or analyses of board papers.

Treating Submissions as "Votes"

There is a strong contrast between the statements made by rule-making bodies about how they treat written submissions, and the manner in which researchers have interpreted those materials. Most rule-making bodies take pains to emphasize that all submissions will be reviewed and carefully examined. For example, the FAF stated that the process of setting new accounting standards required the careful consideration of all elements of the constituency (1977, 18). Similar claims have been made in the United Kingdom and Australia (see ASC 1983, 118; Australian Society of Accountants 1985, 1002.2).

Yet most lobbying studies have viewed the exposure and public submission process as an exercise in which respondents record "votes." These studies have counted and classified "votes" and then claimed to have found whether regulatory bodies were dominated by (or responsive to) particular interests. In effect, these studies have assumed that rule-making bodies only focus on some rudimentary statement of preferences.

That assumption could be considered as an hypothesis—one that remains to be tested (at least, in any published research studies). Testing would require a more detailed examination of submissions in terms of whether they simply expressed support or opposition to a proposal or whether they advanced arguments (such as the consistency or inconsistency of proposals with a conceptual framework, or the relevance or irrelevance of the products of accounting treatments to "users").

While it is acknowledged that staff of rule-making bodies do summarize submissions, informal discussions with current or former staff of rule-making bodies suggest that this task is difficult and subjective. Some responses may be vague (e.g., I wonder if anyone will benefit from this type of disclosure?). Sometimes comments on several issues will be contained within a single paragraph (e.g., I fully support the proposals), making it difficult to tally responses. Few respondents directly address every issue: while some may indicate agreement with all proposals not specifically mentioned in their replies; others may simply criticize proposals with which they disagree—so that a choice has to be made whether respondents' attitudes towards remaining issues should or should not be inferred. Even counting the number of responses may require arbitrary assumptions: if an individual sends in ten responses on the letterhead of ten related companies, should they be counted as ten responses—or one? Should the collective and individual responses of organized interests such as the U.S. Ad Hoc Committee on Full-Cost Accounting or Australia's Group of 100 be counted as individual responses or aggregated as one response?

The "tallying" of "votes" provides the data to which most studies have used to test hypotheses about the processes adopted by rule-makers. However, few studies have included detailed explanations or justifications of how submissions have been tallied. Yet the tallying process necessarily involves the adoption of some major assumptions, the choice of which may have a significant effect on the findings of this form of analysis (and hence on the inferences that can be drawn from those findings).

Early lobbying studies relied on data provided by the FASB itself in which responses were categorized as either supporting, opposing or expressing a neutral position regarding particular issues or proposals (see Haring 1979; Hussein and Ketz 1980). This scheme has been adopted in a series of studies (e.g., Brown 1981; Puro 1985;

Coombes and Stokes 1985; Morris 1986). However this approach treats one-line responses (e.g., expressing mild reservations about the suitability of a particular technique) as having the same weight as lengthy submissions, which might provide detailed analysis and reasoned argument. To date, the relative impact of short or lengthy (possibly vociferous) submissions has not been examined, but it has been noted that the number and length of formal submissions was closely associated with perceptions about the economic and political consequences of proposed rules (MacArthur 1988a).

The support/oppose classification schema has also been applied to "overall" responses to documents—not just to responses on specific issues (Hussein and Ketz 1980, 365). Again, this may necessitate the adoption of arbitrary assumptions. Further, suppose that a discussion memorandum outlined three propositions (a, b, and c). Imagine that a respondent agreed with (a) which outlined general requirements, but disagreed with (b) and (c) which were detailed rules applying those requirements in certain situations. This "overall" response could be interpreted in two ways: (1) as supportive of "the substantive issue" (2) as "opposed to a majority of the proposals." Some researchers have by-passed this problem by focusing on a specific or key issue (Puro 1985), or claiming to adopt the rule-making body's own analysis of key issues (Coombes and Stokes 1985)—though without attempting to justify why those issues were regarded as critical to potential respondents, and why others were ignored.

Some studies (e.g., Haring 1979) claim to have reported the "overall" preferences of groups of respondents. Again, this exercise requires the adoption of arbitrary assumptions—particularly where studies claim to have considered responses to the "major," "fundamental," or "substantive issues" (Hussein and Ketz 1980; Brown 1981; Kelly 1982). Different observers might have different views about what constitutes the "substantive issue" in a particular set of proposals.

Some written submissions may agree with the thrust of a proposal, but disagree with the drafting. Consider the ASC's deliberations on the accounting treatment for research and development expenditure (Hope and Gray 1982). In successive stages of these deliberations, ED 14 (January 1975) advocated that development expenditure "should" be written off; ED 17 (April 1976) intimated that development expenditure "should" be carried forward if specific criteria were met; *SSAP 13* (December 1977) stated that development

expenditure "may" be carried forward if specific criteria were met. Hope and Gray (1982) analyzed these responses in terms of preferences for immediate write off, or for some deferral of development expenditure—and used their findings with considerable effect to illustrate the exercise of "power" in the standard-setting process. However others might claim that the "substantive" issue concerned how the standard was to be drafted: was it to require write-offs, encourage write-offs, or just permit write-offs?

No published study has considered in detail the manner in which written submissions have focused on "substantive" issues as opposed to drafting issues. The possibility of submissions addressing both types of issue could pose further difficulties in the interpretation of responses.

Suppose that a draft standard proposed that research and development expenditure "should" be written off in the year in which it was incurred. Imagine that one respondent strongly opposed the standard, claiming that there are situations in which research and development expenditure should be capitalized. A second response expressed support for the proposal, but suggested that a proviso should be inserted permitting some firms to capitalize research and development expenditure under certain conditions. In effect, both respondents would be saying the same thing (one more diplomatically than the other). How would they be categorized—as both opposed, or one opposed and one supportive? Again, published studies have not explained the basis of such a classification.

The failure of researchers to discriminate between "technical" and "drafting" issues may provide alternative "explanations" of findings that there have been switches in the responses of some parties between a discussion memorandum, an exposure draft and subsequent exposure drafts. Recall again the British experience in producing a standard on research and development, in which one document stated that development expenditure "should" be written off (but permitted an alternative) while the next stated that development expenditure "may" be carried forward (thus giving the alternative some stronger authority). A respondent might have opposed the first draft and supported the second—and thus be regarded as switching position—when in fact a consistent preference was being expressed.

Studies of written submissions to a rule-making body have ignored the manner in which debates about the drafting of accounting rules can affect regulatory outcomes. Government and profession

sponsored bodies adopt differing drafting styles for accounting rules. As statutory rules and other government initiated accounting regulations have greater "authority" than profession sponsored rules—because generally they are expressed as mandatory (and enforceable) requirements—government rule-making bodies tend to employ tight drafting standards. Whereas, private-sector rule-making bodies (such as the accounting profession) have systematically sought to incorporate vagueness or ambiguity in the accounting rules they draft (Walker 1986). It appears that efforts to substitute relatively more permissive profession sponsored for government sponsored rules are a major source of interactions between the accounting profession and government.

Written Submissions as Expressions of Preferences, or Arguments?

Presumably written responses to discussion memoranda and exposure drafts are available to the public to ensure that rule-making bodies can be held accountable for the way they go about making their decisions. Disclosures that a rule-making body consistently ignored or favored the submissions of particular interests might engender concern; as would disclosures that a rule-making body was not making decisions in the light of reasoned arguments.

Recall some of the "findings" of lobbying studies: that rule-making bodies are responsive to written submissions (e.g., see Hope and Briggs 1982; Coombes and Stokes 1985). Both of the cited studies considered whether lobbyists either favored or supported exposure drafts—without explaining whether written submissions merely complained about the "economic consequences" of the proposals, or whether they provided views about the relevance of data provided by alternative techniques to the decisions faced by users.

Likewise a finding that rule-making bodies "either [attempt]...to compromise among diverse constituents' preferences, or...simply [ignore] many constituents' preferences" (Brown 1981, 245) seems to treat all written submissions as mere statements of "preferences"—regardless of whether respondents provided analysis of the issues or simply offered crude statements about what outcomes they wanted.

Participation: Who Lobbies, Who Doesn't, and Why?

Published studies have pursued two main themes when considering factors that may motivate participation in the lobbying process. The first has concerned the activities of accounting firms—and whether their lobbying activities reflect the views of their clients. The second theme is closely associated with efforts to develop a "positive theory" of accounting, and has concerned the lobbying efforts of managers or corporations, and the positions they are likely to take on particular issues.

Accounting Firms

Several studies concluded that the preferences of practicing accountants as expressed in written submissions were not dominated by the views of their clients (Haring 1979; Brown 1981; Puro 1984, 1985; MacArthur 1988b). Such findings may be regarded as reassuring to those who hold that the political processes underlying the development of accounting rules conforms to the ideal of "pluralism." The findings might also provide insights into whether accounting firms seek regulatory outcomes that will be to their own benefit.

Unfortunately these studies have considerably overstated the significance of comparisons of the written submissions from accounting firms and their clients. This evidence may reveal differences between submissions—but it does not in itself shed any light on whether the submissions of an accounting firm reflected the interests of the majority of their clients. Given that some accounting firms have actively "marketed" the service of preparing submissions which stress the economic consequences of proposed rules on corporate clients (see Zeff 1986, 151), it follows that corporate managements which agreed with the submissions of their auditors may not have been motivated to write on their own behalf. On the other hand, a recent study by McKee, Williams, and Frazier (1991) found that the views expressed by audit firms were closely associated with the strength and frequency of separate submissions from clients: suggesting that the direction of influence is from client to auditor, not vice versa.

Correspondingly, studies that have analyzed differences between written submissions of accounting firms and clients have risked

drawing invalid inferences by focusing only on the views of those who made submissions, while ignoring the views of those who did not.

In summary, the manner in which accounting firms prepare their submissions has yet to be fully investigated. Watts and Zimmerman (1981) suggested that accounting standards affect auditors' wealth, and thereby establish incentives for auditors to lobby rule-making bodies. But Watts and Zimmerman neglected to provide any concrete examples of standards which could have that effect, or to justify their contention that changed accounting methods would have a significant effect on the profitability of an audit practice.

Managers and Corporations

A series of empirical studies have endeavored to explain factors that may motivate individuals or corporations to participate in the lobbying process. Watts and Zimmerman (1978) suggested that a manager's attitude towards a proposed accounting standard would depend on the size of the firm and whether the proposed standard would increase or decrease reported earnings; Watts and Zimmerman also reported evidence claimed to be consistent with those propositions. Dhaliwal (1982) considered what he described as some additional "determinants" of lobbying behavior (size and capital structure).

Subsequent studies (Dhaliwal 1982; Kelly 1982, 1985; Griffin 1982, 1983) considered whether submissions by corporate management to a rule-making body were motivated by the anticipated impact of an accounting standard on management wealth. None of these studies demonstrated such an association.

Sutton (1984) reviewed evidence of the incidence of lobbying activity in the United Kingdom and United States, and adopted an "economic standpoint" to analyze characteristics of lobbyists and lobbying-incentives. He concluded (not surprisingly) that "a rational individual will only allocate resources to lobbying if the expected benefits to him from doing so exceed the costs" (p. 93). Morris (1986, 51) noted that some parties lobbied extensively and concluded that those parties "consider that the benefits of submitting outweigh the costs."

These empirical studies have thus focused on "economic" variables. Watts and Zimmerman (1978) acknowledged that lobbying submissions might also be motivated by what they termed *non-*

economic income but justified their disregard for such a factor in their empirical tests by asserting their expectation that "the error will be random" (p. 122). Sutton's self-imposed "economic standpoint" prevented him from exploring the possibility that individuals may engage in lobbying out of a concern to ensure equity in the securities markets, or to express personal beliefs about accounting issues (just as individuals may engage in national politics for a range of reasons other than economic self-interest).

The suggestion that preparers of financial statements might seek to shape financial reporting is hardly new; prior studies have provided descriptive evidence of associations between new capital raisings, takeover bids or defenses, wage negotiations, rate-setting, and the choice of particular accounting techniques. The suggestion that "self interest" may motivate attitudes towards accounting regulation is a logical extension of such observations.

However, the experimental design adopted in the Watts and Zimmerman (1978) study and its successors involved an examination of the characteristics of those corporations or accounting firms that actually made written submissions. The findings of such studies are therefore predestined to shed little light on such predictions as

> large firms which experience reduced reported earnings due to a changed accounting standard will lobby in favor of the change (McKee, Bell, and Boatsman 1984, 647).

since such a hypothesis relates to the whole population of "firms," not just to those which actually lobby. Nevertheless some researchers have made more ambitious claims. For example:

> The results...lend support to Watts and Zimmerman's hypothesis that large firms would oppose an accounting change that causes an increase in reported earnings (Dhaliwal 1982, 264).

Such a claim can be contrasted with evidence of the incidence of lobbying activity: for eleven FASB projects, response rates from corporations in the Fortune 1000 ranged from 7 to 95 (Brown 1982), or less than 10% of the population of major corporations. It seems likely that many of the nonlobbying large firms have also faced accounting changes which might have caused "increases" in reported earnings. But Dhaliwal was only able to provide evidence about the

impact of the accounting standard on a limited number of "large" firms which actually lobbied.

In general, the aim of many of these studies can be restated as an endeavor to explain the lobbying position of those firms *which have lobbied*—rather than the stated aim of explaining why some firms lobby, while others do not.

An exception is Sutton's (1984) analysis of incentives facing potential lobbyists. Sutton distinguished "lobbying" and "voting," noted the lack of a limited time frame for lobbying, and concluded that "producers of financial statements" faced stronger incentives to lobby than consumers, "large producers" are more likely to lobby than "small producers," "undiversified producers" are more likely to lobby than "diversified producers," while "raising (lowering) the cost of noncompliance will increase (reduce) the level of producer lobbying" (p. 93). Sutton described the complexity of the lobbying process and noted the relative ease with which researchers can frame hypotheses as opposed to testing them.

Sutton's "economic analysis" presumed that the cost of making submissions was high and that accordingly that for most firms or individuals, the costs would outweigh the benefits. However one must question whether it is reasonable to assume that lobbying costs are necessarily high (see McKee, Williams, and Frazier, 1991, 290), and that costs explain participation rates. It may be expensive for a corporation or accounting firm to maintain the capability to respond to every issue affecting their interests on which public submissions are invited. But written submissions need not cover every aspect of an issue (and it appears that few do). It might also be noted that some community lobby groups operate on a shoestring budget—indicating that their lobbying efforts are sustained by the interests of individuals, rather than financial strength. Conversely, some members of the community (such as accounting academics) might be expected to have a greater familiarity with technical accounting issues and hence a comparative advantage in participating in debates about those issues—yet academics exhibit a notoriously low participation rate (see Beresford 1991, 94).

Participation Rates in General

Perhaps explanations for relatively low levels of participation or for variations in participation rates may be found from closer

examination of the activities and procedures of rule-making bodies, and of the way that individuals or firms come to prepare written submissions.

For example, nonparticipation may simply be explained by ignorance—either of the proposals, or of their implications. There may be some association between the publicity given to a proposed standard and the level of responses; this has not been investigated. The procedures used to publicize proposals may also influence the type of response that is forthcoming. To illustrate, Australian rule making bodies maintain mailing lists of interest groups and prior respondents; their "public exposure" procedures involve modest advertising in the press, notices in professional journals, and letters of invitation to persons on the mailing list. Such procedures are targeted at a limited subset of potentially-interested parties. If similar procedures are adopted by other agencies, it may partly explain the low level of participation from "consumers" rather than "producers" of accounting information (Brown 1982, 290).

Another possible explanation for the nonparticipation of many corporations is a corollary of Sutton's (1984) observations about penalties for noncompliance. One way of reducing the incidence of penalties for noncompliance with accounting rules is to ensure that those rules are drafted permissively. Accordingly, response rates on exposure drafts may be associated with the style of drafting: if they are expressed as nonmandatory, permissive rules, then "preparers" opposed to a mandatory standard may not consider it worthwhile objecting to a permissive rule which can be evaded with ease.

Other respondents may be discouraged from participating by what they may interpret as a lack of attention paid to earlier submissions, or by a perception that the rule-making process is dominated by the interests of certain groups (such as large corporations or major accounting firms).

Then again, some corporations may not bother to expend time and money on the preparation of written submissions if they believe that their auditors will be making submissions "in their interests." If that was the case, then one might expect to find corporations only participating when they did not agree with the position taken by their auditors—a possible explanation of the lack of alignment between the submissions of auditors and a number of their clients reported by Haring (1979) and Puro (1985).

It has been noted that some submissions to the FASB have had the appearance of an organized campaign principally because a series of letters offered a simple endorsement of the submissions lodged by a trade or industry association (Brown 1982, 286-7). The organization of collusive write-in campaigns by particular interest groups may have a significant effect on response rates (Gibson 1981, 167; McKee, Williams, and Frazier 1991, 291).

Finally, fuller explanations of participation rates may be obtained from an examination of the involvement of individuals. There have been no studies explaining what motivates "consumers" of accounting information (e.g., shareholders, financial analysts) to make submissions, or why some academics adopt particular stances. While some researchers have claimed that "economic incentives" may explain lobbying by preparers or auditors of financial information, it may be that "consumers" (users) of accounting information are motivated by a concern for forms of financial reporting that are seen as contributing to the equitable treatment of participants in the securities market.

It may be noted that some researchers have routinely equated submissions from "corporations" with submissions from "corporate management"; none of the studies (e.g., Dhaliwal 1982; Kelly 1982, 1985) have explained or even discussed the basis of their assumption that the submissions are representative of the views of "corporate management" rather than from members of the accounting profession who are corporate employees. Analysis of corporation submissions made to Australian regulatory bodies revealed that corporate accountants constituted the bulk of signatories to the submissions (similar results are present in McKee, Williams and Frazier 1991, 279-81). Therefore, it seems inappropriate to assume that the written views of corporate accountants always coincide with those of other corporate managers. Yet that assumption has been implicitly adopted in many lobbying studies.

Interpretations of Lobbying Activities

Several researchers have suggested that respondents may adopt sophisticated lobbying strategies when making submissions. For example, Brown (1981, 234) argued that discussion memoranda are neutral documents and so would attract candid and straight forward comments, whereas subsequent stages in the consultative process

might feature strategic lobbying activities such as "vote trading." Johnson and Messier (1982, 205-6) suggested that as a proposed rule advanced through the rule-making process, individual respondents would become aware of the preferences of other interested parties and so would frame their submissions in a reactive manner. Amershi, Demski, and Wolfson (1982, 28-9) have observed that since respondents may frame submissions on a particular draft rule with the aim of influencing other rules (such as proposed tax legislation), lobbying behavior cannot always be relied on to reveal preferences. Similarly, Dyckman (1988) and MacArthur (1988a) observed that respondents have incentives for camouflaging or not revealing their real motives for lobbying. Further, several investigators have noted that occasionally the written comments of particular interest groups indicate that respondents colluded in the preparation of their submissions (Hope and Gray 1982; Brown 1982) or have orchestrated write-in campaigns (Dyckman 1988). Finally, Deegan et al. (1990) found that responses to a government rule-making initiative differed systematically from responses to a proposal from a profession-sponsored agency.

These various observations suggest that there are additional difficulties in the interpretation of written submissions and possibly additional issues deserving careful analysis.

Shifts in Preferences

Submissions on a discussion memorandum constitute the initial point at which the views of interested parties are readily identifiable, and may be compared with submissions on subsequent exposure drafts (or oral testimony at public hearings). McKee, Bell, and Boatsman (1984) reported shifts in respondent attitudes concerning general price level accounting: of the 34 nonregulated firms responding to an FASB discussion memorandum, three changed their positions when commenting on the exposure draft (while the latter document attracted an additional 84 submissions).

One can readily conceive of situations which interested parties may respond in different ways to successive consultative documents. The theoretical discussion in a discussion memorandum may not crystallize issues in the same way as the draft rules in an exposure draft. Indeed, MacArthur (1988a) found that responses were affected by the way that a standard-setting body referred to possible economic

or political consequences: suggesting perhaps that both the content and volume of responses are influenced by the way a regulatory agency has presented issues.

Further, as noted above, apparent changes in respondents' preferences may reflect reactions to the way that a proposed rule has been drafted. A respondent may have a consistent preference for a particular accounting techniques, but adopt a different stance in relation to successive exposure drafts, when the rules were written more or less tightly. Except for MacArthur (1988a), this possibility does not appear to have been recognized in lobbying studies.

Credibility of Submissions

If respondents adopt sophisticated strategies, then there are difficulties in assessing the impact of formal lobbying behavior on regulatory outcomes, or as being indicative of the motivations of respondents.

The evidence on this score is mixed. Kelly (1982) examined firms that responded to a Peat Marwick Mitchell survey on the economic impact of *FAS 8* (dealing with foreign currency). She reported no significant relationship between the claims made in formal submissions, and subsequent corporate reactions to a standard in the form of "changed finance and operating activities," and concluded that reliance on written comments "...may be insufficient or misleading" for assessing the likely economic consequences of a proposed standard (p. 170). On the other hand, King and O'Keefe (1986) found that corporate submissions on the exposure draft of *FAS 19* (on oil and gas accounting) were consistent with share trading activities (p. 89). Similar results were reported by Feroz and Hagerman (1990). King and O'Keefe concluded that the FASB could rely on comment letters as indicating the expected economic consequences of a proposed accounting standard.

While it may be difficult to infer the intent of respondents from their written submissions, some judgments about the credibility of comments can be made from comparing those comments with respondents' prior behavior or subsequent activities.

However, regard must also be had to the possibility that respondents may have been concerned to advance the standard of (say) a regulatory initiative of the profession, as a means of preempting initiatives from public sector agencies. Since most lobbying studies have focused on responses to profession-sponsored

initiatives, they have risked confusing responses to those proposals with efforts to reinforce the profession's role in rule-making.

Collusion in Submissions

There have been several instances in which standard setting bodies appeared susceptible to well-organized lobbying campaigns (e.g., the success of full-cost oil and gas exploration companies in having *FAS 19* overturned). It appears that the influence of lobbying efforts may depend on how well respondents are organized. Interest groups can organize in a variety of ways: for example, they may make use of industry associations, or they may create a temporary body (e.g., the committees formed by "full-cost" oil and gas firms in 1973 and 1977). Similarly, those groups may lobby in different ways: they could make submissions individually, through the industry body, or both; the history of *FAS 19* illustrated how industry groups could even politicize an issue beyond the control of the standard setting body.

In some instances, unambiguous evidence of organized lobbying campaigns is available (e.g., comments in individual submissions affirming the position taken by a representative organization). However, if respondents fear that the rule-making body will discount "organized" submissions, they may try to conceal their collusion. If well disguised, the existence of an organized campaign may not only escape the attention of the standard setting body but also the researcher who only relies on written submissions.

If one of the overriding objectives of research into the political activities surrounding the development of accounting rules is to identify groups which may influence regulatory outcomes, then the lack of attention to possible collusive activity and the impact of that activity on regulatory outcomes constitutes a significant "gap" in the empirical literature. On the other hand, studies which merely counted votes and treated then as having equal weight risked drawing oversimplified conclusions about quite complex political activity.

STUDIES OF INTRA-BOARD POLITICAL ACTIVITY

Rule-making bodies may be complex organizations (see Miller and Redding 1986). Profession-sponsored bodies (such as the FASB) are composed of board members, professional staff, members of advisory

committees and task forces, and consultants. As Plott and Sunder (1981, 231), Dyckman (1988, 7), and McCraw (1981, 268) suggest, all may have interests of their own to advance.

There are relatively few studies of the activities of individuals acting within rule-making bodies. All studies have concerned the APB and the FASB. The main findings of these studies have been that coalitions among board members are not stable and that members from a particular employment category do not appear to exert influence beyond their nominal voting strength (see Newman 1981a; Selto and Grove 1982, 1983; McEnroe and Nikolai 1983; Dyckman 1988).

However, Selto and Grove (1983) observe that the members of a rule-making body may use their voting power in manners inconsistent with the perceived merit of a particular proposal (e.g., engage in "log-rolling," "strategic voting," and "persuasion").

More significantly is the fact that these U.S.-based research studies were only able to examine voting data for resolutions that successfully introduced new rules. Information about voting on resolutions to reconsider or defer contentious issues has not been available. However, McEnroe and Nikolai (1983, 88) speculate that certain interest groups (such as the major accounting firms) may have dominated voting on "unpassed" issues.

However, despite the attractions to researchers of using such sophisticated analytical constructs as voting power indices, it seems likely that better explanations of intraboard political activity may be derived by simpler analyses of the procedural arrangements for the conduct of a rule-making body's activities. For example, the visibility of voting behavior in U.S. rule-making bodies—and the practice of allowing publication of minority opinions—are likely to lead to different forms of intra-board political activity than is practiced in Australia or the U.K. Further, a board's activities may be significantly influenced by the strategies adopted by its chairman—within the constraints established by the membership. The persuasive skills of the chairman of the regulatory body may carry the decisions of that body in a particular direction. Hope and Gray (1982) provide illustrations of such influence: when the ASC was considering accounting for research and development, the ASC's chairman was also chairman of the Review Board for Government Contracts (RBGC). RBGC policies were cited in submissions opposing the exposure draft, and Hope and Gray suggest that the ASC's chairman may have played a pivotal role in the committee's reversal of its position on this issue.

The procedures adopted by different bodies to consider proposals may also affect the influence of individual members. For example, a member may have less influence on the content of rules if he simply has a vote within a formal meeting than if he was given responsibility for chairing a project team to undertake a preliminary review of a proposed rule.

Note again that only U.S. rule-making bodies publish particulars of the "votes" of individual members: Australian and U.K. bodies do not make that information available. Accordingly, the results of U.S. studies may not be generalizable to other environments where rule-making bodies operate less "openly."

Collective Strategies of Rule-Making Bodies

Rule-making bodies, like other organizations, may change over time. The general literature on regulation includes several studies of the "life cycles" of regulatory agencies (reviewed in Mitnick 1980, 34-78).

There has been some acknowledgment of the changing character of rule-making bodies within the accounting literature. Rockness and Nikolai (1977) inferred three phases (research orientation, pragmatic, and housekeeper) in the life of the APB and the pattern of voting appeared to reflect the role the Board accepted for itself at each stage. Similarly, Hope and Gray (1982) concluded that the ASC appears to adopt a survival strategy and its reaction to pressure is determined by its perception of the likelihood of this goal being endangered. Coombes and Stokes (1985, 44) speculated that the Australian debate about the establishment of a government controlled accounting standard setting body may have encouraged the accounting profession's Research Foundation to be more responsive to written submissions. Likewise, McEnroe and Nikolai (1983) speculated that the potential for government intervention had influenced the pattern of voting within the APB and FASB so as to keep the standard-setting process largely in the private sector (p. 89). Walker (1987) recorded the way Australia's ASRB sought to get "runs on the board" by choosing "easy" standards for examination in its early period of operation; his case study of political activity surrounding the ASRB's early history also noted the strategies undertaken by the accounting profession's rule-making organization in its dealings with the ASRB (see also Bachrach and Baratz 1970, 47-8; Lukes 1974, 19).

Mitnick (1980) observed that regulatory organizations "are not passive and/or defensive responders to client-manipulated incentives or disincentives" (p. 76). While Dyckman (1988, 12) suggested that the FASB adopts a long-run strategy when it adopts projects to its agenda and decides upon their ordering, many empirical studies within the accounting literature seem to have been based on precisely that premise. Furthermore, little attention has been given to the strategic activities undertaken by those organizations in seeking to extend or consolidate their influence (Zeff 1984). A major omission has been the lack of concern for the interaction between profession-sponsored regulatory organizations and government agencies.

POLITICAL ACTIVITY REGARDING REGULATORY STRUCTURES

The manner in which responsibility for rule development has either been assumed by the profession, or consciously delegated to the profession, is of overriding significance in any research program seeking to explain the political processes undertaken in the development of accounting rules.

Different arrangements have been adopted within different countries. In the United States during the 1930s, the SEC was assigned power and authority to develop accounting rules—but virtually abandoned that responsibility in a manner that has described as "an event deserving respectful attention" (Chatov 1975, 1). Subsequently, interactions between the accounting profession and government have led to new forms of arrangements whereby the SEC both acknowledges FASB rules and undertakes some rule-making activities of its own.[4] In the United Kingdom, government initiatives in developing more extensive statutory requirements for corporate reporting encouraged the profession to produce "Recommendations on Accounting Principles"; likewise, the changing authority claimed for profession-sponsored rules seems to have resulted from interactions between the public and private sectors. The recognition by the ASC of industry-developed accounting rules by the "franking" of Statements of Recommended Practice (SORPs) was presumably the outcome of inter-organizational political activities. In Australia, the state and commonwealth governments combined to establish the

ASRB—an initiative which encountered strenuous efforts from the accounting profession to secure changes in the powers and duties of that body (Walker 1987).

Overlaying these various arrangements for rule development are mechanisms for the monitoring and enforcement of rules. Responsibility for the development of rules and for the enforcement of rules may be in the hands of different agencies so that the design of overall regulatory systems which involve both government and private-sector organizations may be quite complex—and, presumably, evolve through sporadic lobbying and other forms of political activity (Moran and Previts 1984, 80).

To date, there have been some brief descriptions of lobbying activity involving government regulatory bodies, and of interactions between government and the profession (e.g., Walker 1987; Newman 1981b). Little if any consideration has been given to the pressures exerted on (or by) other bodies which may use accounting rules for their own requirements (e.g., the stock exchanges), or which fund the private-sector standard setting process (e.g., the FAF in the United States or the Consultative Committee of Accountancy Bodies in the United Kingdom).[5]

But the political processes being undertaken in these various arenas do not appear to have been the subject of systematic analysis. Those studies that have alluded to these interactions (e.g., Johnson and Messier 1982; Benston 1980) have tended to make claims that dominance by the accounting profession has risen because of community "support"—an observation which is not self-evident, and which hardly explains the necessity for organized political campaigns by the profession to secure or maintain control over the process. It is interesting to note that while some accounting academics uncritically have lent support to the accounting profession's claim for dominance over the rule-making process, legal researchers have seen the establishment of limitations on the power of organizations operating within the market as one of the main techniques of securities market regulation (see e.g., Howard 1979, 1613).

In short, the accounting literature has yet to produce explanations of how various interest groups influence the design of regulatory structures. Few contributions have even seen that influence as a problem deserving "respectful attention."

DESCRIBING THE OVERALL POLITICAL PROCESS

As already noted, empirical studies of lobbying activity have focused on a limited phase of the rule-development process, have concentrated on profession-sponsored regulatory bodies, have relied upon a limited source of evidence, and have explored a very limited range of issues.

A feature of this literature is the way some writers have not been inhibited by the narrow focus of their work and the fragmentary nature of their evidence. Several have drawn inferences about the overall political process operating in rule development in accounting. Hussein and Ketz (1980), Johnson and Messier (1982) and Coombes and Stokes (1985) all suggest that analysis of written submissions can establish that the accounting rule-making process is "pluralistic."

These studies have adopted naive (and inconsistent) views of "pluralism." Coombes and Stokes (1985), for example, interpret pluralism variously as describing a process whereby policy decisions are framed with regard to the views of the majority of persons affected by decisions (p. 33), and then with the majority of respondents to consultative documents (p. 34).

Without laboring the point: these various studies have only examined rule making by a body funded by a particular interest group (the accounting profession) and operating under the aegis of that same interest group; they have looked at a limited form of lobbying activity dealing with issues which those bodies have allowed entry onto their formal agenda; they have only examined written submissions from a limited range of respondents—despite strong evidence of low levels of participation from both preparers of financial reports and supposed "users" of accounting information. Under these conditions, the claim that the underlying political processes were "pluralistic" seems totally untenable. Moreover, the failure of contributors to this literature to consider the context within which that activity was undertaken—a regulatory structure within which the profession-sponsored agencies have obtained some responsibility for the development of accounting rules—seems to have prompted those researchers to equate the "accounting community" with the general public.

FINAL COMMENTS

This paper has highlighted the way that research into political activity associated with the development of accounting rules has left extensive gaps in knowledge about both the establishment of different types of regulatory structures, and about many phases of the rule development process.

It is clear that the accounting profession's associations have attained a powerful (if not dominant) position in the rule-development process. What is not entirely clear is how associations of accountants have managed to attain (and retain) that position, and how they have sorted out territorial arrangements with government and other private-sector bodies, such as the stock exchanges.

Accordingly, it is suggested that issues deserving further attention by researchers concerns interactions between government and the profession (and other agencies) in relation to the establishment of particular forms of regulatory arrangements. Once one starts questioning the way in which different agencies mark out their territories, then a range of other issues come to mind: for example, how bodies like the International Accounting Standards Committee (IASC) interact with national professional bodies (and why that interaction is productive for the IASC in some cases but not in others); how the IASC has sought the support of regulatory agencies, or bodies like the International Organization of Securities Commissions (IOSCO); how IOSCO, in turn, has endeavored to coordinate and harmonize activities of national security market regulators in relation to various forms of financial reporting; and so forth.

A second set of issues warranting further research concerns the activities which lead to particular issues being placed on the formal agenda of rule-making bodies. Little is known about the process of agenda formation: how some topics are selected for consideration, while others are not; how issues are prefiltered before proposed rules are publicly exposed; or how regulatory agencies come to draft rules tightly or loosely.

A variety of research methods might be employed to address such issues. However case studies, in particular, might provide a better understanding of the influence of different interests in shaping regulatory agendas, and the methods used to secure agenda entrance. These include the activities of interest groups to influence community

opinion about the need for reform or about the inappropriateness of particular proposals. Major firms in industries likely to be affected by particular accounting rules (including accounting firms) may place advertisements, lobby media representatives or undertake other activities designed to shape public opinion: yet those activities are yet to be documented or analyzed. It appears likely that case studies may highlight the role of "key players" in those process. Many institutional histories of the profession have highlighted the activities of "great men"—such as heads of regulatory agencies, or leaders of the profession. But when it comes to political activity surrounding the development of rules on specific topics, the key players may be representatives of interest groups, or employees of regulatory agencies (who have ample opportunity to influence the decisions of board members of regulatory agencies).

Once issues have been admitted to a regulatory agency's agenda, further efforts may be made to influence regulatory outcomes—either before or after invitations are extended to interest groups to make formal written submissions to a rule-making body. Once again, interest groups may seek to influence community opinion; some may make approaches to standard-setting boards, or to individual members, or to politicians who are in a position to influence or dominate the conduct of regulatory agencies. It may be possible to develop some understanding of these political activities by identifying instances of anomalous behavior of regulatory agencies (e.g., changes in rules from what was previously-exposed and supported; changes in the drafting of rules to introduce laxity or ambiguity), and then pursuing inquiries through examination of documents and field interviews with major participants. Studies of this sort may shed light on questions raised in prior literature about "who lobbies": it may be that the majority of persons who lobby through formal submissions are those who have comparatively little access to regulatory agencies—and hence little influence at prior stages of the rule-development process. Alternatively, those who lobby through formal submissions may not be actively seeking changes in proposed accounting rules, but simply registering support for the overall activities of the regulatory agency. Furthermore, much may be learned from studies of the interests and behavior of those who may be affected by proposed accounting standards but who do not lobby. Some may not be aware that an issue is under consideration; some may deliberately choose not to lobby. Furthermore, greater insights

into the overall political process may be obtained by studying the reasons why the majority of affected participants do not lobby, than by studying the motivation of the minority who do.

The priorities reflected by the subject of published research to date seem to have been shaped by the availability and accessibility of data, and the formal statement of some rather crude hypotheses reflecting naive, pluralist models of the political process. Yet the political process is more complex than hypotheses about "size," "managerial incentives" and (formal) lobbying would suggest. Indeed, it seems reasonable to suppose that the stage when regulatory agencies come to invite formal submissions about draft accounting rules is actually a relatively insignificant part of the overall political process. A corollary of that observation is that there are ample opportunities for research into earlier phases in the political process—with the aim of providing more robust explanations of the way accounting rules are developed.

(Appendix follows)

APPENDIX

Studies of Political Activity in Accounting Regarding Items on the Formal Agenda of Regulatory Agencies

Author(s) and Title	*Regulatory Agency*	*Issue(s) Examined*	*Research Method and Major Findings*
Watts and Zimmerman (1978) "Towards a Positive Theory of the Determination of Accounting Standards"	FASB (US) 1974	DM on General Price Level Accounting (GPLA)	Analysis of the association between characteristics of 52 respondents and lobbying position on GPLA proposal. Firm size was the best predictor.
Haring (1979) "Accounting Rules and 'The Accounting Establishment'"	FASB (US) 1974-76	EDs on 8 topics	Analysis of the association between the views of the FASB, accounting firms and their respective interest groups on 20 key issues. Accounting firms were not dominated by the preferences of clients; the FASB was influenced by accounting firms and its own sponsors.
Hussein and Ketz (1980) "Ruling Elites of the FASB: A Study of the Big Eight"	FASB (US) 1974-76	EDs on 10 topics	Limited analysis of comment letters submitted on GPLA and all 10 topics. The position of large CPA firms differed from small CPA firms on the GPLA topic and the number of submissions made on all 10 topics was greater for those topics that materially affected periodic reported earnings compared to those that only affected the form of financial statements.
Brown (1981) "A Descriptive Analysis of Select Input Bases of the Financial Accounting Standards Board"	FASB (US) 1974-77	DM on 8 topics, and ED on Marketable Securities	Analysis of the relationship between the preferences expressed by 27 respondents in 225 submissions made on 51 policy issues. While there were similarities in submissions within groups of preparers and auditors, there was no systematic alignment between the FASB and the preferences of particular respondent groups. The most closely aligned interest group was the FAF.
Brown (1982) "FASB Responsiveness to Corporate Input"	FASB (US) 1974-78	DM on 8 topics and EDs on 11 topics	Descriptive analysis of corporate submissions. Few companies were active but some topics attracted significantly more attention than others.
Hope and Briggs (1982) "Accounting Policy Making—Some Lessons from the Deferred Taxation Debate"	ASC (UK) 1973-78	Two EDs on Deferred Taxation	Analysis of the influence of 233 submissions on ED 11 and ED 19 and other public documents on the ASC's reconsideration of the Deferred Taxation topic. Pressure from business was the primary stimulus for the ASC's reconsideration of the topic.

(continued)

Appendix (Continued)

Author(s) and Title	*Regulatory Agency*	*Issue(s) Examined*	*Research Method and Major Findings*
Hope and Gray (1982) "Power and Policy Making: The Development of an R&D Standard"	ASC (UK) 1975-78	Two EDs on R&D	Analysis of the influence of 115 submissions to ED 14 and ED 17 and public documents (e.g, company reports) on the ASC's reconsideration of the R&D topic. Business pressures (particularly from one industry) coupled with the activities of a key participant induced reconsideration of the R&D topic.
Kelly (1982) "Corporate Lobbying and Changes in Financing or Operating Activities in Reaction to FAS No. 8"	FASB (US) 1975	ED on Foreign Currency	Analysis of the relationship between changes in financing and operating activities, economic variables, and the lobbying behavior exhibited in 14 submissions. No relationship between lobbying behavior and changes in financing and operating activities and firms that lobbied was reported; firms that changed their financing and operating activities had greater leverage, larger asset size and lower management stock ownership. The integrity of submissions was questioned.
McKee, Bell, and Boatsman (1984) "Management Preferences over Accounting Standards: A Replication and Additional Test"	FASB (US) 1974-75	DM and ED on GPLA	Replication of the Watts and Zimmerman's (1978) analysis of the association between characteristics of respondents and position taken in 104 submissions on GPLA. Economic factors were inadequate predictors of lobbying activity.
Puro (1984) "Audit Firm Lobbying Before the Financial Accounting Standards Board: An Empirical Study"	FASB (US) 1975-77	EDs on 6 topics	Analysis of the relationship between audit firm and client submissions. No association was found between audit firm and client preferences when new disclosure rules were proposed, but there was a positive association when standards reducing diversity were proposed.
Puro (1985) "Do Large Accounting Firms Collude in the Standards-Setting Process"	FASB (US) 1975-77	EDs on 7 topics	Big 8 firms lobby more often than smaller firms, vote as a bloc only on disclosure issues, only influence the FASB on disclosure topics and disagree with their clients on disclosure topics but agree on standardisation issues.
Kelly (1985) "Corporate Lobbying on FAS No. 8: Some Further Evidence"	FASB (US) 1975	ED on Foreign Currency	Analysis of the relationship between economic variables and corporate lobbying behavior (54 lobbyists and 116 non-lobbyists). Lobbyists opposed to FAS 8 because of implementation difficulties were larger and

			had a higher proportion of foreign sales than non-lobbyists; lobbyists opposed to FAS 8 for reasons of the income effect had lower levels of management ownership than non-lobbyists.
King and O'Keffe (1986) "Lobbying Activities and Insider Trading"	FASB (US) 1977	DM and ED on Oil and Gas Accounting	Assessment of the credibility of submissions from 34 corporations, by examining the lobbying position and the stock trading activities of executives. Insider trading activity was consistent with preferences expressed in submissions. Contrary to Kelly (1982) submissions were assessed as credible.
Morris (1986) "Lobbying on Proposed Accounting Standards"	AARF (Australia) 1979-80	EDs on 6 topics	Analysis of the economic factors associated with the lobbying activity of 49 audit firms and 110 corporations, and the impact of company submissions. Lobbying companies were found to be larger and more highly geared than non-lobbyists and where company views were contrary to ED proposals, the release of the standard was delayed. Large audit firms lobbied more frequently than small audit firms.
Feroz (1987) "Corporate Demands and Changes in GPLA"	FASB (US) 1974-78	Two EDs on GPLA	Analysis of economic factors influencing the position adopted by 120 respondent companies. Large firms were more likely to demand changes than small firms while firms earning high returns on investments were less likely to demand changes.
Sutton (1988) "The Proposed Introduction of Current Cost Accounting in the UK"	IASG/ASC (UK) 1976-77	ED on CCA	Analysis of the anticipated effects of CCA on 112 (classified as full support, qualified support, disclosure only or opposed). Support for CCA was influenced by the recency and extent of fixed asset revaluations, the exposure of the company to government regulation, and industry membership.
MacArthur (1988a) "An Analysis of the Content of Corporate Submissions on Proposed Accounting Standards in the UK"	ASSC/ASC (UK) 1970-82	21 EDs on 16 topics	Content analysis of the type of references (economic or political) made in company submissions. Corporate management have made reference to the economic or political consequences of proposals (though the responses appeared to be driven by the discussion in some EDs) and the volume of submissions was positively related to the economic or political consequences of each proposal.

(continued)

Appendix (Continued)

Author(s) and Title	*Regulatory Agency*	*Issue(s) Examined*	*Research Method and Major Findings*
MacArthur (1988b) "Some Implications of Auditor and Client Lobbying Activities: A Comparative Analysis"	ASSC/ASC (UK) 1970-82	22 EDs on 16 topics	Analysis of the relationship between submissions made by 126 companies and 27 audit firms. No evidence of collusion between audit firm and client submissions.
Deakin (1989) "Rational Economic Behavior and Lobbying on Accounting Issues: Evidence from the Oil and Gas Industry"	FASB/SEC (US) 1976-78	DM and ED on Oil and Gas Accounting and SEC review of topic	Analysis of economic variables influencing corporate lobbying behavior. The likely effects of the proposal on a corporation's contracts and cash flows were associated with the decision to lobby.
Feroz and Hagerman (1990) "Management Compensation, Insider Trading and Lobbying Choice: The Case of R&D"	FASB (US) 1974	ED on R&D	Analysis of the relationship between economic variables, insider trading and lobbying positions of 69 corporations. Managers in accounting-based compensation schemes opposed the proposal and sold shares, whereas managers in market based schemes supported the proposal and bought shares.
Deegan, Morris, and Stokes (1990) "Audit Firm Lobbying on Proposed Disclosure Requirements"	AARF/NCSC (Australia) 1982-84	EDs on 6 topics and 13 disclosure proposals in NCSC Consultative Paper.	Analysis of the incentives for the submissions of 24 audit firms to AARF and the NCSC on 42 key issues. Auditors' lobbying preferences were influenced by the source of the regulatory proposals. Contrary to Puro (1984), audit firm size, audit firm technology, and the impact of proposals on the demand for audit services were not associated with lobbying positions.
McKee, Williams, and Frazier (1991) "A Case Study of Accounting Firm Lobbying: Advice or Consent"	FASB (US) 1984-85	ED on Accounting for Computer Software Costs	Analysis of the relationship between the lobbying positions of audit firms and clients. While the structure of the arguments was different, audit firms advocated the preferences of politically active clients.
Tandy and Wilburn (1992) "Constituent Participation in Standard Setting: The FASB's First 100 Statements"	FASB (US) 1974-88	97 EDs	Analysis of the participation rates of various constituent groups, the scope of EDs, and the operations of the EITF. Differences were evident in the absolute and relative participation rates of various constituent groups, ED scope affected response rates, and the establishment of the EITF did not affect the scope of EDs but increased participation rates.

NOTES

1. The term accounting rule is used to encompass all regulations governing financial reporting: including profession-sponsored accounting standards, corporate disclosure laws, and stock exchange listing requirements.

2. MacArthur (1988b, 60) notes that the decision of a standard setting body to not proceed with the development of an accounting rule may be evidence of "very effective lobbying."

3. Access to evidence of these forms of lobbying activity may be difficult. Cheshire and Feroz (1990, 127) suggest that interviews with key players and the analysis of personal diaries and notes of the decision makers may be a suitable method for gathering data on the rule-making process (and of lobbying behavior). This approach was employed by Gorton (1991) in an examination of the effect of lobbying activity on the FASB and SEC. However, such an approach risks generating ex post rationalisations of past events (Cheshire and Feroz 1990, 127).

4. Dyckman (1988, 7) notes that the SEC and FASB regularly consult with one another in a "condition of mutual 'nonsurprise'."

5. Dyckman (1988, 14) expresses concern about the level of lobbying activity directed towards the trustees of the FAF and comments that "...the indirect influence of financial standard setting is potentially substantial." Reports in the *Journal of Accountancy* (June 1989, 18; June 1990, 18) suggest that this influence is "real" rather than "potential."

REFERENCES

Amershi, A.H., J.S. Demski, and M.A. Wolfson. 1982. Strategic behavior and regulation research in accounting. *Journal of Accounting and Public Policy* (Fall): 190-95.

Bachrach, P., and M.S. Baratz. 1962 "The two faces of power. *American Political Science Review* (September): 947-52.

________. 1970. *Power and Poverty: Theory and Practice.* New York: Oxford University Press.

Benston, G.J. 1980. The establishment and enforcement of accounting standards: Methods benefits and costs. *Accounting and Business Research* (Winter): 51-60.

Beresford, D.R. 1981. Standard setting in trouble [again]. *Accounting Horizons* (June): 94-96.

Brown, P.R. 1981. "A descriptive analysis of select input bases of the Financial Accounting Standards Board. *Journal of Accounting Research* (Spring): 232-46.

________. 1982. "FASB responsiveness to corporate input. *Journal of Accounting, Auditing and Finance* (Summer): 282-90.

Carey, J.L. 1969. *The Rise of the Accounting Profession*, Vol. 1. New York: AICPA.

________. 1970. *The Rise of the Accounting Profession,* Vol. 2. New York: AICPA

Chatov, R. 1975. *Corporate Financial Reporting: Public or Private Control?* New York: The Free Press.

Cheshire, J.D. and E.H. Feroz. 1989. Alison's models and the FASB Statements No's 2, 5, 13 and 19. *Journal of Business Finance and Accounting* (Spring): 119-30.

Clegg, S.R. 1989. *Frameworks of Power.* Beverly Hills, CA: Sage.

Coombes, R.J., and D.J. Stokes. 1985. Standard-setters' responsiveness to submissions on exposure drafts: Australian evidence. *Australian Journal of Management* (December): 31-45.

Dahl, R.A. 1957. The concept of power. *Behavioral Science* 2: 201-05.

________. 1958. Critique of the ruling elite model. *American Political Science Review* 52: 463-69.

________. 1961. *Who Governs? Democracy and Power in an American City* New Haven, CT: Yale University Press.

Deakin, E.B. 1989. Rational economic behavior and lobbying on accounting issues: Evidence from the oil and gas industry. *The Accounting Review* (January): 137-51.

Deegan, C., R. Morris, and D. Stokes. 1990. Audit firm lobbying on proposed disclosure requirements. *Australian Journal of Management* (December): 261-80.

Dhaliwal, D.S. 1982. Some economic determinants of management lobbying for alternative methods of accounting: Evidence from the accounting for interest costs issue. *Journal of Business Finance and Accounting* (Summer): 255-65.

Dyckman, T.R. 1988. Credibility and the formulation of accounting standards under the Financial Accounting Standards Board. *Journal of Accounting Literature* 7: 1-30.

Feroz, E.H. 1987. Corporate demands and changes in GPLA. *Journal of Business and Finance and Accounting* (Autumn): 409-23.

Feroz, E.H., and R.L. Hagerman. 1990. Management compensation, insider trading and lobbying choice: The case of R&D. *Australian Journal of Management* (December) 297-314.

Gibson, R.W. 1981. "The public comment procedures in the setting of accounting standards. In *Essays in Honour of Trevor R Johnston,* ed. D.M. Emanuel and I.C. Stewart, 149-70. Auckland: University of Auckland and The New Zealand Society of Accountants.

Gorton, D.E. 1991. The SEC decision not to support FAS 19: A case study of the effect of lobbying on standard setting. *Accounting Horizons* (March): 29-41.

Griffin, P.A. 1982. Foreign exchange gains and losses: Impact on reported earnings. *Abacus* (June): 50-69.

________. 1983. Management's preferences for FASB Statement No. 52: Predictive ability results. *Abacus* (December): 130-38.

Haring J.R. 1979. Accounting rules and "the accounting establishment." *Journal of Business* (October): 507-19.

Hope, T,. and J. Briggs. 1982. Accounting policy making—some lessons from the deferred taxation debate. *Accounting and Business Research* (Spring): 83-96.

Hope, T., and R. Gray. 1982. Power and policy making: The development of an R&D standard. *Journal of Business Finance and Accounting* (Winter): 531-58.

Horngren, C.T. 1972. Accounting principles: Private or public sector. *Journal of Accountancy* (May): 37-41.

Howard, J.L. 1979. "Securities regulation: Structure and process. In *Proposals for a Securities Market Law for Canada,* Vol. 3. Consumer and Corporate Affairs, Canada, Minister of Supply and Services Canada.

Hussein, M.E. 1982. "The innovative process in financial accounting standard setting. *Accounting, Organizations and Society* 7 (1): 27-37

Hussein, M.E., and J.E. Ketz. 1980. Ruling elites of the FASB: A study of the Big Eight. *Journal of Accounting, Auditing and Finance* (Summer): 354-67.

Johnson, S.B., and W.F. Messier. 1982. The nature of accounting standards setting: An alternative explanation. *Journal of Accounting, Auditing and Finance* (Spring): 195-213.

Kelly, L. 1982. Corporate lobbying and changes in financing or operating activities in reaction to FAS No. 8. *Journal of Accounting and Public Policy* (Winter): 153-73.

________. 1985. "Corporate lobbying on FSA No. 8: Some further evidence. *Journal of Accounting Research* (Autumn): 619-32.

King, R.D., and T.B. O'Keefe. 1986. "Lobbying activities and insider trading. *The Accounting Review* (January): 76-90.

Kirk, D.J. 1981. Concepts, consensus, compromise and consequences: Their roles in standard setting. *Journal of Accountancy* (April): 83-6.

Lukes, S. 1974. *Power: A Radical Perspective.* New York: MacMillan.

MacArthur, J.B. 1988a. An analysis of the content of corporate submissions on proposed accounting standards in the UK. *Accounting and Business Research* (Summer): 213-26.

________. 1988. Some implications of auditors and client lobbying activities: A comparative analysis. *Accounting and Business Research* (Winter): 56-64.

McCraw, T.K. 1981. Regulation in America: A review article. In *The Development of SEC Accounting,* ed. G.J. Previts, 255-74. Reading, MA: Addison Wesley.

McEnroe, J.E., and L.A. Nikolai. 1983. Voting patterns of Big Eight representatives in setting accounting and auditing standards. *Journal of Business Research* (March): 77-89.

McKee, A.J., T.A. Bell, and J.R. Boatsman, 1984. Management preferences over accounting standards: A replication and additional test. *The Accounting Review* (October): 647-59.

McKee, A.J., P.F Williams, and K.B. Frazier. 1991. A case study of accounting firm lobbying: Advice or consent. *Critical Perspectives in Accounting* (September): 273-94.

Miller, P.B.W, and R. Redding. 1986. *The FASB: The People, The Process, and The Politics.* Homewood, IL: Irwin.

Mitnick, B.M. 1980. *The Political Economy of Regulation.* New York: Columbia University Press.

Moonitz, M. 1974. *Obtaining Agreement on Standards.* Sarasota, FL: American Accounting Association.

Moran, M., and G.J. Previts. 1984. The SEC and the profession, 1934-84: The realities of self regulation. *Journal of Accountancy* (July): 68-80.

Morris, R.D. 1986. Lobbying on proposed accounting standards. *The Chartered Accountant in Australia* (March): 46-51.

Newman, D.P. 1981a. An investigation of the distribution of power in the APB and FASB. *Journal of Accounting Research* (Spring): 247-62.

________. 1981b. The SEC's influence on accounting standards: The power of the veto. *Journal of Accounting Research* (Supplement): 134-56, 170-73.

Nobes, C.W. 1990. Cycles in standard setting and the case of British goodwill. Working paper, University of Reading, August.

Plott, C.R., and S. Sunder. 1981. A Synthesis. *Journal of Accounting Research* (Supplement): 227-39.

Puro, M. 1984. Audit firm lobbying before the Financial Accounting Standards Board: An empirical study. *Journal of Accounting Research.* (Autumn): 624-46.

________. 1985. Do large accounting firms collude in the standards-setting process. *Journal of Accounting, Auditing and Finance* (Spring): 165-77.

Rockness, H.O., and L.A. Nikolai. 1977. "An assessment of APB voting patterns. *Journal of Accounting Research* (Spring): 154-67.

Sampson, A.C. 1983. A regulators view of the FASB: The first 10 years and after. *Journal of Accountancy* (August): 45-56.

Selto, F.H., and H.D. Grove. 1982. Voting power indices and the setting of financial accounting standards: Extensions. *Journal of Accounting Research* (Autumn): 676-88.

________. 1983. The predictive power of the voting power indices: FASB voting on Statements of Financial Accounting Standards Nos. 45-69. *Journal of Accounting Research* (Autumn): 619-22.

Sutton, T.G. 1984 Lobbying of accounting standard-setting bodies in the UK and the USA: A downsian analysis. *Accounting, Organizations and Society* 9 (1): 81-95.

________. 1988. The proposed introduction of current cost accounting in the UK. *Journal of Accounting and Economics* 10 (2): 127-49.

Tandy, P.R., and N.L. Wilburn. 1992. Constituent participation in standard setting: The FASB's first 100 statements. *Accounting Horizons* (June): 47-58.

Walker, R.G. 1986. Accounting standards: Text and context. Paper presented at the New Frontiers in Accounting Education in South East Asian Universities Conference, Singapore, April.

________. 1987. Australia's ASRB—A case study of political activity and regulatory "capture." *Accounting and Business Research* (Summer): 269-86.

Watts, R.L. and J. Zimmerman. 1981. Auditors and the determination of accounting standards. Working Paper, University of Rochester.

________. 1978. Towards a positive theory of the determination of the accounting standards. *The Accounting Review* (January): 112-34.

Zeff, S.A. 1972. *Forging Accounting Principles in Five Countries.* Stipes.

________. 1984. Some junctions in the evolution of the process of establishing accounting standards. *The Accounting Review* (July): 447-68.

________. 1986. Big Eight firms and the accounting literature: The falloff in advocacy writing. *Journal of Accounting Auditing and Finance* (Spring): 131-54.

LOCAL GOVERNMENT AUDIT QUALITY AND THE ANALYST REACTION TO BOND RATING CHANGES

Arthur C. Allen

ABSTRACT

This paper investigates some effects of differences in local government audit quality. Audit quality was hypothesized to decrease the bond analyst reaction to bond rating changes. Two proxies for audit quality were used in this study: auditor firm size and audit fees. In order to control factors which affect audit fees but do not affect audit quality, audit quality was measured as the residual of a regression equation in which auditee size, risk, complexity, and busy season were regressed on actual audit fees. In separate regressions, each measure of audit quality was regressed on a measure of the analyst reaction to bond rating changes. The results of this paper found no evidence that auditor firm size is associated with the analyst reaction to bond rating changes.

Research in Accounting Regulation, Volume 7, pages 41-60.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

Audit fees do appear to be associated with the analyst reaction to bond rating changes. Therefore, this study found support for the contention that audit quality differentials, as proxied by audit fees but not auditor firm size, affect user decisions. Although there is a substantial body of research investigating audit quality issues, this study is one of the first to investigate whether audit quality differentials have an impact on user decisions. Regulators of local government financial reporting (e.g., state legislatures) need to understand the linkage between audit quality and user decisions.

Accounting information is widely believed to be useful in assessing the cash flows of organizations (e.g., Beaver 1981), and therefore, is valuable to investors and creditors. Material errors or omissions in accounting information diminish its value in assessing cash flows. Audits are demanded to reduce the probability of undetected material errors (Simunic and Stein 1986). The higher the audit quality, the smaller the probability of material errors. Therefore, audit quality is a potentially important attribute of the usefulness of accounting information.

Several studies have examined whether audit quality differentials exist in the corporate sector (e.g., Francis 1984; Palmrose 1986, 1988) and in the local government sector (Baber et al. 1987; Rubin 1988; Copley 1989). Most of these studies found evidence that audit quality differentials exist.[1] These studies focused on whether audit quality differentials exist rather than what effects audit quality differentials have on users of accounting information. Little research has investigated whether audit quality differentials are large enough to make a difference to accounting information users. This study is expected to provide insight about the benefits of improved audit quality to local government regulators, officials, and municipal bond investors.

The federal government provides over $100 billion annually to local governments (U.S. General Accounting Office 1986). Local governments must comply with federal rules and guidelines when spending federal monies. Failure to comply with federal guidelines can result in the suspension of future aid or even the revocation of past aid. States also provide substantial financial assistance to local governments. To aid in providing accountability for state and federal

monies, auditors must issue a written report on internal controls and give an opinion on legal compliance. The scope of Governmental Auditing Standards (GAS) is greater than Generally Accepted Auditing Standards in that additional significance is placed on internal controls and legal compliance. Because audits are the primary tool used to determine legal compliance, audit quality is a potentially important attribute to regulators. However, prior research has found evidence of poor quality local government audits, especially with smaller auditors (U.S. General Accounting Office 1986). State governments have the authority to legislate financial reporting practices of local governments including audit procurement practices. Regulators of local governments have to decide whether the benefits of improved audit quality will offset the cost.

The dollar value of bonds issued by state and local governments exceeds that issued by corporations.[2] Financial information is used by raters and bond market participants to assess bonds' default risk. As evidenced by the substantial yield differences between bonds with different ratings, default risk is an important attribute in the pricing of local government bonds. Audits are a potentially important factor in the quality of financial information. Therefore, both bond investors and bond issuers are expected to be affected by the quality of the audit. This study investigates whether audit quality differentials are related to the decisions of one user group, bond analysts. Local government regulators, officials, and investors will benefit by understanding the linkage between audit quality and analyst decisions. This study will also provide evidence on the extent to which accounting information is used directly by bond investors. While interviews with bond investors suggest that they directly utilize accounting information (e.g., Peterson 1985; Robbins and Austin 1986), Ingram et al. (1989) were unable to find that the local government bond analysts[3] react to the release of accounting information.

The next section reviews prior research which has suggested two proxies for audit quality. The second section develops the empirically testable hypothesis. The third section discusses the sample and presents the methods to test the hypothesis. The fourth section presents the results while the final section provides a summary and conclusions.

PRIOR RESEARCH ON AUDIT QUALITY PROXIES

Prior research investigating audit quality has suggested two proxies for audit quality; audit firm size and audit fees. Both of these audit quality proxies will be used in this study. The demand for audit services gives rise to the relationship between audit fees and audit quality.[4] For a given entity, as the level of audit services (i.e., audit quality) increases (because of increased demand), the costs of supplying those services also increase. Since the market for audit services is competitive (Dopuch and Simunic 1980), the cost of high quality audits is likely to be passed on to consumers in the form of higher audit fees. Therefore, differences in the relative level of audit fees provide evidence of quality differentials.

Several studies have documented a link between audit fees and auditor firm size as measured by Big 8 firms (Baber et al. 1987; Copley 1989; Francis 1984; Francis and Stokes 1986; Francis and Simon 1987; Palmrose 1986). These studies argue that audit fee differences between audit firms is evidence of product differentiation (i.e., differences in audit quality). Other approaches have been used to examine the link between auditor size and audit quality. For example, DeAngelo (1981) employed a deductive analysis while Palmrose (1988) examined litigation frequency and success rate to show a link between audit quality and auditor firm size. Only two proxies for audit quality, audit firm size, and audit fees have been suggested by prior research which are available for use. This study will employ both audit fees and audit firm size (Big 8 vs. other independent Certified Professional Accountants [CPAs] to proxy for audit quality.

HYPOTHESIS

The economic transactions of a local government that are recorded by its accounting system are presumed to be relevant information to creditors in assessing that local government's default risk.[5] Errors reduce the amount of information retained by the accounting system. Audit quality is defined as the freedom from material error in the audited financial information.[6] Therefore, audit quality is positively related to the usefulness of that information in assessing local

government default risk. To the extent that financial data are important cues to the level of default risk, and audit quality is an important determinant of the amount of material error in those financial data, audit quality is positively related to the level of investor knowledge about default risk.

Investor knowledge about default risk is proxied by the analyst reaction to bond rating changes. Because bond raters possess information that is not publicly available (Sherwood 1976), raters are able to make accurate assessments of default risk even when the accounting information contains material errors. However, bond raters are sometimes slow to act when default risk changes (Sherwood 1976). Therefore, local government bond investors have incentives to assess default risk independently of ratings. Ingram et al. (1989) found that the variance of municipal bond returns increases with bond rating decisions while Marks et al. (1989) found that the level of prices do not change in response to rating changes. Taken together, the results of prior studies suggest that analysts partially, but not fully, anticipate ratings changes.[7] This study hypothesizes that audit quality, by increasing the level of available information about default risk, increases the analyst anticipation (i.e., decreases the analyst reaction) of bond rating changes. Specifically, the hypothesis to be tested is as follows:

> The higher the local government audit quality, the smaller the analyst reaction will be to bond rating change announcements, ceteris paribus.

If the above hypothesis is supported by the empirical tests, this implies that audit quality affects the usefulness of the audited financial data in assessing default risk. If the above hypothesis is not supported by the empirical tests, this implies either that financial data are not important cues to analysts concerning default risk, or that audit quality does not materially affect the usefulness of that financial data in assessing default risk.

METHODS

Sample

This study used a more comprehensive local government bond price data base than did most previous studies. The data were

obtained from Interactive Data Services, a security pricing service. IDS data are created from a proprietary matrix modeling system; the data may then be subjectively adjusted by IDS analysts. IDS analysts use actual prices primarily to evaluate the validity of the model prices and to adjust the model. Although actual prices may be used to adjust the model prices, IDS prices are primarily the result of the matrix model and analyst input.[8] These data are sold to institutional investors and are intended to reflect potential exchange prices between institutional investors.[9] The IDS data have the advantage of providing a large number of bonds with a relatively homogeneous set of features. However, a limitation of this study is that analysts' matrix prices rather than actual exchange prices are used to measure the analyst reaction to rating changes.[10]

The data base includes 395 local governments with a population of 20,000 or more that have noncallable general obligation bonds outstanding. Bond price data for these local governments were available from January 1978 through September 1987. For this sample, 224 Moody's rating changes occurred in the time period under study. Therefore, the maximum possible sample size would be 224. However, missing data reduced the sample size in the statistical tests as reported below. Also, observations with auditors other than independent CPAs (e.g., state) were excluded from the sample.

Research Design

Regression analysis is used to test the hypothesis. The dependent variable in the regression is a measure of the analyst reaction to bond rating changes. This measure will be discussed in the next section. The independent variables in the regression models include the two proxies for audit quality: *BIG 8,* a dichotomous variable, and audit *FEES,* a continuous variable. The *BIG 8* variable was coded one if the auditor was a *BIG 8* firm, and zero if a non-Big 8 public accounting firm.

Beatty (1989) argued that the demand for quality audits would vary across auditees, and that this differential demand would be captured by audit fees. Beatty built a measure of audit quality by regressing factors affecting audit cost on audit fees; the residuals of this regression were used as a measure of audit quality in subsequent regressions. Copley (1991) employed a similar technique to build a

measure of audit quality for local governments. Copley (1991) used prior local government audit fees studies (Baber et al. 1987; Rubin 1988; Copley 1989) as a theoretical and empirical basis to develop a model of audit fees for the purpose of constructing a measure of audit quality. All variables, except *BIG 8* auditor, common to the three studies were used to control for nonquality factors. *BIG 8* was not used because this variable represents auditor quality.

This study uses the measure of audit quality developed by Copley. Specifically, *FEES* is defined as the residual (predicted fees minus actual fees) of an OLS regression model in which the natural log of audit fees is used as the dependent variable; the independent variables are the natural log of client (city) population, number of client services,[11] long-term debt per capita, a dummy variable coded 1 if the Moody's rating is below A and 0 otherwise, and a dummy variable coded one if the city's fiscal year-end is in the busy season (defined as being between October 30 and February 28) and zero otherwise.[12] The model of audit fees is significant with an R^2 of .5915 ($N = 262$) and an overall F- statistic of 74.128 ($p = .0001$).[13]

In addition to the audit quality proxies, an additional variable is included in the regression to control the level of disclosures contained in annual reports. The level of disclosures is represented in the model by a variable set to one if the city has been awarded the Certificate of Conformance (*CC*)[14] by the Government Finance Officers Association (GFOA). The disclosures required by the GFOA reflect their concern for disclosures relevant to creditors. The level of disclosures is expected to be negatively associated with the bond analyst reaction to bond rating changes because the increased information may be used by investors to better assess default risk, thereby reducing the new information brought to analysts by bond rating changes. Not only is the CC variable expected to reduce the analyst reaction to bond rating changes, but CC also is expected to be related to audit quality for two reasons. First, a higher quality audit is likely to result in the disclosure of additional information (increasing the disclosure variables). Also, managers of high quality accounting systems, those awarded the CC, have incentives to choose high quality auditors to signal the bond market.

Table A.1 (see Appendix) contains a correlation matrix of all the independent variables in the regression models including a variable (*CHANGE*) which indicates the direction of bond rating changes. *CHANGE* is included in the regression models to control for any

differential analyst reaction to bond rating upgrades or downgrades. The direction of bond rating changes is significantly correlated with the Certificate of Conformance variable. The type of auditor is not significantly correlated with any other independent variable including audit *FEES* ($p = .1647$). Audit *FEES* is marginally correlated with the Certificate of Conformance variable ($p = .0897$), as well as bond rating changes ($p = .0818$). Interestingly, the direction of the correlation is negative in both cases.

The research design can be summarized as follows. A measure of the analyst reaction to bond rating changes will be regressed on each measure of audit quality, *BIG 8* firms and audit FEES, along with control variables. Separate regressions will be run so that the two measures of audit quality do not enter the same model. Both measures of audit quality are expected to be negatively associated with the analyst reaction to bond rating changes. Therefore, if the regression coefficients for the measures of audit quality are negative and statistically significant, then such results indicate support for the research hypothesis stated earlier. The next section describes the measure of the analyst reaction to bond rating changes.

Measuring Analysts Reaction

To measure the bond analyst reaction to bond rating changes, this study utilized the standardized squared residuals (SSR) approach. The SSR approach was first employed by Beaver (1968) to assess the reaction to corporate earnings releases. Patell (1976) further refined the properties of the SSR metric for measuring price reaction to events. SSRs are a measure of relative price variability.[15]

To determine the SSR, simple market model regressions were estimated for all bonds that had a bond rating change. These regressions used all available monthly returns in the data base except the months during the 9-month prediction window.[16] The 9-month prediction window includes the month of the rating change, as well as four months prior and four months subsequent to the rating change. The regression parameters were used to predict monthly returns during the 9-month window. The prediction errors (residual returns) then were standardized to form the standardized squared residuals (SSR) as described in Patell (1976). The Appendix contains the technical development of the SSR.

RESULTS

This section is hereafter developed into two subsections. The first subsection discusses the results for the regression model which uses *BIG 8* auditors as the proxy for audit quality. The second subsection discusses the results for the regression models which use audit *FEES* as the proxy for audit quality.

BIG 8 Auditors

Although 224 rating changes occurred for the sampled bonds for which return data were available, only 173 observations were available after deleting data points which were missing one or more of the three independent variables.[17] Initial regression models revealed that the residuals were not normally distributed. To correct this problem, natural log of U_{it}, LU_{it}, was used as the dependent variable in all the reported regression models. Table A.2 reports the results of the regression model in which audit quality is proxied by *BIG 8* auditors.[18] Because the expected direction of the relationships has been hypothesized, one-tailed probability values for audit *FEES* and *BIG 8* are reported in Tables A.2 and A.3. The *BIG 8* variable was insignificant ($p = .9483$) and exhibited the wrong sign. Therefore, when Big 8 auditors are used to proxy for audit quality, this study is unable to find that audit quality is associated with the analyst reaction to bond rating changes. The *RATING CHANGE* and *CC* variables were also statistically insignificant (see Table A.2).

Audit *FEES*

Unlike the type of auditor, audit fees are not generally publicly available. The collection of audit fees for this study was gathered through a mail survey for the year 1985. Results reported in Baber et al. (1987) indicate that audit fees paid by counties do not change greatly from year to year. Despite the relative stability of local government audit fees, extrapolating audit fees over the entire 1978-1987 sample would add substantial noise to the data and reduce the statistical significance of the audit *FEES* variable. Therefore, when the audit *FEES* variable was used to proxy audit quality, the sample was restricted to the period 1983-1987.[19]

Table A.3 reports the results of the regression model in which audit quality is proxied by the *FEES* variable. The audit *FEES* variable is significant ($p = .0292$). This result is consistent with the expectation that audit quality, as proxied by *FEES,* is negatively associated with the analyst reaction to bond rating changes. In the audit *FEES* model, the Certificate of Conformance variable is significant ($p = .0124$). This result is consistent with the expectation that the quality of financial statements, as proxied by the Certificate of Conformance, is negatively associated with the analyst reaction to bond rating changes.

However, the results of the Certificate of Conformance variable are not consistent between the *BIG 8* and audit *FEES* models. This inconsistency is likely a result of the difference in time periods covered by the *BIG 8* and audit *FEES* models. The *BIG 8* model samples bond rating changes over the period 1978-1987 while the time period of the audit *FEES* model is restricted to 1983-1987. When the *BIG 8* model is run over the period 1983-1987, the CC variable and the model are quite significant. Therefore, the inconsistency of the significance level of the Certificate of Conformance variable is not a result of substituting the variable audit *FEES* for the variable *BIG 8*.

SUMMARY AND CONCLUSIONS

Prior research has found evidence of poor quality local government audits (Berry et al. 1987; U.S. General Accounting Office 1986). Prior audit quality research has focused on documenting the existence of audit quality differentials, primarily by documenting that *BIG 8* firms charge higher fees. This study provided an examination of the effects of audit quality in the local government sector. Audit quality was hypothesized to decrease the analyst reaction to bond rating changes. Two proxies for audit quality were used, *BIG 8* auditor and audit *FEES*.

The empirical results found no association between Big 8 auditors and the analyst reaction to bond rating changes. The lack of support for the *BIG 8* variable is consistent with a brand name effect rather than audit quality differentials.[20] Audit *FEES* were significantly negatively associated with the analyst reaction to bond rating changes. The support for audit *FEES* as a proxy for audit quality found by this study is consistent with previous theoretical research

(DeAngelo 1981; Dopuch and Simunic 1982), as well as prior empirical research (e.g., Francis 1984; Francis and Stokes 1986; Francis and Simon 1987; Palmrose 1986, 1988; Copley 1989) which provided support for the existence of audit quality differentials. This study not only found evidence of the existence of an audit quality differentials, but also provided evidence that audit quality differentials are related to user decisions.

This study found mixed support for a relationship between the GFOA's Certificate of Conformance awards and the analyst reaction to bond rating changes; such a relationship implies that bond investors are better informed, relative to bond raters, when the financial statements meet the GFOA's standards for excellence. The Certificate of Conformance variable was significantly negatively associated with the analyst reaction to rating changes in the *FEES* model but not in the *BIG 8* model. The limited empirical support for the relationship between the quality of financial statements and analyst behavior provides evidence that accounting information is used by bond investors.

The major limitations of this research were the proxies for audit quality used (*BIG 8* and *FEES*) and the source of the bond price data. The variable *FEES*, developed by Copley (1991), represented the residuals of a regression model in which several control variables (e.g., SIZE) were regressed on audit fees. Because audit fees can not be predicted with complete accuracy, residuals of any audit fees model may capture omitted variables as well as audit quality. The data were obtained from Interactive Data Services, a security pricing service. These prices are based upon a proprietary model of individual bond prices that are adjusted by analysts who monitor actual prices.

The results of this study should be of interest to local government officials, who decide the level of audit services to be purchased, and local government bond investors, who assess the reliability of accounting information as part of their assessments of default risk. In addition, this study provides insight into the extent to which local government investors directly use accounting information. By providing some evidence that audit *FEES* reduce the analyst reaction to bond rating changes, this study provided evidence that accounting information is being used by bond market participants.

APPENDIX

Variables used in the analysis are defined as follows:

$$u_{it} = R_{it} - (\alpha + \beta_{mt}), \tag{1}$$

where u_{it} is the prediction error for bond i for month t, R_{it} is the holding period return for bond i in month t, R_{mt} is the holding period return for the market index,[21] and α and β are the simple market model regression parameters estimated from returns outside the prediction window. Holding period returns were defined as in Ingram (1985):

$$R_{it} = \ln \{[P_{it} + I_{it}] \; / \; [P_{i(t-1)}]\}, \tag{2}$$

where P_{it} and $P_{i(t-1)}$ are the prices for bond i in months t and t-1, and I_{it} is the coupon interest earned by bond i during month t. The standardized squared prediction error for bond i in month t was defined as:

$$U_{it} = \{[u_{it}^2 \; / \; (C_{it} * s_i^2)]\} * [(T_i - 4)/(T_i - 2)], \text{ where} \tag{3}$$

$$C_{it} = 1 + 1/T_i + \{[R_{mt} - R_m]^2 \; / \; [\sum_{t=1}^{T} (R_{mt} - R_m)^2]\}. \tag{4}$$

"C_{it} reflects the increase in variance due to prediction outside the estimation period" (Patell 1976). T_i is the number of returns outside the prediction window for bond i, and s_i^2 is the mean of the squared residuals for bond i in the simple market model regressions.

U_{it} was the measure used for the analyst reaction to bond rating changes in this study. Table A.4 shows the mean U_{it} for each month in the 9-month window, where month -1 is the month prior to the bond rating change, month 0 is the month of the rating change, and so on. The expected value of U_{it} under the null hypothesis is one. The Z-statistic reported adjacent to the U_{it} tests for increased price variability in that month relative to the months outside the 9-month prediction window. The results support previous findings that analysts do react to rating changes. As shown in Table A.4, the results are consistent across bonds with upgraded and downgraded ratings.

Table A.1. Correlation Matrix of all Independent Variables in the Regression Models

	CC	*RATING CHANGE*	*BIG 8*	*FEES*
CC	1.0			
	—			
RATING	.2580	1.0		
CHANGE	(.0006)	—		
BIG 8	.1023	.0592	1.0	
	(.1807)	(.4394)	—	
FEES	−.2830	−.2899	.1649	1.0
	(.0897)	(.0818)	(.1647)	—

The numbers in parenthesis are the two-tailed significance levels except for the significance level of *BIG 8* vs. *FEES* which is one-tailed. The sample size is 173 for all correlations except those with the *FEES* variable which have a sample size of 37.

CC was coded as a 1 if the local government was awarded the Government Finance Officers Association's Certificate of Conformance award for the most recent set of financial statements prior to the rating change, and 0 otherwise.

RATING CHANGE was coded as a 1 if the rating change was an upgrade. If the rating change was a downgrade, then the *RATING CHANGE* variable was coded as a 0.

BIG 8 was coded as a 1 if the local government used one of the *BIG 8* accounting firms, and 0 otherwise.

FEES is defined as the residual (predicted fees minus actual fees) of an OLS regression model in which the natural log of audit fees is used as the dependent variable; the independent variables are the natural log of client (city) population, number of client services, long-term debt per capita, a dummy variable coded 1 if the Moody's rating is below A and 0 otherwise, and a dummy variable coded 1 if the city's fiscal year-end is in the busy season (defined as being between October 30 and February 28) and 0 otherwise.

Table A.2. Regression Results for LU_{it} on *BIG 8* ($N = 173$)

Variable	*Coefficient*	*t-statistic*	*P-Value*
INTERCEPT	−1.086	−3.285	0.0012
GFOA's CC	−0.197	−0.435	0.2656
Rating Change	−0.111	−0.267	0.3341
Big 8	0.052	0.128	0.9483
	Overall $F = 0.115$	$R^2 =$ .0020	
	p-value = 0.951	Adj. R^2 = -.0157	

The dependent variable was the natural log of the standardized squared residual for the month of the rating change. For a description of the independent variables, see Table A.1. p-values are for one-tailed tests except for the *INTERCEPT* and the *RATING CHANGE* variable.

Table A.3. Regression Results for LU_{it} on *FEES* ($N = 37$)

Variable	*Coefficient*	*t-statistic*	*p-Value*
INTERCEPT	1.394	1.179	0.2467
GFOA's CC	−2.346	−2.352	0.0124
RATING CHANGE	−1.742	−1.668	0.0524
Audit *FEES*	−1.173	−1.960	0.0292
	Overall $F = 4.322$	$R^2 = .2821$	
	p-value = .011	Adj. $R^2 = -.2168$	

The dependent variable was the natural log of the standardized squared residual for the month of the rating change. For a description of the independent variables, see Table A.1. p-values are for one-tailed tests except for the *INTERCEPT* and the *RATING CHANGE* variable.

Table A.4 Test of Bond Analyst Reaction to Bond Rating Changes

	All Rating Change Decisions ($n = 224$)		*Bond Rating Upgrades* ($n = 103$)		*Bond Rating Downgrades* ($n = 121$)	
Month	U_{it} *Mean*	*Z-Statistic*	U_{it} *Mean*	Z-Statistic	U_{it} *Mean*	Z-Statistic
−4	1.268	0.97	0.883	−0.78	1.588	1.20
−3	1.308	0.79	0.913	−0.48	1.641	0.91
−2	1.167	0.76	0.930	−0.41	1.370	0.97
−1	1.558	1.59*	1.386	1.01	1.703	1.25
0	2.794	4.21**	2.266	2.58**	3.241	3.35**
+1	1.168	0.79	0.742	−2.17	1.529	1.39*
+2	1.335	1.23	1.190	0.66	1.456	1.04
+3	1.117	0.42	0.667	−3.41	1.486	0.98
+4	1.135	0.58	0.756	−2.23	1.436	1.08

Significance Levels for One-Tailed Tests: * $p < .10$; ** $p < .01$.

ACKNOWLEDGMENTS

I wish to thank my dissertation committee at the University of Alabama for their guidance during the writing of the dissertation upon which this paper is based: Rob Ingram (Chairman), Barney Cargile, Mike Dugan, Benton Gup, and John Rasp. I also wish to thank the University of Nebraska-Lincoln workshop participants and two anonymous reviewers for their valuable comments on this paper.

NOTES

1. Most of the studies that documented audit quality differentials have used differential audit fees as evidence that audit quality differentials exist. Other evidence that has been gathered to show the existence of audit quality differentials include deductive analysis (DeAngelo 1981), litigation frequency and success (Palmrose 1988), and the belief by Big 8 auditors that premature signoff is less likely to occur than other auditors (Margheim and Pany 1986).

2. For example, the Federal Reserve Bulletin reports that the net borrowing of state and local obligations was 44.2 and 53.7 billion for 1982 and 1983, respectively, while the net borrowing for corporate and foreign bonds was 37.8 and 31.2 billion during 1982 and 1983, respectively.

3. The term "analysts" rather than "market" is used in this study because the source of the bond prices used, Interactive Data Services prices, do not represent actual trade prices but rather reflect the judgements of analysts (who closely monitor the market). IDS data have been used in several prior studies (Ingram and Copeland 1984; Ingram 1985; Hefzi et al. 1988; Ingram et al. 1989; Marks et al. 1989; Raman and Wilson 1990). See the Sample Selection section of this study for a further discussion of IDS data.

4. In the corporate sector, the demand for auditing services stems primarily from the desire to reduce agency costs (Jensen and Meckling 1976). These costs arise because of conflicts of interest between principals (owners) and agents (managers). Monitoring also is important in the local government sector because of conflicts of interest between principals and agents (Wallace 1986). In the local government sector, elected officials are agents, while voters and bondholders are the principles. Elected officials have incentives to satisfy the wishes of voters at the expense of bondholders. Officials and administrators also may wish to consume perquisites which are not in the best interests of bondholders. By monitoring accounting information upon which bondholder contracts are based, auditing is one mechanism that helps limit agents' actions which diverge from their principals' interests. The level of auditing services required for monitoring purposes depends upon the incentives of officials and institutional arrangements. Other sources of demand for auditing services include using the audit as an information source (resulting in improved efficiency) and using the audit for insurance purposes (Wallace 1980, 1986).

5. Empirical research has confirmed that accounting information provides information useful in assessing local government default risk. See Chan and Picur (1986) or Ingram et al. (1987) for a comprehensive review of governmental accounting research.

6. This definition of audit quality is consistent with those used by prior researchers. For example, DeAngelo (1981) defined audit quality as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach," while Palmrose (1988) defined audit quality as "the probability financial statements contain no material omissions or misstatements."

7. Because Ingram et al. (1989) and Marks et al. (1989) used the same type of data (IDS prices), the difference in their results was not likely to have been driven by their data bases. The current study also used IDS prices.

8. Because the IDS estimation procedures are proprietary, only general descriptions of these procedures are available. The following descriptions were taken from IDS (1982, p. 1):

> Interactive Data Services, Inc. reviews market conditions daily primarily through daily trader contact. Secondary sources are also utilized such as the Daily Bond Buyer, Moody's and S&P publications and the Chapdelaine C-Wire. We take into account quality ratings, market performance, call features, geographic or local situations, special types (i.e. Dollar bonds, defaults), as well as other factors (bid vs. offer-discounts vs. premium) in order to arrive at a consistently high quality evaluation service that is a reflection of current or past market.
>
> In addition to its own personnel Interactive Data utilizes the services of Mr. Wilson White, author of White's Tax Exempt Bond Market Ratings, as an exclusive consultant on municipal matters.
>
> As the Official evaluator for a number of open-end and closed-end municipal bond funds, IDSI obtains a considerable amount of market input which is also utilized in the matrix. A major source of such market data is MUNI/NET, Interactive's network of fifteen well-known brokerage firms throughout the United States, which provides input concerning the municipalities in the respective areas of the participating brokers.

9. Nunn et al. (1986) analyzed a similar institutional pricing data set for corporate bonds and compared the institutional pricing data to odd-lot exchange prices. Nunn et al. (1986) found that the institutional prices have dramatically higher R^2 estimates and much lower standard deviation estimates than oddlot exchange prices. Ingram and Copeland (1984), Ingram (1985), and Hefzi et al. (1988) have analyzed municipal bond prices from Interactive Data Services. In all three studies, the bond prices behaved as would be expected of a measure of default risk, no anomalous characteristics of the data were detected, and the authors concluded that the data have considerable potential for research. Ingram et al. (1989) and Marks et al. (1989) used the IDS data to examine the analyst reaction to rating changes and decisions. Ingram et al. found that the variance of bond price returns increased after rating decisions, but Marks et al. found that the level of prices do not change after rating changes. Taken together, the results of prior studies suggest that analysts (the IDS prices) anticipate rating changes, on average, but sometimes anticipate the rating to change by a larger or smaller margin than the actual change. The IDS price reaction to rating changes does not appear to be an artifact of the matrix pricing method.

10. A large sample of local government bonds with actual prices over time is unavailable, and where actual price data is available infrequent trading prevents use of daily prices. Until such a data base is available, research which requires a large sample of local government bonds over time is forced to rely on matrix prices.

11. This variable has a range of 0 to 9 and is defined as the number of the following services provided by the client (city): air traffic, corrections, education, health services, hospitals, electricity, gas, transit, and water.

12. Because *FEES* is the residual of an OLS regression model, it has a mean of zero. *FEES* is intended to represent the relative (not absolute) level of audit fees after controlling for nonquality factors. High values for *FEES* represents high levels of audit fees for that level of client size, number of services, long-term debt per capita, low bond rating, and busy season.

13. Copley's findings were consistent with the audit fee model's residuals being an effective measure of audit quality. Deis and Giroux (1992) found a strong positive correlation between Copley's measure of audit quality and a measure of audit quality based on quality control reviews. Beatty's (1989) findings in the corporate sector were also consistent with an audit fee model's residuals being an effective measure of audit quality. However, because audit fees can not be predicted with complete accuracy, residuals of any audit fees model may capture omitted variables as well as audit quality. Therefore, the results with respect to *FEES* should be interpreted cautiously.

14. Since 1984, the Municipal Finance Officers Association has been known as the Government Finance Officers Association (GFOA). Since January 1986, the GFOA has awarded the Certificate of Excellence in Financial Reporting rather than the Certificate of Conformance. The names "Municipal Finance Officers Association" and "Certificate of Conformance" are used here because the time period covered by the sample relates more closely to the time period in which these names were in use.

15. Ohlson (1979) theorizes that price variability measures the incremental information of a particular information item (e.g., a bond rating change) because the price variability associated with the release of an information item is an inverse function of the frequency of other relevant disclosures. Empirical support for Ohlson's theory is provided by McNichols and Manegold (1983) who found that corporate stock price variability after the release of annual reports is larger when there are no quarterly financial reports. Because the interest of this study is the amount, rather than the directional impact, of information transferred to analysts by rating changes, a price variability approach (SSRs) will be used to assess the analyst reaction to rating changes.

16. In addition, the regressions were rerun using only data from the prior 36 months and subsequent 24 months to the prediction window. Because the results using the reduced estimation period were essentially identical to the results using all available months, only the latter are reported.

17. Of the 173 observations, 83 were associated with Big 8 auditors; the mean population was 217,011.

18. In order to determine whether qualified audit opinions contaminated the results, the regressions were also run after deleting observations that received qualified opinions. The results of the regression analysis were not sensitive to the deletion of observations with qualified opinions regardless of how qualified opinions were defined. A clean audit opinion was alternatively defined as: (1) only opinions based on GAAP audits which found no GAAP violations, litigation problems, consistency exceptions, scope limitations, or any other unusual qualifications noted by the auditor in the opinion; (2) same definition as #1, but with consistency exceptions included; (3) same definition as #2, but with inadequate fixed asset reporting included; (4) same definition as #3, but with litigation problems included; (5) same definition as #4, but with scope limitations included.

19. Ideally, only bond rating changes would be included in the model from 1985, the year audit fees were measured. However, such an analysis would yield an unusably small sample size. In order to gain a sufficient sample, audit fees must be extrapolated to other time periods. The farther in time audit fees are extrapolated, the larger the sample, but the greater the measurement problem. The exact time period chosen, 1983-1987 reflected a necessary trade-off between sample size and measurement problems. Using data from only 1984-1986 results in only 24 observations; the audit FEES variable is marginally significant in this model with a significance level of .0996.

20. A brand name effect implies that Big 8 auditors charge higher fees because they possess a brand name rather than offering higher quality. See Francis and Wilson (1988) for a discussion of the difference between the brand name effect and audit quality.

21. The market index was computed as the unweighted average holding period return for month t for all 395 local governments for which data were available.

REFERENCES

Baber, W., E. Brooks, and W. Ricks. 1987. An empirical investigation of the market for audit services in the public sector. *Journal of Accounting Research* (Autumn): 293-305.

Beatty, R. P. 1989. Auditor reputation and the pricing of initial public offerings. *The Accounting Review* (October): 693-709.

Beaver, W. H.. 1968. The information content of annual earnings announcements. *Journal of Accounting Research* (Supplement): 67-92.

________. 1981. Market efficiency. *The Accounting Review* (January): 23-37.

Berry, L.E., G.B. Harwood, and J.L. Katz. 1987. Performance of auditing procedures by governmental auditors: Some preliminary evidence. *The Accounting Review* (January): 14-28.

Chan, J.L., and R.D. Picur. 1986. Advances in governmental accounting: A review of research and policy. In *Advances in Accounting*, Vol. 3, ed. B.N. Schwartz, 181-220. Greeenwich, CT: JAI Press.

Copley, P. 1989. The determinants of local government audit fees: Additional evidence. In *Research in Governmental and Nonprofit Accounting*, Vol. 5, ed. J.L. Chan, 3-23. Greenwich, CT: JAI Press.

________. 1991. The association between municipal disclosure practices and audit quality. *Journal of Accounting and Public Policy*: 245-266.

DeAngelo, L.E., Auditor size and audit quality. *Journal of Accounting and Economics* (December): 183-199.

Deis, D.R., and G.A. Giroux. 1992. Determinants of audit fees and audit hours using a direct audit quality measure," Paper presented at the American Accounting Association's Annual Conference.

Dopuch, N., and D. Simunic. 1980. The nature of competition in the auditing profession: A descriptive and normative view. In *Regulation and the Accounting Profession,* ed. J.W. Buckley and J.F. Weston, 77-94. Wadsworth.

________. 1982. Competition in auditing: An assessment. In *Symposium on Auditing Research IV*, 401-50. University of Illinois Press.

Francis, J.R. 1984. The Effect of Audit Firm Size on Audit Prices. *Journal of Accounting and Economics* (August): 131-151.

Francis, J.R., and D.T. Simon. 1987. A test of audit pricing in the small-client segment of the U.S. market. *The Accounting Review* (January): 145-157.

Francis, J.R., and D.J. Stokes. 1986. Audit prices, product differentiation and scale economies: Further evidence from the Australian market. *Journal of Accounting Research* (Autumn): 383-93.

Hefzi, H., A.J. Ifflander, and D.B. Smith. 1988. Municipal bond market risk measures and bond ratings. In *Advances in Accounting,* Vol. 6, ed. B.N. Schwartz, 111-26. Greenwich, CT: JAI Press.

Ingram, R.W. 1985. A descriptive analysis of municipal bond price data for use in accounting research. *Journal of Accounting Research* (Autumn): 595-618.

Ingram, R.W., and R. Copeland. 1984. The association between accounting numbers and market risk on municipal bonds. In *Advances in Accounting,* Vol. 4, ed. B.N. Swartz, 19-40. Greenwich, CT: JAI Press.

Ingram, R.W., K.K. Raman, and E.R. Wilson. 1987. Governmental capital markets research in accounting: A review. In *Research in Governmental and Nonprofit Accounting,* Vol. 3, Part B, ed. J.L. Chan, 111-126. Greenwich, CT: JAI Press.

________. 1989. The information in governmental annual reports: A contemporaneous price reaction approach. *The Accounting Review* (April): 250-68.

Interactive Data Services. 1982. *Municipal Bond Pricing System: Concepts and Operating Procedures.* IDS.

Jensen, M.C., and W.H. Meckling. 1976. Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* (October): 305-60.

Margheim, L., and K. Pany. Quality control, premature signoff, and underreporting of time: Some empirical findings. *Auditing: A Journal of Practice & Theory* (Spring): 50-63.

Marks, B., K. Raman, and E. Wilson. 1989. The effect of municipal rating change announcements on seasoned bond prices. Paper presented at the Financial Management Association national meeting.

McNichols, M., and J. Manegold. 1983. The effect of the information environment on the relationship between financial disclosure and security price variability. *Journal of Accounting and Economics* (April): 49-74.

Nunn, Jr., P. Kenneth, J. Hill, and T. Schneeweis. 1986. Corporate bond price data sources and return/risk measurement. *Journal of Financial and Quantitative Analysis* (June): 197-208.

Ohlson, J.A. 1979. On financial disclosure and the behavior of security prices. *Journal of Accounting and Economics* (December): 211-32.

Palmrose, Z. 1986. Audit fees and auditor size: Further evidence. *Journal of Accounting Research* (Autumn): 97-110.

________. 1988. An analysis of auditor litigation and audit service quality. *The Accounting Review* (January): 55-73.

Patell, J.M. 1976. Corporate forecasts of earnings per share and stock price behavior: Empirical tests. *Journal of Accounting Research* (Autumn): 246-76.

Peterson, J. 1985. Disclosure practices in offerings of tax-exempt obligations: A survey of concerns. *Government Finance Review* (August): 15-19.

Raman, K.K., and E.R. Wilson. 1990. The debt equivalence of unfunded government pension obligations. *Journal of Accounting and Public Policy* (Spring): 37-56.

Robbins, W.A., and K.R. Austin. 1986. Disclosure quality in governmental financial reports: An assessment of the appropriateness of a compound measure. *Journal of Accounting Research* (Autumn): 412-21.

Rubin, M.A. 1988. Municipal audit fee determinants. *The Accounting Review* (April): 219-36.

Sherwood, H. 1976. *How Corporate and Municipal Debt Is Rated.* New York: Wiley.

Simunic, D., and M. Stein. *Product Differentiation in Auditing: A Study of Auditor Choice in the Market for Unseasoned New Issues.* Canadian Certified General Accountants' Research Foundation.

United States General Accounting Office. 1986. *CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards.* Washington, DC: GAO.

Wallace, W.A. 1980. *The Economic Role of the Audit in Free and Regulated Markets.* Rochester, NY: University of Rochester.

________. 1986. The timing of initial independent audits of municipalities: An empirical analysis. In *Research in Governmental and Nonprofit Accounting,* Vol. 2, ed. J.L. Chan, 3-51. Greenwich, CT: JAI Press.

THE STANDARD OF CARE FOR INDEPENDENT PUBLIC ACCOUNTANTS: INSIGHTS FOR SELF-REGULATION AND STANDARD SETTING

Ramona L. Paetzold and H. Fenwick Huss

ABSTRACT

This paper provides a descriptive and normative evaluation of the professional accountant's standard of care. It explains the standard of care that has evolved in the context of common law and federal securities law cases, and presents judicial language suggestive of both the legal rules and the legal policies that influence the legal rules. It corrects any misconceptions that compliance with GAAP/GAAS will shelter an accountant from liability for negligence, and presents

Research in Accounting Regulation, Volume 7, pages 61-80.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

arguments why such a shelter is not likely ever to be obtained. Policy implications for self-regulation and standard-setting are considered.

The accounting profession operates in a complex and difficult legal environment. The accountant's legal liability to users of audited financial statements has expanded rapidly in recent years, with many more lawsuits being filed against auditors, and the size of the claims increasing (Mednick 1987). The accounting profession has responded with efforts directed toward litigation and legislative reform, primarily focused on issues such as joint and several liability, the privity standard, and the requirement of actual reliance (Craco and Cooper 1987; Mednick 1987; AICPA Brief 1986). Lesser attention has been given to the issue of the accountant's or auditor's standard of care. This issue is of increased significance given the courts' expanding view of the role of the independent auditor in modern society; the circle of individuals to whom the accountant or auditor owes a duty continues to widen (Gormley 1988).

Many in the profession are aware of the vague notion of public responsibility articulated by the now-famous case of *United States v. Arthur Young:*

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust (at 817-818, emphasis in the original).

At the same time, many accountants continue to believe that performance in accordance with generally accepted accounting principles (GAAP) or generally accepted auditing standards (GAAS) provides a shield from liability. For example, in a recent article in this journal, it was stated that "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....*The measures used to operationalize the "reasonable CPA" test are the *accounting standards of the profession as a whole*" (Johnson and Terando 1990,

79, emphasis added). These comments suggest that the accounting profession can set the legal standards by which accountants will be judged. As will be seen, this is *not,* in general, true: compliance with GAAP/GAAS may not be enough. Further, expert testimony by accountants regarding what competent accountants would have done may be disregarded by the factfinder. Additionally, some accountants argue that compliance with GAAP and/or GAAS *should* provide a shield (Solomon et al. 1976); however, the shield desired by the accounting profession is not likely ever to be obtained.

This paper evaluates the independent public accountant's standard of care, both descriptively and normatively. The scope of the article is limited to the standard of care required in two types of cases: (1) those involving professional negligence (common law intent and fraud are not considered), and (2) those involving situations other than fraud under the federal securities laws. The first section explains the role of standard of care in negligence cases and the ways in which evidence of custom or standard can be incorporated in establishing whether a particular standard of care has been met. The focus of the first section is on the professional standard of care as it is applied to the professions generally. Next, the professional standard of care that has evolved for independent public accountants is discussed in the context of both common law and federal securities law cases. The judicial language included in this section helps both to delineate the legal standard of care for accountants, and to suggest the policies considered by the courts in determining whether accountants meet this standard of care. Finally, we explain why the legal system is not likely to ever afford the accounting profession the type of shield from liability that it would like to acquire, and we discuss policy implications for self-regulation and standard-setting within this context.

LEGAL CONCEPT OF "DUTY" OR "STANDARD OF CARE"

The "standard of care" or "duty" is imposed by law as a means of delineating what kinds of behavior are acceptable in a particular context or situation. Without a required duty or standard, there can be no breach, and hence no liability resulting from breach. When a duty is imposed at law, the standard of conduct that will satisfy

that duty is typically one of two types. The most common standard, which is that imposed on ordinary individuals in a variety of routine activities, is known as the "reasonable person" or "reasonably prudent person" standard. As the terminology suggests, this standard imposes on the individual the obligation to behave as an ordinary person of reason would behave under similar circumstances. A balancing of interests—for example, expected severity of the injury resulting from the breach, and the burden on an individual to take adequate precautions to avoid the injury—is implicit in any determination of duty and breach of duty.

The second standard that is commonly encountered is the standard of the professional, who is assumed to have particular skills, abilities, education, or training. The professional standard replaces the ordinary person standard in cases where the professional is sued for negligence concerning his or her professional conduct. According to the Restatement (Second) of Torts (section 299A):

> [a professional who renders] services is required to exercise the skill and knowledge normally possessed by members of that profession or trade in similar communities.

In other words, the recognized professional is typically held to a higher standard of care than the reasonable person standard alone would provide. The professional must engage in behavior viewed as "good" or "customary" practice by other appropriate professionals in the same field. This is the *minimum* standard that the professional must obtain. It remains a question for the factfinder as to whether the professional has satisfied his or her duty.

> While it may be a matter of law for the trial court to determine the standard of care applicable to the case and to so instruct the jury, the jury must retain the ability to determine whether the professional exercised the proper degree of care, skill and diligence warranted under the circumstances. Evidence of national rules and codes followed by members of the profession may aid the jury in determining whether the proper degree of care was exercised...(*Thayer v. Hicks*, p. 1104).

Expert testimony is typically required to aid the factfinder in knowing what appropriate members of the profession consider to be good practice or custom; as indicated above, this testimony is only evidence (i.e., is not conclusive) as to whether the professional has met the

standard of care. The profession is not allowed to perform its own balancing of interests—its own cost-benefit analysis—and so is not permitted to set legally binding standards, mere compliance with which would absolve its members from breach of duty.

It is important to note that were the professional standard allowed to be wholly determined by the profession itself, it would carry with it both a positive and a negative aspect (from the point of view of social welfare). The positive aspect would be that the professional standard would affirm (as it now does) an obligation on professionals to have and to use greater knowledge, expertise, and/or skill in connection with a particular set of activities than an ordinary person could be expected to have or use. Thus, to the extent that the professional standard is higher than the reasonable person standard, society benefits. But this positive aspect must be distinguished from what could be considered a negative aspect of the professional standard—the profession would then be relieved of liability for risky or dangerous behaviors or procedures as long as the profession as a whole would be willing to tolerate those practices. Once the court determined that a professional standard of care would apply to the defendant, the plaintiff could not establish liability by pointing out that the burden of taking care was less than the expected harm that would result. Society's, as well as the plaintiff's, cost-benefit analyses would be irrelevant under the professional standard, except to the extent that the profession itself would have taken such analyses into account in determining what practices would be acceptable. Thus, courts have not permitted the professions to absolve themselves from liability by mere compliance with internally determined standards and customs.[1]

One important implication of the way in which the two different standards of care are articulated is in terms of the evidence that is required to establish them. What is "reasonable" in the reasonable person standard is thought to be easily within the purview of the jury; although the juror is not to put himself or herself into the *PLACE,* per se, of the defendant, the juror can ask himself or herself how any reasonably prudent person would have behaved under similar circumstances. Thus, expert testimony is typically not required, or allowed, on the meaning of the reasonable person standard.[2] In contrast, the professional standard, since defined in terms of accepted practices within a profession, typically requires expert testimony to provide the jury with a specific meaning of the standard for the situation in which the professional defendant acted.

Often a defendant can introduce evidence of compliance with custom in order to shield himself or herself from liability.[3] However, such evidence may not provide a complete defense against liability, even when the defendant is acting as a member of a particular trade or calling. As Judge Learned Hand articulated in *The T.J. Hooper,* "[a calling] never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission" [at 740]. Thus, although custom can be used as a shield to protect the defendant from liability, evidence of custom does not provide a complete defense. The factfinder is allowed to consider the evidence—to perform its own weighing and balancing—in determining whether the defendant behaved reasonably under the circumstances. As will be seen, this is how evidence of custom, standards, or practice is used in negligence cases involving accountants. Although accounting experts may be allowed to explain their customary practices, their opinions do not bind the jury. For example, although holding in *Hochfelder v. Ernst & Ernst* that the auditor had no duty to investigate a member firm's compliance with the rules of the National Association of Securities Dealers, the Seventh Circuit also indicated in dicta that:

> although the defendant correctly states that generally accepted auditing standards do not ordinarily require such investigation, we do not find that entirely compelling. The teaching of The T.J. Hooper...is not lost to us for we recognize that we are not constrained to accept faulty standards of practice otherwise generally accepted in an industry or profession [at 1113].

(The case was subsequently reversed on a different issue.)

STANDARD OF CARE FOR ACCOUNTANT/AUDITORS

The standard of care issue for independent public accountants is increasingly important given the changes occurring in both the profession and the business community in which it operates. These changes result in increased uncertainty regarding the role that compliance with GAAP and GAAS will play. To date, compliance with these and other "standards" has not guaranteed that the accountant would escape liability. Alleged failures by the accounting

profession to meet the relevant standard of care can result in legal challenges under both common (state) law and the federal securities laws.

Common Law

At common law, the court must determine the appropriate standard of care to be used, keeping in mind that there is often no formally established standard, rule, procedure, or custom for the particular question or problem facing the accountant.[4] There is likely to be a wide variety of sources influencing the accountant's (auditor's) actual behavior during a particular engagement: the profession's general practices, any formal professional standards, such as statements issued by AICPA or FASB, and specific recommendations by other accounting experts. Sometimes these sources may not be in agreement about a recommended, specific course of action, or they may leave the course of action to the individual auditor's "judgment." As an example of the wide latitude given the individual auditor in any particular engagement, consider *SAS 47*'s pronouncement that "(t)he auditor's consideration of materiality is a matter of professional judgment and is influenced by his perception of the needs of a reasonable person who will rely on the financial statements." Little direct guidance is given to the auditor (and consequently to the court) by this standard, since the concept of a "reasonable person who will rely" is not well-established, and since the auditor is assumed to use "professional judgment." Such a standard does not provide the court with a *concrete* standard with which it can compare the auditor's actual audit practices. Expert testimony regarding the profession's interpretation of this standard may be heard, but without a more explicit rule, it will be easier for the court to impose a legal standard consonant with the court's view of accountants as "public watchdogs."

The standard of care applied to accountants and auditors is a matter of state law[5] (at least when no federal laws such as the federal securities laws are involved), and this standard is clearly that of a professional accountant or auditor, as is indicated by the following language from a recent California case:

> [A]n independent auditor has the duty to have that degree of learning and skill ordinarily possessed by a reputable certified public accountant practicing

> in the same or a similar locality and under similar circumstances. It is [the accountant's] further duty to use the care and skill ordinarily used in like cases by reputable members of [his or her] profession practicing in the same or similar locality under similar circumstances, and to use reasonable diligence and [his or her] best judgment in the exercise of...professional skill (*Bily v. Arthur Young*, p. 478).

At least since 1905, accountants in the United States have been accepted as a professional class and subjected to the same rules of liability for professional negligence as have members of other skilled professions (*Stanley L. Bloch, Inc. v. Klein*). What provides uncertainty in the legal environment for the accounting profession, particularly since many state courts have not reached the issue of standard of care, is the type of behavior that the accountant must engage in to *meet* the standard of care. For example, in *Bily v. Arthur Young,* the court explained that:

> in many if not most cases an accountant who has complied with GAAP will be found, in turn, to have satisfied the applicable standard. But this is not to say that GAAS and GAAP define the standard of care. Certified public accountants, like other professionals, must meet the standards of expertise and diligence common to their profession *as proved with respect to the facts of particular cases* by the testimony of suitably qualified expert witnesses (at 484, emphasis added).

In this case, guidelines from an internal accounting manual promulgated by Arthur Young itself were also evidence used to determine whether the accountant had met the professional standard of care.

The use of GAAP or GAAS as satisfying the professional accountant's standard of care can be raised by either side in a lawsuit. It is important in interpreting the courts' rulings to note which side is making the argument. For example, in a negligence case in New York, the plaintiff alleged that, among other things, the accountants improperly represented that the figures taken from the plaintiff's books and records had been verified and audited (*Stanley L. Bloch, Inc. v. Klein*). The court noted that this behavior violated the Code of Professional Conduct of the AICPA, rule 2.03, which required either that stated inventory be verified by independent checking or that it be clearly indicated that no such checking was done. Since no qualification notice appeared on the plaintiff's balance sheet, the

defendant accountants were found to be professionally negligent. Thus, failure to comply with established accounting or auditing standards may clearly establish professional negligence. What remains unclear is whether *compliance* with such standards will protect the accountants from a finding of professional negligence. In dicta in this case, the court indicated that "to relieve themselves of any liability for errors contained in (the) balance sheet, defendants could have and should have indicated on its face all items that were not independently verified." Although this language suggests that compliance with rule 2.03 of the Code would have been sufficient to avoid liability, it is not legally binding since it does not represent the factual issue before the court—that is, the accountants had *not* done so.

Even when the plaintiff establishes failure to adhere to GAAS or GAAP, that failure is merely evidence of negligence—it does not conclusively establish negligence in and of itself.[6] As one court has observed,

> Evidence of national rules and codes followed by members of the profession may aid the jury in determining whether the proper degree of care was exercised, [sic] however, any deviation from the national guidelines...does not automatically constitute negligence (*Thayer v. Hicks*, p. 1104).

Thus, the plaintiff must produce sufficient evidence that the accountant failed to exercise due care to convince a jury that, by a preponderance of the evidence, the accountant was professionally negligent. Evidence of noncompliance with GAAS or GAAP may not be sufficient to establish this, particularly since it is also recognized that accountants do not guarantee or warrant perfect outcomes or judgment (*Gammel v. Ernst & Ernst*; *Maryland Cas. Co. v. Cook*).

Most cases involve accountants raising compliance with GAAP or GAAS as a shield to insulate them from liability. For example, in a recent negligence case in Oregon, the defendant CPA firm argued unsuccessfully that "the standards promulgated by the American Institute of Certified Public Accountants are the generally accepted auditing standards against which an auditor's examination must be evaluated..." (*Madruff Mortgage v. Deloitte Haskins & Sells,* at 1086). The auditor also requested that the instructions to the jury should incorporate GAAS. The trial court admitted GAAS as

evidence but did not include GAAS in the jury instructions. The appellate court upheld this ruling:

> MMC [Madruff] argues that AICPA standards are evidentiary. We agree. They are principles and procedures developed by the accounting profession itself, not by the courts or the legislature. They may be useful to the jury in determining the standard of care for an auditor, but they are not controlling. The amount of care, skill and diligence required to be used by the defendant in conducting an audit is a question of fact for the jury, just as it is in other fields for other professionals (at 1086).

Note that the court adopted the professional standard of care, thereby stating that the standard was to be the amount of care, skill, and diligence that an auditor must use in conducting an audit. But, the court ruled that expert opinion was not determinative, so that the jury was free to provide its own opinion of the quantity of care, skill, and diligence that an audit requires. Thus, the court treated auditing as any other skilled profession,[7] where the reasonableness of the defendant's conduct under the circumstances is a question of fact for the jury to decide.

Similarly, in nonaudit services, the courts have been reluctant to accept the profession's own standards as defining the acceptable level of care (Kozlowski 1988). Expert testimony clearly plays an extremely important role in establishing whether the accountant has satisfied his or her professional duty. For example, in *Robert Wooler Co. v. Fidelity Bank,* the court held that an accountant in a review engagement can be found liable for the failure to warn about internal control weaknesses, even though extant standards did not require an evaluation of internal control in a review engagement. The accounting firm argued that since it was not providing audit services, it had no obligation to inquire into the company's internal control system. Expert witnesses uniformly testified, however, that an accountant "possessing reasonable accounting skill would have been aware of the potential for theft inherent in [the] internal controls." The court held that the accountant's personnel had an obligation to be "reasonably alert to internal control defects that were patently obvious." Thus, the court found that the accountant had not met professional standards; the accountant had a professional duty to warn the client that internal control deficiencies could enhance the possibility of employee defalcations.

Courts are particularly concerned about accountants being able to shield themselves from liability when potential misstatement or misrepresentation is involved. For example, in *Kaiser-Frazer Corp. v. Otis & Co.* the court held that a footnote in the auditor's report, by failing to note that the rise in fourth quarter income for a new company was the result of an inventory adjustment that could be allocated to other quarters, was misleading "regardless of whether [the] accounting system was a sound one" (at 843). In at least two tax cases, courts have held that GAAP methods do not accurately reflect income (*The Tog Shop, Inc.; Thor Power Tool Co. v. Commissioner*). All such cases are important to the broader issue of the accounting profession being able to set its own standards. Lantry (1981) noted:

> While the significance of the *Thor* case has not been lost in the business world, the fact that there has been further erosion of the defense of observing professional standards may have escaped the attention of the accounting profession as certified public accountants now concentrate on how to comply with the Internal Revenue Service rulings following the *Thor* case. They neglect dealing with the broader issue of the authority of the profession to establish what constitutes fair presentation of financial and tax information. The failure to recognize the broader issue may cause certified public accountants to experience legal liability when they assumed no such liability would be experienced because they observed professional standards (p. 96).

Federal Securities Cases

Section 11(a) of the Securities Act of 1933 allows purchasers of securities to sue an accountant when a registration statement prepared or certified by the accountant contains untrue statements or omissions of material fact. An accountant may not be held liable unless the misleading information is expressly attributable to that accountant (*McFarland v. Memorex Corp.*, at 644-47). Also, an independent accountant's liability under this section is limited to only those figures that he or she certifies. (*McFarland v. Memorex Corp.*, at 643). Additionally, accountants benefit from the "due diligence" defense prescribed in Section 11(b).

Although Section 11(c) of the Act specifically dictates that the standard of care should be "the standard of reasonableness...required of a prudent man [sic] in the management of his own property" (15 U.S.C.A. § 77k(c)), the opinion in *Escott v. BarChris Construction*

Corp. created a sliding standard of care for different types of defendants (e.g., directors, lawyers, accountants). In holding *auditors* liable for misstatements in the registration statements, the *BarChris* court concluded that the written program utilized for the review conformed to GAAS, and would have provided the auditors with the due diligence defense had it (i.e., the written program) been complied with. (See Martin [1988, 436] for further discussion.) However, this language is dicta since the auditors had not complied with the program, and the issue before the court was not whether compliance with GAAS would establish due diligence. The court's willingness to rely on GAAS or GAAP is particularly unclear since the court also determined that inclusion in income of proceeds from a sale and leaseback transaction was misleading, without reference to GAAP (at 658-59). *BarChris* does not make clear whether accountants and auditors can be protected by mere compliance with internally promulgated standards.

That compliance with GAAP does not conclusively insulate the accountant from liability was made clear in *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath.* Land had been sold in circumstances making it doubtful that the full purchase price would ever be received. In accordance with standard procedures for real estate transactions, the auditors recognized as gross profit only the small cash downpayment and the amount of liquidated damages to be received in event of buyer's default. They described the contract in detail and issued a qualified opinion subject to the balance receivable under the contract being collected, as would typically be done when collectibility appears doubtful or unlikely. Nonetheless, the court held that full disclosure was required and that such disclosure "cannot be fulfilled merely by following generally accepted accounting principles..." (p. 122). The auditors should have provided all facts necessary so that investors could interpret the financial statements accurately. Thus, the issue in determining the auditors' negligence was not whether the auditors' report satisfied accounting norms, but whether the report presented fairly the financial position of the audited company. According to the court:

> Much has been said...about generally accepted accounting principles and the proper way for an accountant to report real estate transactions. We think this misses the point. Our inquiry is properly focused not on whether...[the] report satisfied esoteric accounting norms, comprehensible only to the initiate, but

> whether the report fairly presents the true financial position of [the client]...to the untutored eye of an ordinary investor (at 121).

Liability under Section 13 of the Securities and Exchange Act of 1934 is also not easily avoided (Martin 1988, 438). In *In re Broadview Financial Corp.*, the SEC provided a brief discussion of the Section 13 requirements:

> The reporting requirements of Section 13(a) of the Exchange Act necessarily include the requirement of supplying true and correct information. A violation of the section is established if annual or quarterly reports contain materially false and misleading statements regarding such items as the level of a company's income. Rule 4-01(a)(1) of Regulation S-X provides that financial statements not prepared in accordance GAAP are presumed to be misleading. No showing of scienter is required for direct violation of section 13(a) of the Exchange Act.

Note that the issue is whether the reports contain information that is materially false and misleading; it is not clear that compliance with GAAP or GAAS alone will shield the accountant. According to Martin (1988), there must be an independent showing of the "substantial accuracy of the information presented" (at 441). Financial statements are *presumptively* misleading in the absence of compliance with established accounting standards; they are *NOT* presumptively acceptable or fair if such compliance can be shown.

In the early landmark case of *United States v. Simon*, accountants were prosecuted because of a footnote in the client's financial statements that concealed the defrauding of the company by its president. Eight expert witnesses from the accounting profession testified that the footnote was consistent with GAAP. The defendants urged that for purposes of determining whether published financial statements were materially misleading, a jury should be conclusively bound by the experts' testimony; they further argued that the presentation was "fair" since, in accordance with GAAP, no disclosure was required. The Court of Appeals stated:

> Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that his basic assumption is false, an entirely different situation confronts him. Then...he must 'extend his procedures to determine whether or not such suspicions are justified.' If...his suspicions [are] confirmed, full disclosure must

> be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established (at 806-07).

Judge Friendly upheld the trial judge's instructions that the "critical test" regarding the standard of care was whether the financial statements as a whole fairly presented the financial data, and that compliance with GAAP was persuasive evidence but was not conclusive. The jury was allowed to consider whether all of the testimony was supported by reason (at 805-06).

DISCUSSION AND ANALYSIS

What is clear from the foregoing discussion is that courts do afford independent public accountants (including auditors) a professional standard of care; however, that does not mean that compliance with GAAS or GAAP will protect the independent public accountant or auditor from liability. Nor is such compliance ever likely to be viewed by courts as a shield, regardless of how actively the profession argues that such a shield is needed, for two interrelated reasons. First, legal factfinders are in the position of judging the auditor's performance with hindsight, after some sort of "failure" has occurred. Second, the external effects of the independent public accounting function imply that the court will view its role as one of balancing societal costs and benefits.

Legal factfinders face the difficult task of evaluating the defendant-auditor's decisions and decision-making processes only after harm or injury has been alleged by the plaintiff. The factfinder should be determining whether the plaintiff's losses were occasioned by the auditor's failure to exercise due care (i.e., the auditor made a bad decision). Losses resulting solely from the inherent risk of the investment should not be compensated by the auditor. With hindsight, however, the factfinder is more likely to consider whether the auditor's decision seems to have been the "right" one, instead of whether it was a "good" one. The *process* the auditor uses to make inferences may be difficult to separate from the actual *judgments* themselves: the legal system may be unable to disentangle the two criteria.

Decision analysts emphasize that decisions should be evaluated independently of outcome; after all, a good decision does not

guarantee a good outcome—all decisions are made under uncertainty (Edwards 1984). Although there may be little agreement as to what completely characterizes a good decision, it is generally agreed that decisions are judged to be good on the basis of whether prescribed procedures are followed. "Goodness" is not binary; some decisions will clearly seem to be better than others. For the factfinder to judge the "goodness" of an auditor's conduct, it would have to put itself in the position of the auditor at the time the decision was made. It would have to see the "facts" as the auditor saw them; it would have to recognize the same set of choices that the auditor believed he or she faced. Expert testimony serves to help the factfinder to perform these difficult functions, but expert testimony is not conclusive.

Sitting in front of the factfinder is a very real plaintiff who can show that he or she was harmed, often by direct reliance on the auditor's decision. As long as the plaintiff's own behavior seems to have been reasonable, the factfinder may tend to focus on the outcome as unfair and with hindsight, conclude that the auditor's decision was incorrect. Decision theory would suggest that the manner or process by which the decision was obtained could become largely irrelevant; the unfortunate outcome or result may tend to dominate the factfinder's evaluation. The more clearly and unambiguously "correctness" can be determined, the more likely it will be that compliance with procedures such as GAAP and GAAS will be deemed insufficient.

The external effects associated with the use of financial information, coupled with society's "public watchdog" view of the profession, suggest that "correctness" will be relatively easy for a factfinder to determine. Auditors have become increasingly aware of the external costs associated with providing audited financial statements as courts have extended independent public accountant's duties to noncontractual third parties. Independent public accountants have now been forced to bear some of these costs (or pass them along to clients) as the scope of their duty has widened. Unlike the medical profession, where the costs of a doctor's negligence flow primarily to the patient, the activities of the accounting profession produce costs that extend beyond the immediate client. In the absence of liability, costs to third-party users, who need not be professionals themselves, would not be taken into account in the profession's cost-benefit analysis. Thus, as discussed previously, courts do not permit the profession to perform its own

balancing of interests in setting a *legal* standard. Courts attempt to balance these external costs and benefits in determining when the professional standard of care is met; that balance need not be satisfied by compliance with GAAP or GAAS.

Audited financial statements, in particular, produce important external effects.[8] Market "failures" in which resources are allocated on the basis of misleading financial information affect not only the buyers and sellers of the securities but society as a whole. First, the "consumption" of information by market analysts determines the market price in an efficient market. Other traders "consume" the information indirectly by relying on the market price. Investing decisions affect both the wealth of the professional information user and the wealth of other market participants as well. Second, the operation of the securities markets allocates society's resources. Unbiased financial information is essential for this process to work in an economy characterized by absentee ownership of capital. A third external effect is the creation of an environment in which prospective traders perceive the fairness of the trading system. The importance of maintaining the integrity of the securities markets has been recognized by the public sector since the passage of the securities laws. In addition to the importance of resource allocation based on decisions using unbiased information, it is also important that participants and prospective traders *perceive* that legitimate and astute analysis will be rewarded.

Although financial information is divisible and priceable, it can result in considerable externalities, thus giving rise to an issue of whether the private sector should be relied upon to produce this type of information. Society's perceptions concerning the importance of the external effects, coupled with the ability of the private sector to produce meaningful financial information, determine the level of public sector involvement in the production of financial information. The "public watchdog" view of the profession suggests that the legal system views many accounting functions through the lens of a public sector service model.

The public sector's interest in the production of audited financial information is, of course, reasonable. Reporting and auditing failures result in losses to the traders of securities and also involve negative external effects to society through a misallocation of resources and through damages to the integrity of the securities markets. For the "production" of audited financial information to remain in the private

sector, the accounting profession must recognize its public interest responsibility and design the "production" of audited information accordingly. If society believes that this quasi-public good is insufficiently provided under GAAP/GAAS, legal factfinders may demand a higher level of "production." Compliance with GAAP/GAAS will not be sufficient; instead, compliance should be viewed as a "'floor' for the auditor's performance" (Sherman 1986, 21).

The public expects that the auditor will design the audit in such a way as to carry out the public interest responsibility. Failure to do so invites further public intervention. The profession must continue to recognize and make operational its "public watchdog" responsibility. The profession needs to adopt standards for performance and reporting that incorporate the auditor's public responsibility. Kaplan (1987) argues that auditors should be required to do an audit that more accurately reflects the popular understanding of an auditor's mission. "It is precisely because people think that an audit does provide significant protection that audited financial statements are given credibility and are deemed useful" (p. 4). The legal system would certainly agree.

In 1988 the AICPA's Auditing Standards Board approved nine new Statements on Auditing Standards to address "expectation gap" concerns. Whether the revised standard auditor's report—an attempt to educate the user—could affect the outcome of a legal factfinder's decision is, of course, unknown. However, the standards that increase the auditor's stated responsibility for fraud, illegal acts and "going concern" are moving in the direction of closing the expectation gap by recognizing societal expectations regarding the level of disclosure of unbiased information. The AICPA's recent endorsement of a proposal for the auditor to blow the whistle when the client fails to correct illegal acts is one appropriate response to society's expectations concerning the auditor's role.

The importance of the auditor's role suggests that public sector involvement in the "production" of unbiased disclosures is sure to continue. Efforts to close the expectation gap that involve trying to change society's expectations have little chance of success. The message from the legal system is clear; the gap should be closed by accounting professionals performing audits "that more accurately reflect the popular understanding of their mission" (Kaplan 1987, 1).

NOTES

1. The medical profession is the only exception to this rule. For the medical profession, the court will not inquire into the cost-benefit analysis that the profession has conducted; it will require only that the specific practices, customs, or behaviors adopted by the profession be established (through expert testimony) so that the defendants's behavior may be compared to them. Breach occurs when the defendant's behavior falls short of what the profession considers to be acceptable. Even within the medical profession, hovever, there has been some movement away from this negative aspect of the professional standard. In informed consent cases, the jury is typically allowed to evaluate the medical profession's norm regarding the giving of information and the obtaining of consent to determine whether it appears to be reasonable.

2. One exception to this rule regarding the use of expert testimony involves evidence of custom. Both (expert) evidence of custom, and evidence regarding the defendant's violation of the custom, are admissible to show breach of duty in some negligence cases. This exception is particularly important when the custom involves safety.

3. This is true even in ordinary negligence cases, again particularly those involving safety custom.

4. The recent case of *FDIC ex rel. Crescent Federal Savings Bank v. Schoenberger* (1992), makes clear that the *duty* of care is imposed by law and exists beyond any contractual duty. Contractual provisions cannot reduce the duty owed by the independent public accountant. Additionally, an independent public accountant (auditor) typically owes no fiduciary duty to a client while providing accounting/auditing services. The job of the independent auditor is to perform services "objectively and inpartially" (p. 1157).

5. State administrative codes can alter any common law notions about the standard of care owed by independent public accountants. For example, in Wisconsin, the Administrative Code required disclosure in circumstances when the AICPA Statement on Auditing Procedure No. 1 did not; in fact, the Code noted the AICPA Statement and "substantially and intentionally departed from it" (*Chevron Chemical Co. v. Deloitte & Touche* 1992). In this instance, compliance with the AICPA Statement was not sufficient to meet the standard of care.

6. Legally, this means that failure to comply with accounting standards is not considered to be negligence per se, or negligence as a matter of law. It is sometimes the case that violation of a statue constitutes negligence per se. Courts recognize that internally promulgated standards of a profession do not rise to the level of statutes. It has similarly been held that violations of the standards of practice of architects given in a handbook published by the American Institute of Architects constitute only evidence of negligence, not negligence per se (*Taylor, Thon, Thompson & Peterson v. Cannaday*).

7. Again, with the exception of the medical profession.

8. The SEC Advisory Committee on Corporate Disclosure argued that corporate disclosures were public goods. The committee concluded that, in the absence of mandated disclosure, financial information would be underproduced if

the production were left solely to the private sector. Others (Brownlee and Young 1987) have countered the committee's argument by noting that two different traders may not be consuming the *same* good. In particular, the trader who possesses the information first owns a potentially more useful good, since the information may not yet be reflected in the stock price. Brownlee and Young conclude that the timing of possession can render financial information a private good.

REFERENCES

American Institute of Certified Public Accountants, Auditing Standards Board. 1983. *Statement on Auditing Standards No. 47, Audit Risk and Materiality in Conducting an Audit.* New York: AICPA.

________. 1988. *Code of Professional Conduct* New York: AICPA.

American Law Institute. 1976. *Restatement (Second) of Torts,* 2nd ed. Washington, DC: American Law Institute.

Bily v. Arthur Young, 222 Cal. App. 3d 289, 271 Cal. Rptr. 470 (Ct. App. 1990).

Brief of the American Institute of Certified Public Accountants as Amicus Curiae in Support of the Petitioners in *Basic, Inc. v. Levinson,* Supreme Court of the United States, No. 86-279.

Brownlee, E.R., II and S.D. Young. 1987. The SEC and mandated disclosure: At the crossroads. *Accounting Horizons,* (September): 17-24.

Chevron Chemical Co. v. DeLoitte & Touche, 168 Wis. 2d 323, 483 N.W.2d 314 (Wis. Ct. App. 1992).

Craco, L.A. and D.E. Cooper. 1987. The institute as amicus curiae: The key to the courthouse. *Journal of Accountancy* (November): 70-74.

Edwards, W. 1984. How to make good decisions. *Acta Psychologica,* 56: 7-10.

Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

FDIC ex rel. Crescent Federal Savings Bank v. Schoenberger, 781 F. Supp. 1155 (E.D. La. 1992).

Gammel v. Ernst & Ernst, 245 Minn. 249, 72 N.W.2d 364 (1955).

Gormley, R.J. 1988. Developments in accountants' liability to nonclients for negligence. *Journal of Accounting, Auditing and Finance* (Summer): 185-212.

Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, aff'd in part, rev'd in part, 540 F.2d 27 (2d Cir. 1976).

Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).

In re Broadview Financial Corp., Admin. Proc. File 3-6502, S.E.C (1985).

Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838 (2d. Cir 1952).

Johnson, O. and W.D. Terando. 1990. From contract to tort: The evolution of accountants' legal liability for negligence. In *Research in Accounting Regulation*, Vol. 4, ed. G.J. Previts, 77-97. Greenwich, CT: JAI Press.

Kaplan, R.L. 1987. Accountants' liabiity and audit failures: When the umpire strikes out. *Journal of Accounting and Public Policy* (Spring): 1-8.

Kozlowski, A.L. 1988. Accountants' liability for unaudited historical and prospective financial statements. *San Diego Law Review* 25 (October): 757-80.

Lantry, T. 1981. *Thor Power Tool Co. v. C.I.R.* further erodes C.P.A.'s defense of observing professional standards. *American Business Law Journal* 19: 87-96.

McFarland v. Memorex Corp., 493 F. Supp. 631 (N.D. Cal. 1980).

Madruff Mortgage v. Deloitte Haskins & Sells, 98 Or. App. 497, 779 P.2d 1083 (1989).

Martin, D.N. 1988. An effort to deter opinion shopping. *The Journal of Corporation Law* (Winter): 419-41.

Maryland Cas. Co. v. Cook, 35 F. Supp. 160 (E.D. Mich. 1940).

Mednick, R. 1987. Accountants' liability: Coping with the stampede to the courtroom. *Journal of Accountancy* (September) 118-22.

Robert Wooler Co. v. Fidelity Bank, 330 Pa. Super. 523, 479 A.2d 1027 (1984).

Securities and Exchange Commission. 1987. *Report of the SEC Advisory Committee on Corporate Disclosure* Washington, DC: U.S. Government Printing Office.

Sherman, W.R. 1986. The accountant and the standard of care. *The National Public Accountant* (December): 20-24.

Solomon, K., C. Chazen, and B. Augenbraum. 1976. Who judges the auditor and how. *Journal of Accountancy* (August). 67-74.

Stanley L. Bloch, Inc. v. Klein, 45 Misc. 2d 1054, 258 N.Y.S.2d 501 (1965).

Taylor, Thon, Thompson & Peterson v. Cannaday, *230 Mont. 151, 749 P.2d 63 [1988]*.

Thayer v. Hicks, 47 Mont. 1082, 793 P.2d 784 (1990).

The T.J. Hooper, 60 F.2d 737 (2d Cir. 1932).

Tog Shop v. United States, 721 F. Supp. 300 (D.C.M.D. Ga. 1989).

Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979).

United States v. Arthur Young, 465 U.S. 805 (1984).

United States v. Simon, 425 F.2d 796 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970).

AN ANALYSIS OF STATEMENTS ON STANDARDS FOR ACCOUNTING AND REVIEW SERVICES NO. 1

Albert D. Spalding

ABSTRACT

The accounting profession, like any profession, must maintain and communicate to its members its own standards of care. These standards effectively define the profession itself, provide guidance for its members, and ensure public confidence in the quality of the profession's credentials so long as the standards reflect current case law and therefore the realities of legal constraint. This paper examines the extent to which *Statements on Standards for Accounting and Review Services No. 1* (*SSARS 1*) reflected case law at the time of its issuance, and whether case law generated since its issuance has been consonant with *SSARS 1*. This practical question posed is whether AICPA promulgations are safe "legal advice" that helps the accountant avoid professional negligence, or malpractice.

Research in Accounting Regulation, Volume 7, pages 81-93.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

INTRODUCTION

Published professional standards, such as *Statements on Standards for Accounting and Review Services* (*SSARS*), are not law, but they are affected by changes in law. This happens in two ways. First, state legislatures, and even the U.S. Congress, from time to time review the standards of care held out by a profession and suggest that those standards be upgraded in certain ways.[1] Lawmakers take particular interest in the accounting profession's "watchdog" function, whereby financial information is certified to a public that increasingly relies on such certification.[2] If a new statute is enacted, the affected professional organizations are generally quick to communicate this change to their members.

Courts use standards to resolve lawsuits. Plaintiffs who allege professional negligence or malpractice are allowed to inquire into a professional defendant's compliance with professional standards of due care as set, in this instance, by independent standards-setting boards such as the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and other professional organizations.[3] But courts sometimes purposely depart from the standards of care as defined by the profession itself and assert that, in the public interest, an alternative standard of care will be applied in determining professional negligence or malpractice.[4] The profession must then modify the standards to accommodate the common law.

The failure of promulgated standards in court is exemplified by cases involving unaudited financial statements that predated the AICPA's *Statements on Standards for Accounting and Review Services No. 1* (*SSARS 1*). During the period from the late 1960s to the mid-1970s, a series of court cases brought the non-audit services of accountants under judicial scrutiny. In the first of these, *Ryan v. Kanne,*[5] the court acknowledged that the accountant and his client had agreed that certain financial information would be prepared by the accountant but that it would be "unaudited" (and marked "unaudited" on each page). Nevertheless, the court determined that the responsibilities of the engagement of the accountant constituted a *de facto audit,* and that the accountant was liable for inaccuracies in the financial information. More prominent was the New York case of *1136 Tenants' Corp. v. Max Rothenberg & Co.,*[6] in which a CPA was held liable for negligence in the performance of a "write-up"

engagement (i.e., a engagement involving the preparation of a basic financial statement without an actual audit of the underlying data). The court determined that the CPA was aware that an employee of the client corporation claimed to have made payment on certain invoices, but that those invoices were missing. The precise nature or comprehensiveness of the engagement was not clear to the court. But the court ruled that even if the CPA had not necessarily been engaged to audit the corporations' books, the CPA was not free to consider the missing invoices and other suspicious circumstances as being of no significance, or to prepare financial statements as if those circumstances did not exist.

The *1136 Tenants' Corp.* case received a great deal of attention in the accounting professional press, as well as in the briefs of plaintiffs' attorneys, and several other similar cases in other states followed in its wake. In the Minnesota case of *Bonhiver v. Graff,*[7] for example, a CPA was also held liable in a write-up engagement, one that was never completed. Again, the court held that the accountant's awareness of certain facts (which, if analyzed, would lead to the conclusion that an employee was embezzling) could not be ignored by the CPA. Instead, the court ruled that the CPA should have investigated the situation more thoroughly (even though not engaged to do so). And in the Nebraska case of *Seedkem, Inc., v. Safanek,*[8] a creditor, who claimed to have relied (in its decision to extend credit) upon unaudited financial statements, was allowed to proceed in a legal action against the CPA who prepared the statements.

Prior to December 1978, the only guidance offered by the AICPA in the area of unaudited financial statements was *Statement of Auditing Procedure* (*SAP 38*), which required that a general disclaimer of an opinion attached to unaudited financial data (with the word "Unaudited" placed at the top of each page of the financial statements) was sufficient to place the user on notice that no assurance was being provided. But, as the growing tide of court cases made clear, the designation "certified public accountant" implied (to some users at least) a certain level of assurance despite complete compliance with *SAP 38*.

In December 1978, therefore, the AICPA issued *SSARS No. 1*,[9] which directed CPA's to designate their level of involvement in the preparation or review of financial statements as being either a compilation (with absolutely no assurance by the CPA) or a review

(with minimal assurance). In addition, a definition for the term "financial statement" was provided, including allowable designations for various types of presentations of financial data. I wish now to examine (1) the case law that preceded and presumably generated SSARS 1; (2) the provisions of *SSARS 1* that attempted to speak to the case law; and (3) the adequacy of the AICPA standards, in the light of later case law. The discussion is limited to four critical issues that arise in accounting negligence litigation: (1) the distinction between audit and nonaudit engagements, (2) minimum standards of inquiry and disclosure, (3) precise, understandable terminology, and (4) the use of engagement agreements.

SSARS 1 AND CASE LAW

Audited/Nonaudited Distinction

Pre-SSARS 1 Case Law

The primary task of the courts, in assessing accountant liability in non-audit situations, is the factual determination of the extent of an accountant's negligence. In making that determination, the duty of the accountant to the client is measured in large part by the contractual arrangement between them. Part of the court's difficulty in arriving at a judgment in the *1136 Tenants' Corp.* case, for example, was the confusion about whether the services for which the client contracted were actually "audit" (or *quasi*-audit, or audit-in-fact) services, despite the designation of the financial statements as "unaudited." It is still a matter of debate among accountants and lawyers as to whether the holding of that case stemmed from a conscious judicial effort to establish a standard of care for non-audit services, or, instead, from the court's effort to clarify the actual nature of the engagement.

Similarly, in the *Ryan* case, the financial statements prepared by the CPA were clearly marked "unaudited" on each page, in accordance with *SAP 38*. Nevertheless, the court ignored the designation, and made an independent investigation into the nature of the services. The court pointedly denied the legal significance of the designation "unaudited" in circumstances involving more than minimal write-up services, reasoning as follows:

> Although in [the accounting] profession a distinction is made between certified audits where greater time and effort are expended to verify book items, and uncertified audits where greater reliance is placed on book items, it is clear to us that accountants, or any other professional persons, must perform those acts that they agreed to do under the contract and which they claim have been done in order to make the determination set forth and presented in their report. Their liability must be dependent upon their undertaking, not their rejection of dependability. They cannot escape liability for negligence by a general statement that they disclaim its reliability.[11]

In the *Bonhiver* case, the court went even further. Rather than limit the duty of the accountant to that created by the clear contractual language of the engagement agreement (as confirmed by the disclaimer language of the CPA's cover letter to the financial data), the court essentially re-wrote the agreement and dubbed it an engagement for an "audit-in-fact." Again, the court investigated the actual nature of the CPA's current and prior work in determining the extent to which any sense of assurance could be derived from the CPA's involvement.

One common thread in the pre-*SSARS* cases, then, is the concept that the duty of the certified public accountant is derived primarily from the actual nature of the services performed, rather than the designation of those services as "unaudited" or the effort to disclaim responsibility for any assurances derived from those statements. The courts appear to base this policy on two premises: first, that in most situations the accountant performs a certain amount of audit-like procedures, such as development of accounting workpapers and verification of certain items on the financial statements; and second, that the certified public accountant is just that, a public professional whose task is primarily to "certify" even when he or she attempts to "decertify" the product of his or her efforts, and that therefore the CPA bears the burden of proof on the issue of whether assurances could or should be derived from the facts surrounding his or her engagement.

Prior to the issuance of *SSARS 1*, the only promulgated standard covering non-audit engagements was *SAP 38*, which simply declared that unaudited statements did not involve the expression of an opinion by the CPA. Clearly, the courts in the cases of Ryan, *1136 Tenants' Corp.*, and their progeny were not persuaded by such a blanket disclaimer.

The SSARS 1 Response

SSARS 1 retains the concept of unaudited financial statements, but drops the term "unaudited" in favor of two levels of financial statements engagements: "compilation" and "review." A compilation is the presentation of financial information that is the representation of management without an undertaking by the accountant to express any assurance on the statements; a review, on the other hand, involves the performance of inquiry and analytical procedures that provide the accountant with a reasonable basis of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles.[13]

Adequacy

Recent case law suggests that the distinction is not viable in the courts, as several cases will illustrate.[14]

Spherex v. Alexander Grant & Co. The text of the *Spherex* case[15] does not specify whether the unaudited financial statements involved were compiled or reviewed, but it does provide confirmation that the CPA was liable in either event. The liability stemmed from inaccurate financial statements prepared by the CPA from information provided by the client, on which a third party relied. The court refused to be bound by the introduction of *SSARS 1* standards and the designation of the financial statements as being unaudited.

Robert Wooler Co. v. Fidelity Bank. The *Wooler* case[16] involved a review under the guidelines established by *SSARS 1*, which provide that a "review does not contemplate a study and evaluation of internal control."[17] The court found that the CPA was liable when internal control weaknesses triggered problems for the client, finding that *SSARS 1* was not controlling in that situation. The opinion in that case includes the observation that "[i]n the absence of specific language relieving it from acts of negligence, [a contract] did not relieve [the accountant] from acts of negligence, [and] did not relieve it from liability for ignoring suspicious circumstances which would have raised a 'red flag' for a reasonably skilled and knowledgeable accountant."[18]

The court essentially required that the CPA perform services (such as internal control testing) for which the CPA had not been hired. Once again, even after the issuance of *SSARS 1*, the system placed upon the accounting profession a duty of care, including a standard of inquiry and disclosure, beyond that which the profession claimed for itself and beyond that for which the individual CPA and his client had contracted.

If an engagement letter, specifying the extent of internal control testing to be performed, had been utilized in the *Wooler* case, the result would have been different. The court in that case observed that "the specific scope of an accountant's duty to a client must be determined primarily by the terms and conditions of the contract of employment."[19]

William Iselin & Co., Inc. v. Landau. In a departure from a seemingly endless line of cases holding accountants liable in non-audit circumstances, the court in the *Iselin* case[20] gave credence to the lower level of inquiry implemented in a "review," and shielded the CPA from liability for negligence when it turned out that the financial statements prepared by the CPA did not sufficiently warn a third party of the client's impending bankruptcy. Nevertheless, it was the testimony of expert witnesses, and not the statements or stature of *SSARS 1*, that persuaded the court.

Union Bank v. Ernst & Whinney. In holding the accounting firm liable for not detecting financial problems of a company founded and operated by individuals convicted of crimes in connection with the operation of the company, the court in the *Union Bank* case[21] disregarded the designation of the financial statement as a "review" under the *SSARS 1* framework. The court was more concerned about the level of skill brought to the engagement, than in the characterization of the engagement by the accounting firm, noting that the fact the report was not an unqualified certified audit does not relieve the accounting firm from liability.

Joel v. Weber. In a case involving pop singer Billy Joel, the New York court held that the designation of an engagement as a "review" did not exempt an accounting firm from performing services in accordance with a standard of care imposed by law. The court quoted from a 1938 court case, indicating that an accountant's negligence can be equated with malpractice or even fraud, as follows:

> A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless [and] disregard of consequence may take the place of deliberate intention.[23]

Just as courts prior to *SSARS 1* were unimpressed by the "audited/unaudited" distinction, cases since its issuance have been reluctant to be bound by the promulgated definitions of "compilation" and "review." Accountant malpractice trials generally involve extensive discovery and fact-finding proceedings which, in turn, attempt to establish an understanding of the nature of the duties agreed to by the parties, and the standards of care implicit in those duties. Once this process is completed, the designation of the engaged services as comprising a "compilation" or a "review" becomes less relevant. Further, the burden of proof that the engagement comprised a lower level of services begins to shift against the accountant.[24]

Minimum Standards of Inquiry and Disclosure

Pre-SSARS 1 Case Law

Another common thread found among the pre-SSARS is the judicial expectation that the accountant would investigate and disclose problems that he or she knows of (or should know of). In the *1136 Tenants' Corp.* the problem triggering the lawsuit was a $237,279 embezzlement that was not discovered during the accountant's $600 write-up of the client's financial data. The court held that when a CPA is associated with financial information, the client can expect the CPA to perform some minimal investigative procedures and to disclose the results of that inquiry.

A similar standard of inquiry and disclosure was imposed in the *Bonhiver* case. There, the accountant had audited the client during a previous engagement, had discovered certain facts during that previous engagement which could have led the accountant to the conclusion that the client was nearing insolvency, but did not investigate those facts again during the later non-audit engagement. Even though the client's later engagement did not call for such an investigation, the court imposed the requirement because the accountant had actual prior knowledge of the possibility of

insolvency. The case establishes a continuing duty to inquire into problems that were uncovered during prior engagements, even when the present engagement does not call for such an investigation.[25]

SSARS 1 Response

SSARS 1 states that in a compilation engagement, the CPA "is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity."[26] Even if the CPA happens to learn of problems or negative information during a prior engagement, the problem or negative information need not be divulged if the CPA includes a paragraph in the report letter stating that substantially all disclosures have been omitted—but the suppression of some information may be misleading, and association with that action could constitute collusion on the accountant's part. Imminence of bankruptcy, for example, might be of such significance that it must be disclosed.

In a review engagement, similarly, the aim of a CPA's investigation has less to do with verification, corroboration, or review of data supplied by management for the purpose of substantiating its accuracy, than it has to do with assuring that the financial statements are themselves in conformity with generally accepted accounting principles ("GAAP") or are otherwise consistent with the non-GAAP method of accounting selected. There is a *SSARS 1* directive that, in review engagements, the CPA obtain "specialized knowledge" regarding the client's industry and specific business, but it is the integrity of the accounting system itself, and the internal consistency of the resultant financial statements, that receive the greatest emphasis. And, again, even if the CPA does become aware of financial information that is, incomplete, or otherwise unsatisfactory, it is the relationship of that information to the financial statements themselves the at becomes the issue—unless, of course, the CPA is authorized to omit substantially all disclosures, in which case the materiality of the omitted information does not matter.[27]

Nevertheless, *SSARS 1* does at least require that even errors, irregularities or illegal acts which are not disclosed in the financial statements be reported to management.[28]

Adequacy

Sufficient case law has been generated, as described above, to allow the promulgation of a standard of minimum inquiry applicable to virtually all en gagements involving certified public accountants. In view of the above court cases, that myth, implicitly advanced by *SSARS 1* compilation or review report language allowing the accountant to state that "management has elected to omit substantially all disclosures," has not served the profession well.[29]

Precise, Understandable Terminology

Pre-SSARS 1 Case Law

Testimony taken during the trial of the *1136 Tenants' Corp.* included an admission by a partner in the defendant accounting firm that the work performed as part of the write-up included procedures that were also performed as part of an audit engagement.[30] The terminology used by the CPA's during the trial began to become vague, even to the point where the term "audit" was used imprecisely, allowing the court to use that vagueness as part of its justification for finding the defendant CPA liable. The case serves as a warning, therefore, against the utilization of terminology that can be confusing to the client or to a user of the financial information, even if that terminology holds specific connotations to the professional accountant.

SSARS 1 Response

SSARS 1 requires that the term "compilation" or "review," as used in the CPA's report letter, be defined in the same letter. This helps to clarify the breadth of services performed by the CPA as a result of the engagement. But *SSARS 1* as a whole does not necessarily bring complete clarity to unaudited financial statements: it recommends, for example, that typical financial statement language, such as "balance sheet" and "income statement," be replaced by other terminology when financial data is presented in a manner not entirely consistent with prevailing GAAP. Hence, a "statement of assets, liabilities, and capital" is preferred over the term "balance sheet" in certain circumstances; and "statement of revenues and expenses" is sometimes required of "income statement."

Adequacy

Many statutes, and many legal documents drafted by attorneys, contain a section dedicated to the definition of terms. This approach would serve the accounting profession well. Ambiguous terminology can be construed against the accountant, and to avoid problems, accountants could add a footnote defining the terminology utilized in the financial statements. Since all financial statement users are not necessarily informed as to the profession's published distinctions between "balance sheets" and "statements of assets and liabilities."

Utilization of Engagement Agreements

Pre-SSARS 1 Case Law

The pre-*SSARS* cases encourage CPA's to obtain written engagement agreements in non-audit situations. If an executed engagement letter exists, it can provide the court with some guidance (but is not determinative) as to such issues as the duty of the accountant and the expectation of the client.[31] But if a written contract does not exist, as in the cases of *1136 Tenants' Corp.* and *Ryan,* the courts tend to fill that void by shifting the burdens of proof of those issues against the accountant.[32]

SSARS 1 Response

SSARS 1 not only recommends the use of engagement letters, it actually provides illustrative specimens of compilation and review engagement letters as appendices to its main text. The sample engagement letters provide a "layperson's summary" of the extent of the services to be provided by the CPA, and include excerpts from the standard report language expected to be employed in connection with the resultant financial statements at the conclusion of the engagement.

Adequacy

SSARS 1 contains sample engagement letter language, and encourages the use of engagement letters. This "legal advice" should be upgraded to a requirement that engagement letters be used in all cases, and that the actual services to be performed (and not

performed) be itemized in such documents. A carefully drafted engagement letter (properly performed by the accountant) can prevent misunderstandings between the parties and limit the liability of the accountant.[33] It can also reduce the need for expensive discovery proceedings, designed to clarify the nature of the engagement, when a dispute does occur.

CONCLUSION

Court cases decided since the issuance of *SSARS 1* have continued the pattern of judicial determinations of the nature of an accountants' engagement, and have not looked favorably on the broad *SSARS 1* disclaimer language. In addition, court cases have continued to require that even in a compilation engagement, a CPA must make inquiries into problem areas about which the CPA knows or should have known, and, again, to disclose same in the financial statements (or the footnotes to the financial statements). To the extent that *SSARS 1* represents a set of standards of care to be acknowledged and applied by the courts, it has not been successful: courts tend to inquire into the nature of the services for which accountants have been engaged, and then to develop their own version of the required standards of care to be followed.

NOTES

1. See, for example, Staff of the Subcommittee on Reports, Accounting and Management of the Senate Committee on Government Operations, "The Accounting Establishment: A Staff Study," *Journal of Accountancy* (March 1977), pp. 108-111.
2. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 818, 104 S.Ct. 1495, 1503, 79 L.Ed.2d 826 (1984) (noting the importantance of the public watchdog function of the C.P.A.) and *Note,* "Raritan River Steel Co. v. Cheery, Bekaert & Holland: Accountants' Liability to Third Parties for Negligent Misrepresentation," 67 N.C.L.Rev 1459, 1467 (1989) (noting the heavy and increasing public reliance upon audited financial information).
3. See, for example, *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. Rptr. 218, 224-25 (1986) (AICPA professional standards are an indicator of the standard an accountant must meet.).
4. *Bily v. Arthurt Young & Co.,* 222 Cal. App. 3d 289, 271 Ca. Rptr. 470 (1990). The Bily court held that adherence to GAAP and GAAS does not establish that an account has fulfilled his duty to use professional care. 271 Cal. Rptr. at 474.

5. 170 N.W. 2d 395 (Iowa 1969).
6. 36 A.D. 2d 804, 319 N.Y.S.2d 1007 (N.Y. App. Div. 1971), *aff'd without opinion,* 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).
7. 311 Minn. 111, 248 N.W. 2d 291 (1976).
8. 466 F. Supp. 340 (D.Neb. 1979).
9. AICPA, "Statement on Standards for Accounting and Review Services No. 1," (1978).
10. Dzienkowski, John S., "Accountants' Liability for Compilation and Review Engagements," 60 Tex. L. R. 759 (1982).
11. 170 N.W.2d at 404.
12. 311 Minn. at 118-119, 248 N.W..2d at 297-98.
13. AICPA *SSARS No. 1,* 1978, § 4.
14. Some fo the cases cited are also pertinent in an analysis of an accountant's duty to third parties. Here, we have not attempted to focus on the duties owed by the accountant to the client as compared to the duties owed third parties who rely on the financial information, because the distinction does not affect the principle being argued.
15. 122 N.H. 898, 451 A.2d 1308 (1982).
16. 330 Pa. Super. 523, 479 A.2d 1027 (1984).
17. AICPA, *SSARS No. 1,* 1978, § 29.
18. 479 A.2d at 1032.
19. 479 A.2d at 1027.
20. 128 A.D.2d 453, 513, N.Y.S.2d 3 (1987).
21. 227 Cal. App. 3d 1389; 1991 Cal. App. LEXIS 192; 278 Cal. Rptr. 490; 91 Daily Journal DAR 2347.
22. 65 N.Y.2d 536; 483 N.E.2d 110; 493 N.Y.S.2d 435 (N.Y. 1st Dept., 1991).
23. State Street Trust Co. v Ernst, 278 N.Y. 104, 112 (1938).
24. Essentially, this is exactly what occurred in *1136 Tenants' Corp. v. Max Rothenberg & Co. supra.* See Dzienkowski, John S., "Accountants' Liability for Compilation and Review Engagements," 60 Tex.L.Rev. 759, f.n. 287.
25. 311 Minn. at 118-119, 248 N.W.2d at 297-98.
26. AICPA *SSARS No. 1,* 1978, § 12.
27. AICPA *SSARS No. 1,* 1978, § 29.
28. AICPA *SSARS No. 1,* 1978, § 29.
29. But see, *Ris v. Finkle,* 148 Misc. 2d 773; 561 N.Y.S.2d 499; 189 N.Y. Misc. LEXIS 891 (1989) (Summary judgement granted to defendant accountant on issue of liability for reliability of complied financial statemewnts with accompanying disclaimer of disclosure language.)
30. 36 A.D.2d at 804, 319 N.Y.S.2d at 1007.
31. Van Son, Guy & Betts, "Engagement Letters: What Practice Shows," J. Acct., June 1982.
32. 36 A.D.2d at 804, 319 N.Y.S.2d at 1007; 170 N.W.2d at 398-99.
33. See *Robert Wooler Co. v. Fidelity Bank,* 330 Pa. Super. 523, 531; 479 A.2d 1027, 1031 (1984); and *Gannt v.Boone, Wellfod, Clark, Langschmidt, Pemberton,* 559 F.Supp. 1219, 1228 (M.D. La. 1983), *aff'd mem.* 742 F.2d 1451 (5th Cir. 1984) (Accountants' duties can be limited by agreement.).

THE DISTRIBUTION OF MANAGEMENT ADVISORY SERVICES: THE CASE OF ACTURIAL SERVICES

Noel Addy, Alan Friedberg, and Alan Mayper

ABSTRACT

The provision of Management Advisory Services to audit clients is controversial, since it has been argued that independence may be impaired. To control potential impairment, CPA firms segregate Management Advisory Services from audits. If the separation were so effective as to make Management Advisory Service divisions behave as though they were not related to audit divisions, there should be evidence that Management Advisory Services clients are independent of audit clients. We specifically study the extent to which the set of Management Advisory Services clients is independent of the set of audit clients. Independence of client groups implies independence of marketing these two services. But, if the two groups

Research in Accounting Regulation, Volume 7, pages 95-115.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

are not independent, then a condition necessary for impaired independence would exist, although the condition is not sufficient to guarantee that "independence in fact" has been impaired. We narrow the research design to consider (1) only the single Management Advisory Service of actuarial services to define benefit pension plans, (2) only CPA firms who are significant providers of these services, and (3) only clients who can demand these services by having defined benefit pension plans. The results show CPA firms offer actuarial services for defined benefit pension plans primarily to their audit clients. This result suggests that the perceptions of potential impaired independence are not misplaced.

It has been argued that by providing management advisory services (MAS) to audit clients, CPA firms may impair their independence. Professionally, impairment of independence is affected by the type of MAS provided. For example, executive recruitment is specifically proscribed because it jeopardizes independence (Hermanson, Strawser, and Strawser 1993, 66-67). There is a delicate balance between the scope of services that can be offered and controls that must be implemented to preserve the accountant's independence. These controls may include standards of professional conduct prescribed by the AICPA, internal CPA firm policies and procedures that may be subject to peer review, and rules and regulations when government regulated.

One control used by large CPA firms is separation of duties: separating the audit function from the MAS function. By segregating individuals responsible for functions that would otherwise clearly impair independence, firms maintain independence. For example, a CPA firm may consult on the development of an accounting system and audit the same client, but it enhances independence by having these functions performed by individuals from organizationally separate units within the firm. Proponents of staff separation view it as the best control for maintaining independence while offering both MAS and audit services even though it requires an element of "self-discipline." Previts (1985, 165) notes the crux of the issue:

> The matter [management of MAS and independence] revolves around whether we as a group of professionals have a sufficient degree of self-discipline to voluntarily circumscribe our self-interest in favor of the well-being of the society which we serve, placing independence above economic gain.

If separation of duties were so effective as to make MAS divisions behave as though they were not related to audit divisions, one would expect to find evidence that MAS clients are independent from audit clients. That is, the marketing of the two services would be independent. This study accumulates evidence on CPA firm self-discipline by observing whether or not CPA firms disproportionately market MAS to audit clients compared to nonaudit clients. If we observe a joint marketing of MAS and audit services, then a condition necessary for impaired independence would exist, although the condition is not sufficient to guarantee that "independence in fact" has been impaired.

Specifically, our study examines the client mix for the MAS of actuarial services supplied by CPA firms to clients with defined benefit plans.[1] Our data imply that the two CPA firms we examined jointly marketed audit service and the MAS of actuarial services. As a result, an outside observer may perceive a lack of independence for these firms, although there may still be "independence in fact." In the discussion section, we propose several alternative steps that could be taken to change an outside observer's perception of this lack of independence.

This paper first presents the background of CPA firm provision of actuarial services for clients with defined benefit pension plans, including a discussion of regulatory concerns and a review of the literature. The results of the present study are presented next. The final section discusses the results and the implications of the study.

BACKGROUND

Regulatory Concerns

Both Congress and the SEC have singled out actuarial services as a particularly sensitive consulting area. The report of the Senate Subcommittee on Oversight (CSS) (1976, 51) charged that actuarial services present a greater conflict of interest than does executive recruitment (a practice since proscribed). The study states:

> Contributions by corporations to employee pension plans generally have a direct and substantial impact on corporate earnings. When an accounting firm provides actuarial service relating to such plans for a corporate client, the firm is directly involved in working with the client's management on matters which

> may substantially affect the client's earnings. An accounting firm cannot properly act as the independent auditor for such a client.

The Senate Subcommittee Report (CSR) (1985) echoed this view and stated that nonaccounting management services such as executive recruitment, marketing analysis, plant layout, product analysis, and actuarial services are incompatible with the public responsibilities of independent auditors. CSR recommended that CPA firms stop providing these services.

The SEC issued *Accounting Series Release* (*ASR*) *250* as a response to the Congressional concern about the provision of nonaudit services by auditing firms. *ASR 250* required proxies to disclose the type of nonaudit service (such as actuarial services) provided by the CPA firm and the fee paid as a percentage of the audit fee. The rule was in effect for proxy statements filed after September 30, 1978. The SEC rescinded the rule effective February 1982. In a later *ASR* (*ASR 264*), the SEC stated that the profession was not adequately sensitive to the potential lack of independence caused by the provision of nonaudit services. The SEC specifically stated that the provision of actuarial services to an audit client is always cause for concern. Further, there are no offsetting benefits to this potential impairment of independence; spillover between actuarial services and audit is at best imaginary (in the view of the SEC). In its opinion, no economies exist in the joint provision of such services.[2]

There was considerable confusion as a result of *ASR 250*. The reporting of fee percentages implied that there was a threshold percentage above which the auditing firm would lack independence. As a result, the firm would no longer be able to provide MAS to the client, even though the auditing firm might have many clients and the total amount of fees from a single client was insignificant. The stridency with which *ASR 264* criticized MAS activities confused auditors and audit committees. As a result, the SEC rescinded *ASR 250* and *ASR 264*, although the views expressed in *ASR 264* were unchanged, according to *ASR 296*.

Apparently, the concerns of the SEC and Congress are widely shared.[3] Pany and Reckers (1984) find that subjects perceived that actuarial services endanger audit independence, even if they are performed by a distinct department. According to the subjects, actuarial services endanger audit independence more than the

recruitment of outside directors does. Thus, the Pany and Reckers subjects, like those of the CSS, perceived that the provision of actuarial services to clients with defined benefit pension plans is more likely to endanger independence than is executive recruitment.

The accounting profession, however, has been more reluctant than the SEC or Congress to conclude that the provision of actuarial services by CPA firms impairs audit independence.[4] The first issue that the Public Oversight Board (POB) of the AICPA addressed was that the audit staff might not be independent of the actuarial staff. Two areas of concern for this potential impaired independence were as follows:

1. The review of the actuarial specialist performing the work is also a review of a fellow employee of the auditing firm.
2. The audit staff might use the actuary's test of client-supplied data as the audit test of the data.

The POB rejected these concerns. Regarding the first item, the POB found that CPA firms judge the actuary to be competent during the hiring process. The screening for a potential employee is undoubtedly more rigorous than any screening performed on an outside specialist. Hence, the first point should not affect audit outcomes. Regarding the second point, the POB noted that, in general, the audit staff should never assume that the test of client-supplied data by the actuary is sufficient as an audit test. Hence, the second point should not affect audit outcomes. Therefore, neither potential impairment should affect the independence of the CPA firm that also provides actuarial services.

A second issue addressed by the POB is whether the actuary can be independent of the client. The POB observed that the actuary who works for the CPA firm is at least as objective as the actuary who works for a professional actuarial firm; hence there should be no effect on independence.

The AICPA has also considered ethics rulings to determine the potential harm to independence caused by the provision of actuarial services. Citing Rule 101 on independence, the AICPA stated in Ethics Ruling 54 that a member can provide actuarial services to a client with a defined benefit pension plan, including inputs to the financial statements, if all of the significant matters of judgment involved are determined or approved by the client and the client is

in a position to have an informed judgment on the results. Referring to Rules 501 through 505 on other responsibilities and practices, the AICPA in Ethics Ruling 115 authorizes members to purchase the portion of an insurance brokerage firm that performs actuarial and administrative services in connection with employee benefit plans and to conduct the operation as a separate partnership. In summary, the AICPA has made no attempt to limit the provision of actuarial services by CPA firms to clients with defined benefit pension plans, and no rules currently limit the auditor's use of an in-house actuary.

ASR 250 Studies

Beck, Frecka, and Solomon (1988b), Schiener and Kiger (1982), Schiener (1984), and Cowen (1980) use *ASR 250* data to estimate the extent to which MAS is provided to audit clients. Cowen reports that about 1 percent of clients received actuarial services from CPA firms. Schiener and Kiger include 39 audit clients of Coopers and Lybrand (CL) and 55 audit clients of Peat Marwick Mitchell (PM) in their sample and conclude that "various nonaccounting and non-financial systems services and actuarial services are provided to less than 3 percent of the companies" (p. 486). CL collected an additional 12 percent of the audit fee, on average, from audit clients purchasing actuarial services. Actuarial services provided the largest amount of additional revenue from the set of MAS services provided by CL.

Beck et al. (1988b) report that 49.40 percent of the audit clients purchased pension and personnel-related services in 1978 from the CPA firm, but only 6.97 percent of clients purchased these services in 1979. The Beck et al. category of pension and personnel-related services is a combination of three categories similar to those used by Schiener and Kiger: audit of employee benefit plans, employee interviewing-personnel services, and actuarial services. Audit of employee benefit plans, however, became an audit service (per Staff Accounting Bulletin No. 33) as of July 1979, and so the difference in percentage between years could be, at least partly, a result of a redefinition between years. Beck et al. do not disaggregate data further so this point could not be settled. In contrast to the volatility reported by Beck et al., Schiener (1984) does not find a significant change in the provision of actuarial services from 1978 to 1979 when considering the single MAS of actuarial services.

A problem with *ASR 250* studies is they consider all clients to be potential consumers of all lines of business offered by CPA firms. However, only clients with defined benefit pension plans are potential consumers of the actuarial services contemplated in the current study. Addy and Swanson (1991) state that only 60 of 113 companies reported an amortization period for prior service cost in 1983. As a benchmark, this implies that approximately 53 percent (60/113) of audit clients have defined benefit pension plans.[5] Testing the dependency of marketing auditing and actuarial services should confine the sample to clients with defined benefit pension plans and to CPA firms that provide actuarial services.

Surveys

The CSS sent a questionnaire to the (then) Big Eight CPA firms. The questionnaire (dated December 19, 1975) included requests for information regarding services offered by the CPA firms. Coopers and Lybrand (PM) reported that 2 percent (1 percent) of total revenues came from actuarial services (Table 1, p 30, question 7 of CSS). Touche Ross provided actuarial services through a separate firm, Touche Ross Stennes. The other CPA firms replied that they did not provide actuarial services. Reports to the SEC Practice Section of the AICPA provide limited information on MAS fees. The report for CL (PM) for fiscal 1989 states that MAS fees from SEC audit clients amount to 4 percent (3 percent) of total fees while MAS fees from all other clients were 18 percent (17 percent). There is no breakdown by type of MAS, so the relative significance of actuarial services is not available. Nor is there a breakdown of the proportion of the 18 percent (17 percent) provided to nonaudit clients.

Palmrose (1988) reports on a survey of companies regarding purchases of MAS. The survey instrument requested information about audit fees and management advisory service fees. She aggregates several types of MAS services; therefore, it is not possible to determine the distribution of actuarial services in the surveyed sample. However, Palmrose documents the existence of sales of nonaudit services to audit clients of other CPA firms, a feat not possible from *ASR 250* data. Approximately 11 percent of all sample companies purchased at least some services from CPA firms that were not currently auditing the company. According to the results of a survey by Abdel-khalik (1990), 42 percent (of 84 companies)

purchased MAS from the CPA firm that provided their audit services. Abdel-khalik does not identify the particular CPA firms or type of MAS provided or the provision of MAS to nonaudit clients.

Each study contributes evidence concerning the magnitude of actuarial services offered by CPA firms, but none is comprehensive. The current study attempts to provide a more complete, detailed distribution, including a description of the primary competitors in the field of actuarial services.

The current study uses data from (1) Form 5500 for pension and welfare plans; (2) the *Active Actuary Register* from the Joint Board for the Enrollment of Actuaries; (3) the 1988 yearbooks from the Society of Actuaries and American Academy of Actuaries; and (4) *America's Corporate Families, Directory of Corporate Affiliations, Who Owns Whom,* and *Who Audits America.* From these data we estimated the extent to which CPA firms provide actuarial services. For a full discussion of these sources, see the appendix.

RESULTS

Table 1 reports the distribution of enrolled actuaries across the largest professional firms employing enrolled actuaries. For inclusion in the 1987 distribution, we deleted all actuaries enrolled after April 1, 1988. The exact cutoff is arbitrary. However, most plans have a year-end cutoff several months prior to the sponsor's fiscal year. Form 5500 is due seven months after the plan's year-end. Hence, April 1, 1988, is a reasonable, although approximate, estimate of when an actuary would need to be enrolled to service the plan for 1987. As of April 1, 1988, 3,094 actuaries were listed on the *Active Actuary Register.* The results are not sensitive to variation in this cutoff.

There is no traditional cutoff for size in the actuarial profession similar to the Big Six in accounting, so we used a cutoff of 30 enrolled actuaries per firm for inclusion in the table. This cutoff captures the variable of interest, major CPA firms providing actuarial services. The cutoff includes about 42.21 percent of the total number of enrolled actuaries.

Significant size differences are evident. According to the number of enrolled actuaries as a measure, three professional firms are much larger than any of the others. The smallest of what might tentatively be called the Big Three is more than twice the size of the fourth ranked firm. PM and CL rank in the top 12 employers of enrolled actuaries.

Table 1. Distribution of Enrolled Actuaries across Large Professional Firms

Rank	*Firm*	*Number of Enrolled Actuaries*	*Society of Actuaries*	*American Academy of Actuaries*
1	Mercer Meidinger Hansen, Inc.	289	332	319
2	The Wyatt Company	241	329	267
3	Towers Perrin Forster & Crosby	202	340	232
4	Hewitt Associates	97	145	103
5	George Buck Consulting Actuaries	96	87	103
6	Milliman & Robertson	74	193	219
7	A. Foster Higgins & Co.	71	82	65
8	Coopers & Lybrand	63	89	108
9	Alexander & Alexander	58	61	61
10	KPMG Peat Marwick	41	66	60
11	(tie) Kwasha Lipton	37	42	40
11	(tie) Martin E. Segal Co.	37	38	42
	Total	1,306*	1,804	1,619

*42.21% of 3,094

Table 2. 1987 Form 5500 Data Characteristics

Source	*Total*	*Percentage of Plans on Tape*
Plans on the tape	107,711	100.00
Less: Plans other than defined benefit plans	86,098	79.94
Defined benefit plans	21,613	20.06
Less: Actuarial services not provided by the largest 12 actuarial firms	9,904	9.19
Actuarial services provided by the largest 12 actuarial firms	11,709	10.87

Table 1 also presents the total number of actuaries that both the Society of Actuaries and the American Academy of Actuaries report for each actuarial firm. This provides perspective on the number of actuaries who are enrolled.

Table 2 describes the Department of Labor information. There are 107,711 separate pension and welfare plans on its 1987 tape (see the Appendix). Most of the 86,098 plans on the tape are defined contribution or health and welfare plans, do not require the actuarial services contemplated in this paper and were discarded. This leaves 21,613 defined benefit pension plans. The 1,306 actuaries working for the largest

Table 3. Distribution of Actuarial Services to Defined Benefit Plans Across Actuarial Firms

Professional Firm	*Total Number of Plans*	*Actuaries Signing Plans*
Mercer Meidinger Hansen, Inc.	2,426	217
The Wyatt Company	2,449	187
Towers Perrin Forster & Crosby	1,916	151
Hewitt Associates	1,043	54
George Buck Consulting Actuaries	784	62
Milliman & Robertson	434	40
A. Foster Higgins & Co.	586	48
Coopers & Lybrand	352	43
Alexander & Alexander	502	43
KPMG Peat Marwick	281	31
Kwasha Lipton	377	28
Martin E. Segal Co.	559	30
Total	11,709	934

Table 4. Distribution of Defined Benefit Plans by Type of Company: Actuarial Services are Provided by an Auditing Firm

	Auditing Firm				
Actuarial Firm	*Coopers & Lybrand*	*KPMG Peat Marwick*	*Other Auditing Firm*	*No Auditing Firm Identified*	*Total*
Coopers & Lybrand					
Plans	98	16	65	114	293
Co.s	52	11	32	92	187
KPMG Peat Marwick					
Plans	2	48	48	109	207
Co.s	1	29	23	101	154
Total					
Plans	100	64	113	223	500
Co.s	53	40	55	193	341

12 actuarial plans provided services for 11,709 of the plans. As a result, about 42.21 percent of the enrolled actuaries accounted for the actuarial work on about 54 percent (11,709/21,613) of the defined benefit pension plans.

These 11,709 plans were clients of the 12 professional firms described in Table 3. Of the 289 enrolled actuaries working for Mercer Meidinger Hansen, Inc. in 1987 (see Table 1), 217 signed at least one Form 5500 schedule B. The 217 Mercer Meidinger Hansen actuaries provided services to a total of 2,426 defined benefit pension plans.

Table 4 reports the net result of our efforts at tracking the 352 (281) plans for which CL (PM) provided actuarial services. Using the references cited in the appendix, we could trace 293 (207) plans to domestic (U.S.) companies of the 352 (281) plans for which CL (PM) provided actuarial services.[6] Table 4 reports our findings regarding these plans. The 293 (207) plans for which CL (PM) provided actuarial services are distributed across 187 (154) companies. CL also provides the audit service for 52 companies, represented by 98 plans. CL provides the actuarial services for 65 plans, across 32 companies, for clients that another CPA firm audits. PM provides the actuarial services for 29 companies for which it also provides the audit service.

The other side of estimating client mix is to identify the possibility that another actuarial firm (besides CL or PM) provides actuarial services to CL or PM audit clients. We used a procedure that sampled from the non-CL and non-PM actuaries in Table 3 because it was not feasible to investigate all of the remaining 11,076 plans (11,709 less 352, less 281) across 860 actuaries (934 less 43, less 31). Selection of the exact sample size was arbitrary, so we drew a sample size from the other 10 firms listed in Table 1 equal to the number of actuaries (104) listed in Table 1 from CL and PM. We used the results from these 104 (randomly drawn) actuaries to represent the distribution of clients from the remaining actuaries (those actuaries not employed by CL or PM).

We inspected the same set of references as before to identify sponsoring companies. Table 5 details the work of the 104 randomly selected actuaries. These actuaries provided actuarial services to 649 plans of domestic (U.S.) companies. Among the other data reported in Table 5, CL was the auditing firm for 16 companies, 3 of which had Mercer Meidinger Hansen, Inc. as the actuarial firm. Towers Perrin Forster & Crosby provided actuarial services to 25 plans, across 6 companies, for which PM provided the audit service.

Table 6 combines information from Tables 4 and 5 concerning companies for which we identified the CPA firm. As Table 6, Panel B, presents, CL provided combined audit and actuarial services to 52 of the total 355 identified companies. CL provided audit services to about 54.74 percent (52/95) of the clients to whom they provide actuarial services. PM provides audit services to about 54.72 percent (29/53) of the clients to whom they provided actuarial services.

The null hypothesis, tested with these data, is that there is no association between the marketing of audit and actuarial services. This hypothesis is rejected at the .01 level. This is true whether we consider

Table 5. Distribution of Defined Benefit Plans by Type of Company: Actuarial Services are Provided by Professional Actuarial Firms

	Auditing Firm				
Actuarial Firm	*Coopers & Lybrand*	*KPMG Peat Marwick*	*Other Auditing Firm*	*No Auditing Firm Identified*	*Total*
Mercer Meidinger Hansen, Inc.					
Plans	3	2	59	52	116
Co.s	3	2	35	44	84
The Wyatt Company					
Plans	2	3	76	18	99
Co.s	1	3	26	15	45
Towers Perrin Forster & Crosby					
Plans	13	25	96	39	173
Co.s	10	6	46	23	85
Hewitt Associates					
Plans	1	9	40	5	55
Co.s	1	4	15	3	23
George Buck Consulting Actuaries					
Plans	5	6	58	23	92
Co.s	1	4	15	18	38
Milliman & Robertson					
Plans	0	1	11	3	15
Co.s	0	1	4	3	8
A. Foster Higgins & Co.					
Plans	0	0	29	7	36
Co.s	0	0	9	6	15
Alexander & Alexander					
Plans	0	2	48	4	54
Co.s	0	1	14	4	19
Kwasha Lipton					
Plans	0	0	7	2	9
Co.s	0	0	6	2	8
Martin E. Segal Co.					
Plans	0	0	0	0	0
Co.s	0	0	0	0	0
Total					
Plans	24	48	424	153	649
Co.s	16	21	170	118	325

the test on individual plans or companies. To demonstrate the pattern of association, the number of plans (or companies) expected under the null hypothesis is presented in Table 6, Panel B. Given no association, only 19 companies would be expected to select CL to provide both

actuarial and audit services. In fact, 52 companies did. As a result, we conclude that CL jointly markets these services. A similar conclusion about PM can be drawn.

Two conditional probabilities can be estimated from the data in Table 6: the probability of CL (PM) having the audit engagement, given that CL (PM) provides the actuarial services and the probability of CL (PM) having the actuarial engagement, given that CL (PM) provides the audit services. The relative importance of these probabilities depends on how marketing is thought to proceed. Sales of actuarial services to potential audit clients could apprise CPA firms of conditions when a bid on audit services might be accepted. This scenario emphasizes the probability of obtaining the audit engagement, given the provision of actuarial services. Other scenarios might emphasize the other conditional probability.

Table 6. Distribution of Audit and Actuarial Services

	Auditing Firm			
Actuarial Firm	*Coopers & Lybrand*[a]	*KPMG Peat Marwick*[a]	*Other Auditing Firm*[b]	*Total*
Panel A: Plans				
Coopers & Lybrand	98	16	65	179
(expected)	(29)	(26)	(124)	
KPMG Peat Marwick	2	48	48	98
(expected)	(16)	(14)	(68)	
One of the Remaining Ten	24	48	424	496
(expected)	(79)	(72)	(345)	
Total	124	112	537	773[c]
Panel B: Companies				
Coopers & Lybrand	52	11	32	95
(expected)	(19)	(16)	(60)	
KPMG Peat Marwick	1	29	23	53
(expected)	(10)	(9)	(34)	
One of the Remaining Ten	16	21	170	207
(expected)	(40)	(36)	(131)	
Total	69	61	225	355[d]

[a] The column data for CL and PM are reproduced from Table 4.

[b] The column data for the remaining ten professional actuarial firms are reproduced from Table 5.

[c] A test of the source of audit service for companies is independent of actuarial services for plans has a computed chi square of 362, signifiant at the .01 level.

[d] A test that audit services are independent of actuarial services for companies has a computed chi square of 163, significant at the .01 level.

Naturally, c and d are not independent tests.

Given that CL (PM) provides the actuarial services to a company with a defined benefit pension plan, the chance that CL (PM) has the audit engagement is 52/95 (29/53), or about 54 percent (54 percent). The literature does not report such an estimate. The other conditional probability is that given that CL (PM) provides the audit to a company with a defined benefit pension plan, what is the chance that CL (PM) has the actuarial engagement? The distribution determined for the 104 random actuaries (see page 105 of our paper) can be used to represent the remaining actuaries. When the 104 random actuaries are used to estimate the unknown distribution, the computed chances are about 13 percent (5.8 percent) of CL (PM) being the actuarial vendor, given that CL (PM) provides the audit. Including all CPA firms and all clients, Cowen (1980) estimated that 1 percent of clients received actuarial services from CPA firms. By considering only clients with defined benefit pension plans and only CPA firms who can supply actuarial services, our estimates (13 percent and 5.8 percent) are more appropriate estimates of joint actuarial/audit services to audit clients. Clearly, different CPA firms have different capabilities, different clients demand different services, and the previous overall estimate did not capture this variation.

We can also compare our figures to other reported information. The practice report for 1989 states that CL (PM) had 1,386 (2,244) SEC audit clients. Using the Addy and Swanson (1991) benchmark that 53 percent of companies amortize prior service cost (hence, have defined benefit plans), CL (PM) should have about 732 (1,169) SEC audit client candidates for its actuarial services. At a rate of 13 percent (5.8 percent), we should have identified 95 (69) SEC audit clients using CL (PM) for actuarial services. Our figure is different from that figure for at least two reasons. First, the inability to name-match from plan sponsor to a single reporting company is a significant source of understatement. Many of the 193 companies included in the "No auditing firm identified" column of Table 4 may have had CL or PM as auditing firms. Second, the estimate of 53 percent is only a benchmark estimate of the frequency of defined benefit plans among audit clients. The actual frequency may be lower. Nevertheless, the estimated distribution presented here is an improvement over information presented in the literature.

The evidence suggests large CPA firms may be classified according to whether they offer actuarial services or not. It is also clear that firms offering actuarial services offered such services primarily to their audit

clients. This result suggests that the perceptions of potential impaired independence are not misplaced. An engagement partner rejecting a client's accounting for a transaction imperils two sources of revenue, not one source of revenue.

DISCUSSION

The types of MAS provided by CPA firms varies substantially. Only two CPA firms, CL and PM, were significant providers of actuarial services among CPA firms. CL and PM compete both with three actuarial firms, each of which has many more actuaries than the CPA firms have, and with a second tier of actuarial firms that are approximately the same size as CL and PM. These two CPA firms are the most successful competitors for providing actuarial services to their audit clients. The client mix has been previously assumed but not documented.

Hillison and Kennelley (1988) cite some possible sources of a net advantage to the CPA firm supplying both audit and actuarial services. First, a cost savings resulting from a single vendor, compared to the cost from multiple vendors may exist. The provision of both services to a client can eliminate duplication of effort. Thus, the cost of a single vendor may be lower than the cost of multiple vendors. In providing actuarial services, the actuary's test of client data would never be sufficient as a audit test, but the audit test would be sufficient for the actuary's test. Hence, a single test can be used for both purposes. This cost savings to the single vendor can be shared with the client in the form of lower fees.

Second, the audit firm must attract, and retain, a certain number of actuaries for insurance reserve computations, comfort letters, and other work. Actuarial services for clients with defined benefit plans can be priced to make a contribution to the fixed cost of retaining an actuarial staff, even if the service makes no obvious profit itself.

Third, expansion into actuarial services may reduce a CPA firm's business risk since a company with two products has diversified away a portion of business risk. This argument may be less important for actuarial services. Actuarial services are provided predominantly to audit clients. It is a very limited form of diversification to count on demand for one service to make up for reduced demand in another service within a single client. More likely, a client's willingness to pay

for these services will move in concert. To diversify risk, CPA firms should sell actuarial services to nonaudit clients. Clearly, CL and PM would like to sell actuarial services to nonaudit clients, but are less successful in attracting these clients than audit clients.

Whatever the form of the net advantage that induces the client to select the CPA firm to provide actuarial services, there is an additional cost that may not enter the calculation. That additional cost is the result of perceived lack of auditor independence. Our study demonstrates that a necessary condition of impaired independence exists: the nonrandom marketing of audit and actuarial services. Should further conditions, necessary to show impaired independence, be empirically demonstrated, the profession may wish to respond by taking some action.

One response would involve education of the public regarding forces that keep the CPA firm independent in fact. Since our evidence indicates CPA firm reliance on the same client for both MAS and audit fees, CPA firms may wish to explicitly educate the public about the controls in place that ensure independence in fact. Another response would involve disclosing economic facts along with the audit report to demonstrate why the CPA firm is not dependent on the client. A fourth possibility is to bring MAS under peer review. An extension of existing peer reviews could bring the entire scope of MAS services under review. Sternberg (1992) reports the more novel suggestion of removing marketing altogether from the auditing engagement. For example, the audit could be rotated across the pool of CPA firms. This would eliminate consideration of whether the client was also paying for MAS services.

Though relatively little is known about investor reaction to audits, economic inefficiencies may exist. When independence is perceived to be impaired, investors should be induced to price protect themselves from the reduced credibility of the financial statements. Feedback mechanisms that push this cost back onto management have been hypothesized. First, companies seeking new capital will experience higher cost of capital when financial statements have reduced credibility. Second, companies can become takeover targets when prices are low as the result of reduced credibility of financial statements. The effectiveness of these mechanisms is an open question.

Managements or boards of directors may have other reasons to object to the single vendor approach. First, the single vendor approach can generate difficulties in monitoring the cost of audit and actuarial services. There can be a perception that the audit or actuarial staff will

shift billings between services to maximize the receipts from the client. As a result, a cost-conscious management may avoid single vendors for both services. Second, since boards of directors are responsible for overall corporate governance, they may find it beneficial to preempt impairment of independence. The effectiveness of these mechanisms in influencing decisions is also an open question.

APPENDIX: DESCRIPTION OF DATA SOURCES

The Joint Board for the Enrollment of Actuaries (the Joint Board) is a quasi-governmental agency that enrolls (licenses) qualified actuaries. The Joint Board does not keep archived lists of enrolled actuaries, but it provided its most recent listing, the *Active Actuary Register,* dated April 30, 1990. There are 3,409 actuaries on the list, which catalogues the actuaries in good standing with the Joint Board. The *Active Actuary Register* provides the actuary's ID number (a permanent enrollment number), name, professional firm for which he or she works, the date that the actuary was first enrolled, and the renewal date. The Joint Board deletes from this list actuaries when they fail to complete CPE requirements or fail to renew the enrollment.

Enrolled actuaries provide information for Form 5500 that sponsors of defined benefit pension plans must file with the Internal Revenue Service. Form 5500 documents the extent of deductibility for tax purposes of the contribution to the defined benefit pension plan trust. The Department of Labor (DOL) makes the data on these forms available as public information. On Schedule B, the actuary provides the present value of vested and nonvested benefits, the normal cost, and other charges to the funding standard account. The actuary attests that the information is complete, accurate, and reasonably related to the experience of the plan, as well as the actuary's best estimate of anticipated experience. The client selects the contribution to the pension plan, the credit to the funding standard account. The funding must fall within limits determined by the charges to the funding standard account.[7] The actuary also provides the service cost, present value of projected benefit obligation, and present value of accumulated benefit obligation for use in financial statements per *SFAS 87.* The actuary provides the information and a transmittal letter stating that the actuary produced the information consistent with the actuary's understanding of *SFAS 87* (*American Academy of Actuaries 1988 Yearbook* p. 72).

The DOL enters codes of selected information from Form 5500 onto a computer and makes the information available on magnetic tape. The 1987 tape was the most recent year available and was estimated by the DOL to be at least 85 percent complete. The particular actuarial firm providing services is not listed, but the actuary's ID number is coded. As a result, by matching the ID number reported on the tape with that provided by the *Active Actuary Register,* we identified the individual actuary and actuarial firm providing the actuarial services.

Professional organizations (The Society of Actuaries and American Academy of Actuaries) were consulted to make certain that the actuary worked in 1987 for the professional actuarial firm reported on the *Active Actuary Register* for April 30, 1990. *The Society of Actuaries 1988 Yearbook* (*Society Yearbook*) and the *American Academy of Actuaries 1988 Yearbook* (*Academy Yearbook*) presented the employment status of members as of November 1, 1987. We compared the employment status of each actuary on the *Active Actuary Register* with the reported employing professional actuarial firm in both the *Society Yearbook* and the *Academy Yearbook* to backdate the employment to the year 1987. As a result, it was possible to establish the number of enrolled actuaries, the employing professional actuarial firm for each actuary, the associated ID numbers, and the plans for which each actuary provided services for the year 1987.

Each sponsor of an individual pension plan could be a company, or the sponsor could be merely a division or a subsidiary of a company. A search was conducted using *America's Corporate Families* (vol. I, 1988, and vol. II, 1988, which includes international affiliates), *Directory of Corporate Affiliations* (1988), *Who Owns Whom* (North America, 1988), and Who Audits America (20th ed., December 1988) to identify the company sponsoring the defined benefit pension plan. If the company is domestic (U.S.) based, *Directory of Corporate Affiliations* and *Who Audits America* state the audit firm.

NOTES

1. Actuaries might also be employed for establishing the adequacy of insurance reserves (for insurance companies), valuation of management compensation plans,

or other special studies. None of these services are contemplated in this paper—only the provision of actuarial valuations for defined benefit pension plans.

Abdel-khalik (1990) characterizes MAS with this description (cited here in part): (1) variation in the activities that a CPA firm can provide, (2) no professional standards the client can use to evaluate the service, and (3) the service providedis free of regulatory oversight. Item (1) is descriptive of the market for actuarial services; only two of the Big Six CPA firms provide the actuarial services contemplated here. Items (2) and (3) are less descriptive of the market for actuarial services. The enrolled actuary is a member of a licensed profession and assists the client in meeting regulatory requirements described herein. An actuary is enrolled after passing two examinations and satisfying an experience requirement (*Society Yearbook* 72).

2. *ASR 264* was intended to persuade rather than be a statement of fact. To claim that no economies existed is to claim insight into the production functions and determinants of cost of capital across companies in diverse circumstances.

3. Literature has dealt with both the perceptions of financial statement users (Pañy and Reckers 1984, 1988) and the theoretical economic impact on auditor-client decisions (Beck, Frecka, and Solomon 1988a; Hillison and Kennelley 1988; Simunic 1984; Palmrose 1986).

4. For a criticism of the accounting profession's arguments see Bartlett (1991).

5. This benchmark understates the number of audit clients with defined benefit pension plans because not all defined benefit pension plans have unamortized prior service cost, hence, no reported period of amortization. This benchmark overstates the number of audit clients with defined benefit pension plans because it consists of large companies, which are more likely to have such plans.

6. We have traced audit and actuarial suppliers for domestic (U.S.) companies only. Foreign companies and organizations other than companies (e.g., unions, colleges, and charitable organizations) have been excluded because the audit supplier is not as easy to identify for these groups.

7. Sponsors can justify contributions below this bound by (1) the level of prior funding, (2) a funding waiver, or (3) the alternative minimum funding standard. Contributions above this bound are not tax deductible.

REFERENCES

Abdel-khalik, R. 1990. The jointness of audit fees and demand for MAS: A self-selection analysis. *Contemporary Accounting Research* (Spring): 295-322.

Addy, N., and E. Swanson. 1991. The relationship between income strategy and lobbying position on accounting for income taxes. Working Paper, Texas A&M University, September.

American Institute of Certified Public Accountants. 1983. *Audits of Employee Benefit Plans*. New York: AICPA.

———. 1992. *AICPA Professional Standards Volume 2*. New York: AICPA.

American Academy of Actuaries. 1988. *American Academy of Actuaries 1988 Yearbook*. Washington, DC: American Academy of Actuaries.

Anderson, G., and R. Ellyson. 1986. Restructuring professional standards: The Anderson Report. *Journal of Accountancy* (September): 92-104.

Bartlett, R. 1991. A heretical challenge to the incantations of audit independence. *Accounting Horizons* (March): 11-16.

Beck, P., T. Frecka, and I. Solomon. 1988a. A model of the market for MAS and audit services: Knowledge spillovers and auditor-auditee bonding. *Journal of Accounting Literature*: 50-64.

________. 1988b. An empirical analysis of the relationship between MAS involvement and auditor tenure: Implications for auditor independence. *Journal of Accounting Literature*: 65-84.

Briloff, A. 1990. Accounting and society: A covenant desecrated. *Critical Perspectives in Accounting* (March): 5-30.

Campbell, P. 1978. Enrolled actuaries and welfare plans. *Journal of Accountancy* (July): 68-69.

Canadian Institute of Chartered Accountants. 1984. Report of the Joint CICA/CIA Task Force on the roles of the auditor and the actuary in respect of financial statements. Toronto: CICA.

Commission on Auditor's Responsibilities (the Cohen Commission). 1978. The Commission on Auditors' Responsibilities: Report, conclusions, and recommendations.

Cowen, S. 1980. Nonaudit services: How much is too much? *Journal of Accountancy* (December): 51-56.

DeAngelo, L. 1981a. Auditor size and audit quality. *Journal of Accounting and Economics* (December): 183-99.

________.1981b. Auditor independence, 'low balling', and disclosure regulation. *Journal of Accounting and Economics* (August): 113-28.

DeBerg, C., S. Kaplan, and K. Pany. 1991. An examination of some relationships between nonaudit services and auditor change. *Accounting Horizons* (March): 17-28.

Dopuch, N. 1988. Discussion of a model of the market for MAS and audit services: Knowledge spillover and auditor-auditee bonding and an empirical analysis of the relationship between MAS involvement and suditor tenure: Implications for auditor independence. *Journal of Accounting Literature*: 85-93.

Dun & Bradstreet International. 1988. *Who Owns Whom 1988 North America.* Dun & Bradstreet International.

Dun's Marketing Services, Inc. 1988. *America's Corporate Families Volume I.* Dun's Marketing Services.

________.1988b. America's Corporate Families and International Affiliates Volume II. Dun's Marketing Services.

Eichenseher, J., and D. Shields. Forthcoming. Corporate capital structure and auditor "fit." In *Advances in Accounting,* ed. B.N. Schwartz. Greenwich, CT: JAI Press.

Hillison, W., and M. Kennelly. 1988. The economics of nonaudit services. *Accounting Horizons* (September): 32-40.

Ippolito, R. 1987. The implicit pension contract developments and new directions. *The Journal of Human Resources* (Summer): 441-67.

National Register Publishing Company. 1988. *Directory of Corporate Affiliations, 1988*. National Register Publishing Company.

The Data Financial Press. 1988. *Who Audits America*. The Data Financial Press.

Olson, W. 1980. What is auditor independence? *Journal of Accountancy* (April): 80-82.

Palmrose, Z. 1984. The demand for quality-differentiated audit services in an agency cost setting: An empirical investigation. Paper presented at the *Sixth Symposium on Auditing Research*. University of Illinois.

________. 1986. The effect of nonaudit services on the pricing of audit services: Further evidence. *Journal of Accounting Research* (Autumn): 405-11.

________. 1988. Public accounting firms and the acquisition of nonaudit services by public and closely-held companies. *Auditing: A Journal of Practice and Theory* (Fall): 63-71.

Pany, K., and P. Reckers. 1984. Nonaudit services and auditor independence—A continuing concern. *Auditing: A Journal of Practice and Theory* (Spring): 89-97.

________. 1988. Auditor performance of MAS: A study of its effects on decisions and perceptions. *Accounting Horizons* (June): 31-38.

Previts, G.J. 1985. *The Scope of CPA Services*. New York: John Wiley.

Public Oversight Board. 1979. *Scope of Services by CPA Firms*. New York: AICPA.

________. 1986. *Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients*. New York: AICPA.

Scheiner, J. 1984. An empirical assessment of the impact of SEC nonaudit service disclosure requirements on independent auditors and their clients. *Journal of Accounting Research* (Autumn): 789-97.

Scheiner, J., and J. Kiger. 1982. An empirical investigation of auditor involvement in non-audit services. *Journal of Accounting Research* (Autumn): 482-96.

Simunic, D. 1984. Auditing, consulting, and auditor independence. *Journal of Accounting Research* (Spring) 679-702.

Society of Actuaries. 1988. *Society of Actuaries 1988 Yearbook*. Itasca, IL: Society of Actuaries.

Sternberg, W. 1992. Cooked books. *The Atlantic* (January) 20-38.

United States Congress, Senate Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs. *Improving the Accountability of Publicly Owned Corporations and their Auditors*. 95th Cong., 1st Sess. (the Metcalf Report).

________. *The Accounting Establishment: A Staff Study* 94th Cong., 2nd Sess.

United States House, Subcommittee on Oversight and Investigations and the Committee on Energy and Commerce. *Hearings on Oversight of the Accounting Profession and the Securities and Exchange Commission: Effectiveness, Independence, and Regulation of Corporate Audits*. 99th Cong., 1st Session (the Dingell Hearings).

RESEARCH REPORTS

EXTENDED ADOPTION WINDOWS BY THE FINANCIAL ACCOUNTING STANDARDS BOARD:

THE CASE OF *SFAS 87*

John A. Brozovsky, Dennis Murray, and

Frank H. Selto

ABSTRACT

In December 1985, the FASB issued *SFAS 87,* "Employers' Accounting for Pensions." A novel feature of this standard is that it allowed an unusually long (three year) adoption period. This long adoption period was justified by the FASB as necessary because of the anticipated difficulty and cost in assimilating and implementing the complex standard. This paper investigates whether the economic

Research in Accounting Regulation, Volume 7, pages 119-136.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

incentives (e.g., not violating debt covenants) and/or the difficulty and cost of adoption affected managers' decisions about when to adopt *SFAS 87*. The results show that while other economic incentives did play a role in the decision of when to adopt *SFAS 87*, the cost of adoption also influenced the decision.

INTRODUCTION

In December 1985, amid great controversy, the Financial Accounting Standards Board (FASB) issued *Statement of Financial Accounting Standards No. 87* (*SFAS 87*), "Employers' Accounting for Pensions." This standard instituted sweeping changes in financial reporting for pension-related assets, liabilities and expenses.

An interesting aspect of *SFAS 87* is the three-year time span between its issue date and mandatory adoption date. The FASB set this period one year longer than usual (*SFAS 87,* paragraph 259). This extension allowed calendar year end companies the option of adopting *SFAS 87* in 1985, 1986, or 1987. The FASB cited the difficulties of assimilating and implementing *SFAS 87* as reasons for this extension.

Recently, considerable attention has been devoted to the economic determinants of managers' accounting policy choices (e.g., Watts and Zimmerman 1986). Previous researchers have hypothesized that (1) managers' earnings-based compensation plans, (2) firms' debt restrictions and (3) firms' political costs can explain managers' accounting choices. These incentives, in contrast to the difficulties of implementing *SFAS 87*, provide alternative explanations for managers' utilization of *SFAS 87*'s extended adoption window. To the extent that these influences played a role in managers' decisions regarding when to adopt *SFAS 87*, managers may have benefitted from *SFAS 87*'s three year adoption period in ways unintended by the FASB.

The objective of this paper is to investigate the role these alternative explanations played in managers' early/late adoption of *SFAS 87*. The results should be of use to the FASB in assessing the desirability of incorporating extended adoption windows in future reporting standards. Although two previous studies (Stone and Ingram 1988;

Norton 1989) have compared firms that adopted *SFAS 87* early versus late, they do not examine the explanation we find to be relevant.

In the next section we provide a brief overview of the pension accounting issue. The third section discusses a testable hypothesis based on FASB's difficulty of implementation reasoning. The fourth section discusses how the *SFAS 87* adoption choice may be affected by other economic motivations. The fifth section describes the sample and research design. The final section provides a discussion of the results and conclusions. The details of the design and analysis are provided in the Appendix.

THE PENSION ACCOUNTING ISSUE

Critics of prior pension reporting requirements (e.g., Deaton and Weygandt 1975; Seaman and Hensold 1982) increasingly voiced concerns that pension cost was not comparable across firms and often not comparable over time for the same company. These critics also argued that major pension-related assets and liabilities were not disclosed in financial statements. In response to these criticisms, the FASB agreed to reconsider the method of accounting for pension costs and liabilities. After a nearly 10-year controversial effort (e.g., Francis 1987; Liebtag 1984), the FASB issued *SFAS 87* in December 1985.

SFAS 87 significantly altered previous policy. It limits pension expense calculations to a standardized actuarial cost method and attributes pension costs to the periods of employee service. Provisions also were made for amortization of transition amounts and prior service costs.[1] These requirements of *SFAS 87* can have a dramatic impact on pension costs—in either direction. In general, under *SFAS 87* pension cost will increase for underfunded plans and decrease for overfunded plans. (The pension footnote in the 1987 annual report indicated that the change increased the net income for Ford Motor Co. by $148 million in the year of adoption.) For only a few firms in our sample (8 of 373 or 2%) did *SFAS 87* increase pension costs. Accordingly, the remainder of this paper is concerned with the great number of firms for which *SFAS 87* had a positive effect on earnings. For these firms, early adoption of *SFAS 87* is an income-increasing accounting policy choice.[2]

DIFFICULTY OF ADOPTION

The FASB reasoned as follows: "The Board decided to allow more than the normal time between issuance of this Statement and its required application to give time for employers and their advisors to assimilate the requirement and to obtain the information required" (*SFAS 87,* paragraph 259). One means of testing if the extended adoption period served its intended purpose is to assess whether the firms that adopted *SFAS 87* relatively late were those for whom the standard presented the most difficulty and costs. Some respondents to the FASB's 1983 Discussion Memorandum Employers' Accounting for Pensions and Other Postemployment Benefits argued that the difficulty and cost of implementing new pension accounting rules are relatively more costly for smaller firms (*SFAS 87*, paragraph 205; Garrett 1987). Actuaries with whom we have discussed this issue suggest that the costs incurred to generate the necessary *SFAS 87* information do not vary greatly with firm size. That is, a large fixed cost component exists; the cost of generating the accounting information for a plan of 500 participants does not differ greatly from the cost for a plan with 5,000 participants. Given the relatively greater costs for smaller firms, we present the following hypothesis:

Hypothesis 1. Early adopters of *SFAS 87* were larger than later adopters.

ECONOMIC MOTIVATIONS OF PENSION ACCOUNTING CHOICES

The positive theory literature argues that managers have economic incentives to manage reported earnings via accounting policy choices and choices of accounting estimates. These incentives arise because accounting earnings affect managerial wealth in three general ways: (1) through management compensation plans that are tied to earnings, (2) through the effects of restrictive debt covenants on current and future cash flows to the firm and (3) through the effects of third party intervention (e.g., government regulation) attracted by high levels of profitability and size of the firm. The literature has found mixed evidence to support these hypothesized effects on accounting choice (e.g., Holthausen and Leftwich 1983). Each is discussed in turn below.

Management Compensation Plans

It seems reasonable to expect that managers have incentives to report higher earnings in the current period if their compensation is tied to earnings. Healy (1985) found that managers' choices of accounting accruals may be consistent with reporting higher earnings within the upper and lower bounds that are typical of many management compensation plans. Ayres (1986) attempted to measure this motivation with a proxy, percentage change in reported earnings. She argued that managers have incentives to increase earnings by only modest percentages over the previous year; therefore, early adopters of income increasing accounting policies would have been more likely to report lower income growth without the effect of the adoption than later adopters. Ayres' results were consistent with this hypothesis, and we adopt it for this study.

Hypothesis 2. Managers that adopted *SFAS 87* early had a lower growth in earnings without the positive effect of adoption than later adopters.

Management Control

Dhaliwal et al. (1982) hypothesized and found that managers who owned a small proportion of their firms' stock were more likely to choose income increasing accounting methods than managers who owned a larger share of their firm's stock. Since managers of firms characterized by low degrees of managerial ownership (MO) are likely to have more of their compensation tied to earnings than managers of high MO firms, then low MO firm managers may have greater incentives to manage reported earnings via the *SFAS 87* adoption decision. Ayres (1986) found that low MO firms were more likely to adopt SFAS 52 early, which she assumed was income increasing. Therefore, we hypothesize that:

Hypothesis 3. *SFAS 87* early adopters had a lower extent of MO than late adopters.

Restrictive Debt Agreements

Many firms have debt or lending agreements that require maintenance of certain financial ratios and that restrict payment

of dividends to a measure of retained earnings. The nature and possible effects of these restrictions have been discussed at length in the literature (e.g., Jensen and Meckling 1976; Smith and Warner 1979; Holthausen 1981; Leftwich 1981). Since *SFAS 87* increased reported earnings for most firms, one would expect that early adopters were more likely to be close to debt restrictions than later adopters.

Most studies in the positive theory literature have used various financial ratios as proxies for closeness to actual restrictive debt agreements. These studies have assumed that these restrictions are uniform across the population of firms under study. The most commonly used proxies are interest coverage, long term debt to total assets and cash dividends to unrestricted retained earnings ratios, which are components of many known debt agreements.[3] We adopt these assumptions and proxies for this study as well and accordingly present the following debt-related hypotheses:

Hypothesis 4. Early adopters of *SFAS 87* were more likely to have (a) lower interest coverage, (b) higher long term debt to total assets and (c) higher cash dividends to unrestricted retained earnings.

Political Cost

Since Watts and Zimmerman's seminal article in 1978, studies in the positive theory literature have tested whether managers' concerns for cost induced by third party interventions lead to managing reported earnings via accounting choices. Directly measuring actual political cost has not been feasible, and most studies have adopted Watts and Zimmerman's logic that larger firms (with deep pockets) are prime targets for intervention and transfers of wealth. Thus, managers of large firms, ceteris paribus, have an incentive to lower earnings in an attempt to avoid political costs. It is clear, though, that size may be a proxy for many underlying characteristics of the firm (e.g., Ball and Foster 1982), only one of which may be political costs. However, many studies (reviewed in Watts and Zimmerman 1986) have found that larger firms have been more likely to adopt income decreasing accounting methods or to delay adopting income increasing methods. This generates a hypothesis in direct conflict with the difficulty of implementation of *SFAS 87* espoused in

Hypothesis 1. That is, while Hypothesis 1 posits that early adopters will be larger than late adopters, conventional positive accounting theory suggests that since *SFAS 87* is an income increasing accounting change earlier adopters will be smaller than late adopters.

SAMPLE, DATA AND RESEARCH DESIGN

Sample

We chose Compustat industrial firms traded on the major exchanges as our population of firms for ease of data collection and since they were likely to be significantly affected by *SFAS 87*. We excluded from this Compustat population financial institutions, regulated firms, firms with other than calendar fiscal year ends and firms with missing (relevant) Compustat data. Financial ratios of financial institutions are fundamentally different from other firms, and regulated firms are likely to choose accounting methods with less freedom than other firms. The calendar year end restriction insured a common decision horizon. These screens produced an initial sample of 836 firms. A number of these firms had to be dropped from the sample for a variety of reasons.[4] The most pervasive cause for deletion was the absence of any evidence of a defined benefit pension plan. The small number of Compustat firms that adopted *SFAS 87* in 1985, as a practical matter, prevents powerful tests of the hypothesized effects on managers' 1985 choices, so these firms were deleted from our sample. Only a few firms reported negative income effects of adopting the new pension accounting rules, so they, too, were dropped from the sample. These screens resulted in a final sample of 365 firms.

Many firms simultaneously adopted *SFAS 87* and *SFAS 88,* "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits." For several reasons, these firms were analyzed separately from those firms that adopted *SFAS 87* only. First, in order to adopt *SFAS 88,* a firm was required to adopt *SFAS 87*. Thus, a firm may have adopted *SFAS 87* merely to enable it to adopt *SFAS 88*. Second, Handallah and Ruland (1986) show that, in part, variables other than the ones investigated here affect plan termination decisions. Accordingly, the hypotheses developed in this paper may be less applicable to firms

Table 1. Sample Partitioned by Income Effect and Adoption Decision

	Effect of Adoption on Net Income		
Adoption Decision	*Positive*	*Immaterial**	*Total*
SFAS 87 in 1986	141	38	179
SFAS 87 and *SFAS 88* in 1986	27	12	39
SFAS 87 in 1987	48	86	134
SFAS 87 and *SFAS 88* in 1987	2	11	13
	218	147	365

* The income effect is classified as immaterial if the financial statements either identified it as such or did not disclose the magnitude of the income effect.

that adopt both *SFAS 87* and *SFAS 88* than to firms that adopt only *SFAS 87*. Finally, most firms that adopted both *SFAS 87* and *SFAS 88* reported only a combined income effect. Since we are forced to use this combined number, our measure of the income effect of *SFAS 87* for these firms is misstated.

Table 1 summarizes the sample by income effect and adoption decision.[5] A number of firms indicated that the income effect of adoption was immaterial. Some made no mention of the income effect. For these latter firms we also assumed that the income effect was immaterial. It is reasonable to expect that the economic incentives would not be as strong or as immediate if adoption of *SFAS 87* had no material income effect. Therefore, we separately analyzed those firms that experienced positive versus immaterial income effects. This partitioning plus the separation of firms that adopted *SFAS 87* from those that adopted both *SFAS 87* and *SFAS 88* led to four subsamples that were analyzed separately.

The following section provides a summary of the significant results of our analysis. The details of the variables and statistical techniques used are contained in the Appendix. The Appendix also reports the results of the statistical analyses conducted.

DISCUSSION AND CONCLUSION

This study tested difficulty of implementation and positive theory predictions of the economic motivations for managers' choice of adoption date for *SFAS 87*. The FASB offered firms an unusually wide adoption window (potentially three years) for adoption of

SFAS 87. Following the positive theory literature, we predicted that, since the great majority of our sample firms had positive income effects from the new rules, early adopters of the new pension rules would have (1) lower income growth, (2) lower management ownership, (3) lower interest coverage, (4) higher leverage, (5) higher ratio of dividends to unrestricted retained earnings, and (6) a smaller size. Difficulty of implementation predicts that early adopters would be of larger size than later adopter. Both univariate and multivariate tests supported some but not all of these hypotheses. However, low R^2s (this statistic tells how much of the variation between the firms in the sample is explained by the variables used in the statistical equation) admit the possibility of the effects of omitted variable bias on coefficient estimates.

The most interesting relationship relates to size: on average, early adopters were larger than late adopters. This significantly supports the difficulty of implementation hypothesis rather than the positive accounting theory hypothesis. It may be that only large firms had the expertise to adopt the new pension rules early, or that adoption required a large fixed cost that small firms wished to defer. While this supports the FASB's logic for extending the adoption window, it is largely in conflict with prior literature. Ayres (1986) found that firms which adopted *SFAS 52* (assumed to be income increasing) early were smaller than firms that adopted late. Trombley (1989) also found that firms which adopted *SFAS 86* (also income increasing) early were smaller than late adopters. A potential (but as yet unexplored) difference between *SFAS 87* and both *SFAS 52* and *SFAS 86* is that *SFAS 87* is more complex and often requires the employment of costly external consultants.

In agreement with the prior literature, the significant results for CNI (change in earnings before discontinued operations and extraordinary items from the previous year deflated by total stockholders' equity) and LEV (long-term debt divided by total assets) indicate that the longer adoption window also may have been used to manipulate earnings and to loosen debt contract restrictions. To the extent that the FASB views these uses to be undesirable, the board needs to assess the tradeoffs of both the desirable and undesirable uses of a long adoption window when setting future accounting standards.

APPENDIX

The methodology appendix is divided into two sections: the design and the statistical results. The design section describes the variables and the statistical methods used to analyze the data. The results section describes the results of both the univariate and multivariate statistical analyses.

Design

Variable Measures

The independent variables are defined below. Measurements are made with 1986 data since that is the year of the adoption decision. Data were obtained from *Compustat* unless otherwise stated.

SIZE = The natural log of sales.

CNI = Change in earnings before discontinued operations and extraordinary items from the previous year, deflated by total stockholders' equity.[6] For firms adopting in 1986, the disclosed income effect is removed from reported net operating income.

MO = The percentage of shares of common stock owned by officers of the firm, obtained from *Compact Disclosure.*

LEV = Long-term debt divided by total assets.

DIVRES = Cash dividends divided by unrestricted retained earnings, adjusted for the income effect of adoption, if applicable. When unrestricted retained earnings was not disclosed, retained earnings was used. To assess the effects of this decision, we also made separate analyses of firms for which unrestricted retained earnings was available.

INTCOV = Net operating income, adjusted for the income effect of adoption, if applicable[7] divided by interest expense.

Statistical Research Design

Univariate tests report how a single variable relates to the early adoption decision. Multivariate tests, on the other hand, report how the variable relates to the adoption decision when all other variables are also factored in. Since the choice of adopting *SFAS 87* occurs in a multivariate environment, multivariate tests are

more valid and should be more powerful than univariate tests which assume that each hypothesized effect is independent of the others. However, to be consistent with the previous literature in this area we conducted both univariate and multivariate tests. The reported univariate tests are Mann-Whitney tests, though *t*-tests yielded the same inferences.

Results

Univariate Tests

Table A.1 reports the results of tests designed to assess if the early and late adopters differ with respect to the independent variables. Mann-Whitney tests are used for this purpose.[8] Results are reported for the different sample partitions. Differences in SIZE are significant in all subsamples. Early adopters, many of whom experienced a material positive income effect of adopting, were larger than late adopters. This is consistent with Hypothesis 1 supporting FASB's difficulty in implementation argument. However, it is contrary to the political cost argument. Thus, difficulty of implementation appears to have had a more material impact on the decision of when to implement *SFAS 87* than did political cost.

Early adopting firms that experienced a positive income effect of adoption had significantly lower *CNI* than late adopters. This result is consistent with an economic incentive argument. However, while the direction of the difference between early and late adopters with an immaterial income effect is as predicted, conventional significance levels are not achieved. Economic incentives to adopt *SFAS 87* are likely to be less compelling if the income effect is immaterial. Differences between early and late adopters with respect to *INTCOV* and *DIVRES*[9] are insignificant in all four subsamples. The results for *MO* are significant and in the predicted direction for all subsamples. However, the *LEV* results are significant and in the predicted direction for only one subsample.

In sum, the univariate tests, while providing support for the difficulty of implementation, provide only partial support for positive theory hypotheses. *SIZE* was consistently significant supporting the difficulty of implementation. This result is inconsistent with the political cost hypothesis. *MO* was significant in all four subsamples, and CNI and LEV were significant in some of the groups where the

Table A.1 Mann-Whitney Tests of Independent Variable Differences Between Early and Late Adopters

	Mean Ranks[a] and Significance Levels					
	Independent Variable					
	SIZE	*CNI*	*INTCOV*	*DIVRES*	*MO*	*LEV*
Positive income effect of adopting *SFAS 87* only						
Early	101***	89*	92	98	90*	100*
Late	76	112	103	85	110	82
Significance	.005	.014	.215	.151	.030	.049
Positive income effect of adopting either SFAS 87 or both SFAS 87 and SFAS 88						
Early	116***	103**	106	112	104*	114
Late	87	132	121	102	127	96
Significance	.004	.003	.156	.358	.022	.079
Immaterial income effect of adopting SFAS 87 only						
Early	81***	54	62	64	53*	67
Late	54	66	63	62	67	61
Significance	.000	.088	.927	.770	.046	.395
Immaterial income effect of adopting either SFAS 87 or both SFAS 87 and SFAS 88						
Early	93***	67	73	75	64*	77
Late	64	77	74	73	79	73
Significance	.000	.166	.879	.803	.036	.606

[a] The rank of one (1) is assigned to the lowest value of each variable. Accordingly, the economic motivation hypotheses predict that early adopters will have higher ranks for *DIVRES* and *LEV* and lower ranks for *CNI, INTCOV, SIZE* and *MO*. The difficulty of implementation predicts that early adopters will have higher ranks for *SIZE*.

* Difference in ranks is statistically significant at a 0.05 level and in the direction predicted.

** Difference in ranks is statistically significant at a 0.01 level and in the direction predicted.

*** Difference in ranks is statistically significant at a 0.01 level in the direction of the difficulty of implementation hypothesis contrary to the political cost hypothesis.

incentives are likely to be strongest because of the material, positiveincome effect of adopting *SFAS 87*. *INTCOV* and *DIVRES* were consistently insignificant.

Table A.2. OLS Tests of Independent Variable Differences Between Early and Late Adopters

Coefficients and Significance Levels	*Independent Variable*[a]					
	SIZE	*CNI*	*INTCOV*	*DIVRES*	*MO*	*LEV*
Predicted Signs	−	−	−	+	−	+
Positive income effect of adopting SFAS 87 only						
Coefficient	.031	−.443**	−.002	−.050	−.300	.463*
S E	.020	.163	.002	.015	.252	.218
Significance	.114	.007	.210	.002	.236	.034
Adjusted R^2	.136					
F (signif.)	5.95	(.000)				
Positive income effect of adopting either *SFAS 87* or both *SFAS 87* and *SFAS 88*						
Coefficient	.030	−.277**	−.002	−.042	−.254	.387*
S E	.019	.093	.001	.014	.234	.186
Significance	.103	.003	.125	.003	.279	.037
Adjusted R^2	.062					
F (signif.)	3.50	(.002)				
Immaterial income effect of adopting *SFAS 87* only						
Coefficient	.087***	.002	−.001	−.034	−.052	.170
S E	.029	.037	.003	.020	.286	.296
Significance	.004	.945	.711	.095	.855	.564
Adjusted R^2	.078					
F (signif.)	2.74	(.016)				
Immaterial income effect of adopting either *SFAS 87* or both *SFAS 87* and *SFAS 88*						
Coefficient	.083***	.024	−.001	−.018	−.062	.020
S E	.027	.033	.003	.017	.275	.263
Significance	.003	.447	.695	.281	.823	.940
Adjusted R^2	.064					
F (signif.)	2.68	(.017)				

[a] Dependent variable is coded 1 if early and zero if late.
* Coefficient is statistically significant at the 0.05 level and in the direction predicted.
** Coefficient is statistically significant at the 0.01 level and in the direction predicted.
*** Coefficient is statistically significant at the 0.01 level. It is in the direction of the difficulty of implementation hypothesis contrary to the political cost hypothesis.

Multivariate Tests

In addition to the univariate tests, we also conducted multivariate tests, which simultaneously assess differences between early and late adopter with respect to the independent variables. We employed ordinary least squares regression (OLS) and coded early adopters as 1 and late adopters as 0.[10] The OLS tests of our adoption hypotheses[11] are in Table A.2.

Consistent with the univariate tests, *SIZE* was significant for those firms whose income effect of adoption was immaterial. When managers do not have significant economic incentives, *SIZE* is significant in favor of the difficulty of implementation hypothesis. As one would expect, since income effects were immaterial for these firms, none of the economic incentive variables were significant.

When the adoption effect is material, *SIZE* is still directionally in favor of the difficulty of implementation; however, it no longer reaches the conventional 0.05 level of significance. Consistent with the univariate tests, *CNI* and *LEV* are significant and in the predicted direction for the positive income effect firms, and *INTCOV* is not significant in any analysis. *DIVRES* and *MO* are either not significant or are significant in the wrong direction.

Overall, the univariate and multivariate tests provide limited support for positive theory predictions. Only *CNI* and *LEV* are frequently significant in the predicted direction. *SIZE* is frequently significant, but never in the predicted direction of positive theory. We consider *SIZE* to be a proxy for firms' resources and pension management expertise, which enabled them to adopt the new pension reporting statements early. Thus, the results support the FASB's assessment of the difficulty of implementing *SFAS 87*.

ACKNOWLEDGMENTS

We are grateful for the comments of workshop participants from Curtin University, Murdoch University, and the University of Western Australia. The assistance of the anonymous referees is also gratefully acknowledged.

NOTES

1. Another provision relates to a minimum liability to be displayed on the balance sheet. We do not address this issue because the requirement (1) has no income effect, (2) is not salient for many overfunded plans and (3) has a mandatory adoption date that is two years later than the rest of *SFAS 87*.
2. Francis and Reiter (1987) have examined the determinants of pension funding strategies, a different discretionary management choice.
3. Press and Weintrop (1990) developed measures for closeness to debt covenant restrictions. They found that the standard leverage variables, such as debt to equity or as used in this study debt to assets, were significantly correlated to their measures for closeness to covenant restrictions. Duke and Hunt (1990) found that debt-equity

ratio captured the existence and tightness of retained earnings restrictions and the existence of net tangible asset and working captial restrictions. On the other hand, Healy and Palepu (1990) suggest that closeness to debt covenants may not be a good explanatory variable of accounting choice. Therfore, Begley (1990) suggests that the underlying theory needs further development and specification.

4. Companies were deleted from the population for the following reasons: no defined benefit plan, 247; defined benefit plan but no mention of *SFAS 87*, 3; missing annual report, 87; change in fiscal year end, 7; foreign company not subject to *SFAS 87*, 47 missing management ownership data, 47; 1985 adopters of *SFAS 87*, 25; and adopters with a negative income effect, 8.

5. The average effect of the change on those firms that had an income increase was 21% of the absolute value of income in the year of adoption before discontinued operations and extraordinary items. The maximum increase was 961% (SD = 83%). When we recoded the maximum increase to 300%, the mean increase became 16.7% (SD = 40%), still a large average income effect.

6. Total stockholders' equity is used in the denominator because (1) it avoids the problem of a small, zero or negative denominator sometimes introduced by the use of the previous year's earnings in the denominator and (2) many compensation schemes are related to return on investment.

7. As was done in earlier studies, we tested the sensitivity of our results to various restrictions on several of these ratio measures that can become distorted with zero, very small or negative denominators. No *DIVRES* ratio with a denominator (unrestricted retained earnings) greater than zero equalled or exceeded a value of eight. Accordingly, *DIVRES* was set equal to eight if the denominator was zero. If the denominator was negative, *DIVRES* was set equal to nine. *INTCOV* was extremely large for several firms and was restricted to 75, except for a few firms with a zero denominator where *INTCOV* was set equal to 100. These constraints were varied with no qualitative change in the results.

8. The Mann-Whitney test is a univariate, nonparametric test. Univariate tests examine only one variable at a time. Nonparametric tests do not make assumptions about the distribution properties of the variables that parametric tests do. Since accounting data do not usually meet these assumptions, the use of a nonparametric test was considered appropriate. Note, however, that *t*-tests were also conducted and they yielded results very similar to the Mann-Whitney tests.

9. These tests assume if *URE* was not disclosed that retained earnings is a reasonable proxy for *URE*. Identical Mann-Whitney tests were performed on the smaller number of firms that disclosed *URE*. For these firms the direction of differences were similar to those in Table A.2, but there were many fewer significant differences between early and late adopters. The smaller sample sizes may account for the fewer statistically significant results. This difference in significance also holds for the ordinary least squares (OLS) tests reported in the next section.

10. Investigating the adoption decision involves a qualitative, dichotomous dependent variable. Ordinary least squares regression (OLS) in many ways is the most convenient statistical test because of the detailed diagnostic statistics that are available. However, the restricted dependent variables lead to violation of the assumption of normally distributed, constant variance errors and usually to inefficient estimators of individual variable coefficients (the heteroscedasticity of the

data was confirmed by a Goldfeld-Quandt test). Noreen (1988) has found that OLS was as powerful as Probit analysis for dichotomous dependent variables and sample sizes similar to ours with heteroscedastic data. Furthermore, he found that the OLS test statistics were closer to theoretical expectations than were the Probit statistics. On the other hand, Stone and Rasp (1991) found that Logit may be better at prediction than OLS even for sample sizes as low as 50. However, they also found that OLS may result in better test statistics when the data is skewed which is typical of accounting data. Since we are not making predictions OLS may be the better test statistic. Maddala (1991) suggests that logit or probit may be more appropriate than OLS even for small samples. We report OLS results, though Probit results were similar.

11. We tested for multicollinearity by computing variance inflation factors (VIFs) (Neter et al. 1985) for each of the independent variables. The largest VIF was 1.97. Since multicollinearity is generally not a problem unless the VIF is in excess of 10, we did not pursue any corrective measures for multicollinearity.

REFERENCES

Accounting Principle Board. 1966. *Opinion No. 8: Accounting for the Cost of Pension Plans.*

Ayres, F. 1986. Characteristics of firms electing early adoption of SFAS 52. *Journal of Accounting and Economics* 8: 143-58.

Ball, R., and G. Foster. 1982. Corporate financial reporting: A methodological review of empirical research. *Journal of Accounting Research* (Supplement): 161-234.

Begley, J. 1990. Debt covenants and accounting choice. *Journal of Accounting and Economics.* 12 (January): 125-39.

Committee on Accounting Procedures. 1956. *Accounting Research Bulletin 47: Accounting for Costs of Pension Plans.*

Deaton, W., and J. Weygandt. 1975. Disclosures related to pension plans. *Journal of Accountancy* 139: 44-51.

Dhaliwal, D., G. Salamon, and E. Smith. 1982. The effect of owner versus management control on the choice of accounting methods. *Journal of Accounting and Economics.* 4 (July): 41-53.

Duke, J., and H. Hunt. 1990. An empirical examination of debt covenant restrictions and accounting-related debt proxies. *Journal of Accounting and Economics.* 12 (January): 45-63.

Financial Accounting Standards Board. 1985a. *Statement of Financial Accounting Standards No. 87*: "Employers' Accounting for Pensions." Stamford, CT: FSAB.

________. 1985b. *Statement of Financial Accounting Standards No. 88:* "Accounting for Pension Plan Terminations." Stamford, CT: FASB.

Francis, J. 1987. Lobbying against proposed accounting standards: The case of employers' pension accounting. *Journal of Accounting and Public Policy* 6: 35-57.

Francis, J., and S. Reiter. 1987. Determinants of corporate pension funding strategy. *Journal of Accounting and Economics* 9 (July): 35-60.

Garrett, H. 1987. Panel: FASB employers' accounting for pensions. In *The Proceedings, 1986-87,* 1-25. Itasca, IL: Conference of Actuaries in Public Practice.

Handallah, A.E., and W. Ruland. 1986. The decision to terminate overfunded pension plans. *Journal of Accounting and Public Policy* 2: 77-91.

Healy, P. 1985. The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics* 7 (April): 85-107.

Healy, P., and K. Palepu. 1990. Effectiveness of accounting-based dividend covenants. *Journal of Accounting and Economics* 12 (January): 97-123.

Holthausen, R. 1981. Evidence on the effect of bond covenants and management compensation contracts on the choice of accounting techniques: The case of the depreciation switch-back. *Journal of Accounting and Economics* 3 (March): 73-109.

Holthausen, R., and R. Leftwich. 1983. The economic consequences of accounting choice: Implications of costly contracting and monitoring. *Journal of Accounting and Economics* 5 (August): 77-117.

Jensen, M., and W. Meckling. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3 (October): 305-60.

Leftwich, R. 1981. Evidence of the impact of mandatory changes in accounting principles on corporate loan agreements. *Journal of Accounting and Economics* 3 (March): 23-42.

Liebtag, B. 1984. Controversy livens Financial Accounting Standards Board hearings on pension accounting. *Journal of Accountancy* (March): 55-60.

Liebtag, B. 1986. Accounting for pensions. *Journal of Accountancy* (April): 53-57.

Maddala, G. 1991. A perspective on the use of limited-dependent and qualitative variables models in accounting research. *The Accounting Review* (October): 788-807.

Neter, J., W. Wasserman, and M. Kutner. 1985. *Applied Linear Statistical Models.* Homewood, IL: Richard D. Irwin.

Noreen, E. 1988. An empirical comparison of probit and OLS regression hypothesis tests. *Journal of Accounting Research* 26 (Spring): 119-33.

Norton, C. 1989. Transition to new accounting rules: The case of FAS 87. *Accounting Horizons* 3 (December): 40-48.

Press, E., and J. Weintrop. 1990. Accounting-based constraints in public and private debt agreements: Their association with leverage and impact on accounting choice. *Journal of Accounting and Economics* 12 (January): 65-95.

Seaman, J., and H. Hensold. 1982. *Accounting for the cost of pensions: More information on APB* #8. *Journal of Accountancy* (July): 82-88.

Smith, J. 1977. Actuarial cost methods—Basics for CPAs. *Journal of Accountancy* (February): 62-66.

Smith, C., and J. Warner. 1979. On financial contracting: An analysis of bond covenants. *Journal of Financial Economics* 7 (June): 117-61.

Stone, M., and R. Ingram. 1988. The effect of Statement No. 87 on the financial repoits of early adopters. *Accounting Horizons* 2 (September): 48-61.

Stone, M., and J. Rasp. 1991. Tradeoffs in the choice between logit and OLS for accounting choice studies. *The Accounting Review* 66 (January): 170-87.

Thomas, J. 1988. Corporate taxes and defined benefit pension plans. *Journal of Accounting and Economics* 10 (July): 199-237.

Trombley, M.A. 1989. Accounting method choice in the software industry: Characteristics of firms electing early adoption of SFAS No. 86. *The Accounting Review* (July): 529-38.

Watts, R., and J. Zimmerman. 1986. *Positive Accounting Theory*. Englewood Cliffs, NJ: Prentice-Hall.

ACCOUNTANT LIABILITY:
A PERSPECTIVE ON SECTION 10(B)(5) AIDING AND ABETTING

Mark A. Segal

ABSTRACT

In recent years there has been a proliferation of lawsuits brought against accountants for aiding and abetting the perpetration of alleged securities law violations. In particular these actions have been based upon claimed aiding and abetting of Section 10(b)(5) violations. This trend will likely continue as investors and creditors seek financial redress for financial injuries caused by a failed enterprise, and certain jurisdictions utilize expansive approaches to determine when an accountant can be held liable for aiding and abetting. In this paper the law and issues concerning aiding and abetting Section 10(b)(5) violations will be examined and recommendations for legislative reform of the law in this area provided.

Research in Accounting Regulation, Volume 7, pages 137-149.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

In recent years investors and creditors allegedly victimized by securities law violations have increasingly discovered that the principal wrongdoer is either bankrupt or insolvent. As a result plaintiffs have sought recovery against collateral parties for allegedly "aiding and abetting" the commission of the violation. Section 10(b)(5) has been the principal securities law violation with regard to which aiding and abetting claims have been raised.

Liability for aiding and abetting constitutes a form of derivative liability as it is imposed upon defendants due to their relationship with the primary wrongdoer rather than their actual violation of the express terms of the relevant statute. (Kadish 1985; Fischel 1981). Certified public accountants' association with financial statements and offering materials, and duty of independence and objectivity, have made them a frequent subject of aiding and abetting actions (*W.O. Akin, et al.* 1992; *Farlow* 1992). Liability for these claims can be particularly onerous as these actions are often brought as a class action (Rule 23 of the Federal Rules of Civil Procedure).

Acceptance of aiding and abetting as grounds for liability raises significant issues ranging from defining the elements of such liability and their parameters to the policy implications such liability holds for the accounting profession. In this article these issues are examined and suggestions for the modification of the legal approach to 10(b)(5) aiding and abetting actions offered.

AIDING AND ABETTING UNDER SECTION 10(B)(5)

If a party is found liable for aiding and abetting a Section 10(b)(5) violation such party may be held jointly and severally liable, as would the primary violator (IIT 1980). The Securities Exchange Act does not expressly provide a private cause of action for aiding and abetting a Section 10(b)(5) violation. To date the Supreme Court has neither expressly accepted nor rejected recognition of a private cause of action for aiding and abetting a Section 10(b)(5) violation (*Herman and MacLean* 1983; *Ernst and Ernst* 1976). A private cause of action for aiding and abetting a Section 10(b)(5) violation has however been recognized at the Circuit Court level.

The Circuits are divided over the precise elements necessary to support an aiding and abetting claim (*Abell* 1988; *SEC v. Seaboard Corp.* 1982; *IIT* 1980; *Rolf* 1978).

- According to the Fifth Circuit the requisite elements are:
  1. A 10(b)(5) violation by the primary party.
  2. The aider and abettor must have possessed a general awareness of its role in the principal 10(b)(5) violation.
  3. The aider and abettor must have knowingly rendered substantial assistance in the Rule 10(b)(5) violation.
- According to the Second and Ninth Circuits the requisite elements are:
  1. A 10(b)(5) violation by the primary party.
  2. The aider and abettor must have had knowledge of the primary violation.
  3. The aider and abettor must have performed acts which substantially assisted in the 10(b)(5) violation.

ELEMENTS OF AIDING AND ABETTING SECTION 10(B)(5) VIOLATION

The first element of an aiding and abetting claim is the establishment of a primary Section 10(b)(5) violation. Under Section 10(b)(5) persons are forbidden in connection with the purchase or sale of securities.

a. To employ any device, scheme or artifice to defraud.
b. To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
c. To engage in any act practice or course of business which operates or would operate as fraud, upon any person.

In addition, to a scienter/recklessness requisite, the following criteria must be met for a Section 10 (b)(5) violation to be found:

a. The showing of a material misstatement or omission
b. of material fact (made with the requisite scienter or recklessness)
c. on which the plaintiff relied
d. that proximately caused injury.

Materiality

An item will be considered material if there is a substantial likelihood that a reasonable shareholder would consider it important in making deliberations (*Accord Fund of Funds, Ltd.* 1982; *SEC v. Research Automation Corp.* 1978). Whether an item is material is resolved by an examination of the relevant facts and circumstances. For example, a dollar amount considered material with regard to a small business might not be considered material for a major corporation. In certain instances it is likely that a court will find an item immaterial which an accountant guided by the principle of conservatism considers material.

Reliance

The plaintiff must establish reliance on the misrepresentation or omission in making a purchase or sale decision and that such reliance was reasonable (*List, Inc.* 1965). Reliance will not be considered present where the plaintiff made the decision on grounds independent of any misrepresentation or omission. Reliance can often be refuted where the plaintiff did not read, hear or comprehend the item upon which reliance is alleged or was reckless in making the decision (*Wilson* 1981; *Kliman* 1980).

In certain instances reliance will be presumed. The most common rationale upon which such presumption is based is the theory of fraud on the market (*Basic Inc.* 1988; *Peil* 1986; *Blackie* 1975). Founded on the efficient capital markets concept fraud on the market exists if a misrepresentation or omission is material and affects the price of the stock in the market.

Damages

The plaintiff must establish that the loss was proximately caused by the misstatement or omission. In order to establish this the plaintiff must show that acquisition or sale of the security was based upon the misstatement or omission and that the misstatement or omission was the proximate cause of the loss, for example, the decline in the price of the security subsequent to acquisition (*Fund of Funds, Ltd.* 1982; *Stokes* 1981; *Rolf* 1978).

KNOWLEDGE OR GENERAL AWARENESS

Depending on the Circuit to hold a party liable for aiding and abetting the defendant must have had knowledge of the primary violation or a general awareness of his role in the illicit activity (*Cleary* 1983; *SEC v. Seaboard Corp.* 1982; *Edwards and Hanly* 1979; *Brennan* 1966). A minority of circuits have held that the mere showing of the primary violation is adequate (*Landy* 1973). In many respects the knowledge requirement has been absorbed by the scienter or recklessness requisite.

Establishment of liability for aiding and abetting requires that the defendant must be shown to have acted with a certain state of mind. This criteria is satisfied if the defendant acted with scienter. Scienter is a form of intentional conduct. As expressed by the Fifth Circuit in *Woodward* scienter is a mental state involving an intent to deceive, manipulate or defraud (*Woodward* 1975). Unlike a primary 10(b)(5) action, recklessness will only be sufficient to maintain an aiding and abetting action where the defendant either possesses a fiduciary duty or a duty of disclosure to the plaintiff (*Woodward* 1975; *Edwards and Hanly* 1980). Recklessness is defined as:

> Conduct which represents an extreme departure from the standards of ordinary care ... to the extent the danger was either known to the defendant or so obvious that the defendant must have been aware of it (*SEC v. Southwest Coal and Energy Co.* 1980; *McLean* 1979; *Frank* 1976).

SUBSTANTIAL ASSISTANCE

Determining if the defendant provided substantial assistance in the commission of the Section 10(b)(5) violation has been the most problematic of the aiding and abetting elements. Typically some affirmative act is necessary, for example, consciously concealing information through overt action. A major dilemma encountered by accountants concerns when silence or inaction will constitute substantial assistance. A prerequisite for finding such assistance in the case of silence or inaction is the existence of a duty of disclosure and that the accountant knew or should have known (absent recklessness) of the materially misleading information or omissions (*In re Union National Carbide Corp. Consumer Products Business Security* 1987; *Sirota* 1982).

DUTY OF DISCLOSURE

The parameters of a duty of disclosure have primarily been dealt with in cases involving allegations of principal Section 10(b)(5) violations. In resolving these cases the following seven factors have assumed importance (*Arthur Young and Co.* 1991):

1. The respective parties relative access to information (*Chiarella* 1980).
2. The benefit the defendant derives from the sale of the securities (*Dirks* 1983; *Landy* 1973; *Buttrey* 1969).
3. The defendant's awareness of the plaintiff's reliance on the defendant in making investment decisions (*Fine* 1990).
4. The defendant's role in initiating the sale (*Rudolph* 1990; *Hollinger* 1990; *Jett* 1988).
5. The extent of the defendant's knowledge.
6. The significance of the nondisclosure.
7. The extent of the defendant's involvement in the fraud. (*In re: National Smelting of N.J. Inc. Bondholders Litig.* 1989).

No single factor is by itself necessary to support a duty of disclosure nor need all of these factors be present to support a duty of disclosure (*Arthur Young* 1991).

While these factors provide useful guidance in determining whether a duty to disclose exists in an aiding and abetting action differences exist between the analysis undergone to determine whether a duty to disclose exists in a principal 10(b)(5) action and in a 10(b)(5) aiding and abetting action. In contrast to a defendant alleged to have committed the primary wrong, a duty to disclose in an aiding and abetting action must be supported by a greater weight of evidence or factors. Possession of a duty of disclosure in an aiding and abetting action appears to require either:

1. Knowledge of the impropriety and a duty owed to the plaintiff; or
2. A duty of inquiry, which if properly implemented would have uncovered the impropriety and a duty to the plaintiff.

A QUESTION OF DUTY: AIDING AND ABETTING

A crucial question encountered in aiding and abetting cases concerns to whom is a duty of disclosure owed. Furthering a fraudulent scheme with scienter will make the accountant vulnerable to liability to a broad class of parties. In contrast, the recklessness standard and a duty to disclose will typically only apply to parties with whom the accountant has a fiduciary or special relationship.

Courts have been divided as to how expansive the scope of the duty to disclose should be. The Ninth and Eleventh Circuits have held that the mere use of the accountant's name in offering materials is sufficient to produce a fiduciary duty to investors relying on the materials (*Roberts* 1989; *Rudolph* 1986). These courts and certain lower district courts have held that a duty extends to those parties making investment decisions in reliance upon the accountant's professional reputation (*In re Worlds of Wonder Securities Litigation* 1989; *Blake* 1988; *Wool* 1987; *Halperin* 1977; *Brennan* 1968). In contrast the Fifth, Seventh and District of Columbia Circuits have adopted a more restrictive approach (*Dileo* 1990; *Latigo Ventures* 1989; *Abell* 1988; *Zoelsch* 1987; *Barker* 1986).

The recent decisions of *Rudolph* and *Roberts* exemplify the expansive approach (*Rudolph* 1986 and *Roberts* 1989). In *Rudolph* the Eleventh Circuit allowed an action for aiding and abetting to be maintained where the plaintiffs claimed reliance upon a private placement memorandum that contained historic financial statements audited by Arthur Andersen. The memorandum contained several misrepresentations and omissions. Although no allegation was made as to the impropriety of the financial statements, the court held that even if Arthur Andersen's audit was proper, Arthur Andersen could be held liable as an aider and abettor if it could be shown to have known of the scheme, and not disclose it. The decision suggests that even if the fraudulent activity occurred after the audit Arthur Andersen had a duty of disclosure to potential investors if it knew, or absent recklessness would have known of the scheme, or the misrepresentations or omissions. According to the court a duty exists to investors who might assume that the accounting firm would not permit its name to be used in or associated with a placement memorandum that the firm knew to be fraudulent.

The logic of *Rudolph* was applied by the Ninth Circuit in *Roberts.* In *Roberts* the court maintained an action for aiding and abetting due to a reference in a fraudulent private placement memorandum that the accounting firm had agreed to render accounting services. Although no material prepared by the accounting firm appeared in the memorandum, the association of the accounting firm with the offering materials was considered to create a fiduciary duty to parties who could foreseeably rely on the accounting firm's reputation in making their investment decisions.

A NARROWER STANCE

In *Abell* the Fifth Circuit held that permitting one's name to be used in an offering statement did not by itself create a duty to potential investors (*Abell* 1988). As expressed in *Abell* even had the defendant been reckless in ignoring warning signals, it could not be held liable to the class absent a special or fiduciary relationship.

The Seventh Circuit has consistently rejected the *Rudolph* and *Roberts* line of reasoning. In Latigo Ventures the court dismissed an aiding and abetting claim for nondisclosure of material financial information arising after issuance of an audit report due to the plaintiff's lack of reliance on the statements. (*Latigo Ventures* 1989). Likewise in *Robin* the Seventh Circuit held that for aiding and abetting purposes no duty to disclose information arising after the date of the audit exists even if GAAS require the making of adjustments to financial statements or additional disclosures (*Robin* 1990).

Prior to *Robin,* in *Dileo* the Seventh Circuit dismissed an aiding and abetting claim based upon allegations that an accounting firm had participated in fraud or acted recklessly in not increasing a reserve for uncollectible accounts quickly enough; thus, causing receivables to be overstated (*Dileo* 1990). In a harsh opinion the court noted that there exists no general duty of disclosure under the securities law absent scienter or some special relationship. Since in this circumstance no such duty or relationship existed in order for the plaintiff to maintain the action scienter had to be adequately alleged. In addition according to the court to support an aiding and abetting action specific facts had to be raised showing that the plaintiff's damages were attributable to fraud and why the firm would participate in such fraud.

An expansive approach to allowing actions against accountants was also rejected in the *Wessel* and *Zoelsch* cases (*Wessel* 1971; *Zoelsch* 1987). In *Wessel* the Ninth Circuit denied recovery to investors who claimed reliance upon a prospectus containing financial statements which had been audited by the accounting firm, but which did not include the accountant's report. The plaintiffs contended that the accountant should have realized that the financial statements would be used in the prospectus and so should be held responsible for the contents of the prospectus. According to the court since the firm did not participate in the preparation of the prospectus the firm should not be held responsible for its contents.

The D.C. Circuit case *Zoelsch* concerned an aiding and abetting action based upon a reference made in offering materials to the fact that questions regarding the materials were purportedly gone over with an accounting firm (Arthur Andersen). Citing *Wessel* no liability was found as the court found the accounting firm not responsible for any of the misleading material contained in the prospectus.

CONCLUSION

There exist two principal objectives for allowing the recovery of damages where aiding and abetting of a Section 10(b)(5) violation is found:

1. Motivating increased disclosure and production of valuable in formation to the public
2. Enhancing the ability of those harmed by a Section 10(b)(5) violation to receive appropriate compensation.

In determining whether aiding and abetting liability should be recognized, and if so what its elements should be, inquiry must be made into whether the objectives underlying such liability are being furthered and if so what constitute the costs and benefits to society of allowing such liability. While any new grounds for imposing liability increase the likelihood of plaintiff recovery, whether increased disclosure will result is uncertain (Kothari, Lys, Smith, and Watts 1988). The desirability of achieving these objectives must be balanced with the provision of fundamental fairness to the defendant and the related costs to society. That the defendant has the means

to pay the claim, and can then pass on and spread the cost to clientele is insufficient grounds to find liability. The actual degree and nature of involvement in the wrong, and the appropriateness of the sanction in light of the facts and circumstances must also be considered.

Allowing litigation to proceed where the accountant is alleged to have been but incidentally involved in the wrong; for example, a name used by the primary party in a prospectus without any actual work or statement made by the accountant being used or cited places the accountant in a dilemma. Even if unsuccessful, such lawsuits act to stigmatize the accountant, damage the reputation of the profession, increase accountant malpractice insurance premiums, and induce accountants to undergo additional procedures to provide increased assurance regarding the validity of the work done (Benston 1985). Decisions such as *Roberts* and *Rudolph* suggest that even should the utmost care and compliance with GAAS be exercised, the accountant may still find himself implicated in injurious litigation. An overly expansive interpretation of aiding and abetting harms the defendant (accountant) and the accounting profession, and results in an added cost to society. This is because any additional cost incurred and time expended by accountants will likely be passed on to the customers of accounting services, who in turn take such cost into account in determining the price to charge for their own goods and services (Fischel 1987).

A more equitable balance between the rights of plaintiffs and defendants in Section 10(b)(5) aiding and abetting actions, requires at least four reforms:

1. Implementing a strict application of the scienter or recklessness requirement established as applicable in primary 10(b)(5) actions as well as aiding and abetting 10(b)(5) actions.
2. Limiting foreseeability as determinative of those parties to whom the accountant owes a duty of disclosure. Where scienter, is not involved, case law reveals that such a duty is owed only to those to whom the accountant holds a fiduciary or other special relationship.
3. Establishing GAAS as the general legal standard of care that must be followed by accountants (auditors) conducting audits. At present no uniform legal standard exists. Although GAAS is considered evidence of the standard of care, most courts do not accept GAAS as "the" standard of care. This perspective

on the role and responsibilities of the auditor is aptly expressed in the following quote from the 1990 case of *Mishkin.*

> An auditor who undertakes to examine the books and audit the accounts of a client does not guarantee the correctness of the accounts. He does undertake to use skill and due professional care and to exercise good faith and to observe generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances. He is not responsible for mere error of judgment. The standards concern themselves not only with the auditor's professional qualities but also provide that judgment provide may be exercised by him in the performance of his examination and in his report. Deviation from standards does not per force thereof spell negligence in an audit, nor are innocent blunders culpable fault.

4. Having damages for aiding and abetting based upon proportionate liability rather than joint and several liability. This type reform has recently been proposed with regard to Rule 10(b)(5) in bipartisan reform legislation H.R. 5828 and S.3181 which is being actively promoted by the AICPA.

REFERENCES

Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988); vacated in part on other grounds, sub nom *Fryar v. Abell,* 109 S. Ct 322 (1989), cert. denied sub nom *Abell v. Wright, Lindsey and Jennings,* 109 S. Ct. 3242 (1989).

Accord Fund of Funds, Ltd. v. Arthur Andersen and Co. 545 F. 2d 1314 (S.D.N.Y. 1982).

Affiliated Ute Citizens v. U.S., 406 U.S. 128 (1972).

Arthur Young and Co. vs. Reves, et al., 937 F.2d 1310 (8th Cir. 1991), cert granted by the Supreme Court, 112 S. Ct. 1159 (1992).

Barker v. Henderson, Franklin, Starnes and Holt, 797 F.2d 490 (7th Cir. 1986).

Basic Inc. v. Levinson, 485 U.S. 224 (1988)

Benston, G. 1985. The Market for public accounting services: Demand, supply and regulation. *Journal of Accounting and Public Policy* 4:33.

Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert denied 429 U.S. 816 (1976).

Brennan v. Midwestern United Life Ins. Co., 286 F.Supp. 702 (N.D. Ind. 1968); aff'd 417 F.2d 147 (7th Cir. 1969); cert denied 397 U.S. 989 (1970).

Buttry v. Merrill, Lynch, Pierce, Fenner and Smith, Inc., 410 F.2d 135 (7th Cir.), cert. denied 396 U.S. 838 (1969).

Chiarella v. U.S., 445 U.S. 222 (1980).

Cleary v. Perfectune, Inc., 700 F.2d 774 (lst Cir 1983).

Dileo v. Ernst and Young, 901 F.2d 624 (7th Cir. 1990)
Dirks v. SEC, 103 S. Ct. 3255 (1983) rev'g on other grounds 681 F.2d 824 (D.C. Cir. 1982).
Edwards and Hanly v. Wells Fargo SEC Clearance Corp., 458 F. Supp. 1110, rev'd other grounds 602 F.2d 478 (2nd Cir. 1979), cert. denied 4444 U.S. 1045 (1980).
Ernst and Ernst v. Hochfelder, 425 U.S. (1976), rev'g 503 F.2d 1104 (7th Cir. 1974).
Farlow v. Peat Marwick, Mitchell and Co., 956 F.2d 982 (10th Cir. 1991).
Fine v. American Solar King Corp., 919 F.2d 290 (5th Cir. 1990).
Fischel, D.R. 1981. Secondary liability under Section 10(b) of the Securities Act of 1934. *California Law Review* 69:80.
________. 1987. The regulation of accounting: Some economic issues. *Brooklyn Law Review* 52: 1051.
Frank v. Midwestern Oklahoma Development Authority, 428 F. Supp. 719 (W.D. Okla, 1976).
Fund of Funds, Ltd. v. Arthur Andersen and Co., 545 F. Supp. 1314 (S.D.N.Y. 1982).
Halperin v. Edwards and Hanly, 430 F. Supp. 121 (E.D. N.Y. 1977).
Herman and MacLean v. Huddleston, 459 U.S. 375, 379 n.5. (1983).
Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) modified by No. 87-3837 (Nov. 13, 1990).
In re National Smelting of N.J. Inc. Bondholders, Litig., 722 F. Supp. 152 (D.N.J. 1989).
In re World of Wonder Securities Litigation, 721 F. Supp. 1140 (N.D. Cal. 1989).
In re Union National Carbide Corp. Consumer Products Business Security, 666 F. Supp. 547 (S.D.N.Y. 1987).
IIT: An International Investment Trust v. Cornfeld, 619 F.2d 909 (2d Cir. 1980).
Jett, 840 F. 2d 1493 (9th Cir. 1988).
Kadish, S. 1985. Complicity cause and blame: A study in the interpretation of doctrine. *California Law Review* 73: 332.
Kliman v. Homeland Inc. 611 F.2d 783 (9th Cir. 1980).
Kothari, S.P., T. Lys, C.W. Smith, and R.L. Watts. 1988. Auditor liability and information disclosure. *Journal of Accounting, Auditing and Finance* 3:307.
Landy v. FDIC, 486 F.2d 139 (3rd Cir. 1973), cert. denied 416 U.S. 960.
Latigo Ventures v. Laventhol and Horwath, 876 F.2d 1322 (7th Cir. 1989).
List v. Fashion Park, Inc., 340 F.2d 457 (2nd Cir.) cert. denied 382 U.S. 841 (1965).
McLean v. Alexander, 599 F.2d 1190 (3rd Cir. 1979).
Mishkin v. Peat, Marwick, Mitchell and Co., 744 F. Supp. 531 (S.D.N.Y. 1990).
Peil v. Speiser, 806 F.2d 1154 (3rd Cir. 1986).
Roberts v. Peat, Marwick, Mitchell and Co. 857 F.2d 646 (9th Cir. 1988), cert. denied 110 S. Ct. 56 (1989).
Robin v. Arthur Young and Co. 915 F.2d 1120 (7th Cir. 1990).
Rolf v. Blyth, Eastman, Dillon and Co. 570 F.2d 38 (2nd Cir. 1978), cert. denied 439 U.S. 1039 (1978).
Rudolph v. Arthur Andersen and Co., 800 F.2d 1140 (11th Cir. 1986), cert. denied 480 U.S. 946 (1987).
Rule 23 of the Federal Rules of Civil Procedure.
SEC v. National Student Marketing Corp., 457 F. Supp. 682 (S.D.Cal. 1978).

SEC v. Research Automation Corp., 585 F.2d. 31 (2nd Cir. 1978).
SEC v. Seaboard Corp., 677 F.2d. 1301 (9th Cir. 1982).
SEC v. Southwest Coal and Energy Co., 624 F.2d 1312 (5th Cir. 1980).
Sirota v. Solitron Devices, Inc., 673 F.2d 566 (2nd Cir. cert. denied 459 U.S. 838 (1982).
Stokes v. Lokken, 644 F.2d 799 (8th Cir. 1981).
W.O. Akin, et al. v. Q-L Investments, Inc., Etc., et. al. and *Laventhol and Horwath*, 959 F.2d 521 (5th Cir. 1992).
Wessel v. Buhler, 437 F.2d 279 (9th Cir 1971).
Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2nd Cir. 1981).
Woodward v. Metro Bank, 522 F.2d 84 (5th Cir. 1975).
Wool v. Tandem Computers, Inc., 818 F.2d 1433 (9th Cir. 1987).
Zoelsch v. Arthur Andersen and Co., 824 F.2d 27 (D.C. Cir. 1987).

SOME FACTORS RELATED TO THE FAILURE OF SAVINGS AND LOANS

James H. Thompson

ABSTRACT

The financial press and politicians have attempted to place the blame for many recent S&L failures on several sources including S&L management, economic conditions, and improper accounting methods. One of the accounting methods depicted as a "culprit" in the S&L crisis is regulatory accounting procedures (RAP). S&Ls presently may elect to use either generally accepted principles (GAAP) or RAP. The National Commission on Financial Institution Reform, Recovery, and Enforcement (FIRREA) was established by Congress to investigate the causes of the S&L debacle and make recommendations to Congress. The commission report will address how egregious accounting practices can be avoided, including the

Research in Accounting Regulation, Volume 7, pages 151-158.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

possibility of putting the SEC in charge of accounting procedures. The report also will compare GAAP and RAP procedures and consider the approaches of the FHLBB, the FSLIC, the Internal Revenue Service, and the accounting profession generally. Empirical studies have not considered GAAP/RAP selection as a predictive variable of S&L failure. This study considers whether GAAP/RAP selection and four other independent variables—association type, assets, net income, and regulatory capital as a percentage of total assets—are useful in predicting the failure of an S&L. The findings of this study indicate that the choice between GAAP or RAP did not successfully predict failure. In this study, the amount of regulatory capital and net income were the only independent variables that were significantly ($p < .01$) correlated with survival of the S&L. Findings also show that mutual S&Ls are significantly more likely to use RAP accounting, have less assets and produce more income than stock S&Ls.

The financial press and politicians have attempted to place the blame for many recent S&L failures on several sources including S&L management, economic conditions, and improper accounting methods. Regulatory Accounting Procedures (RAP) are among the accounting methods depicted as a "culprit" in the S&L crisis. The Federal Home Loan Bank Board (FHLBB) allowed the use of RAP beginning in the early 1980s. Savings and Loans may presently elect to use RAP in lieu of generally accepted accounting procedures (GAAP).

RAP has been called a "liberal" accounting method and a possible cause of the S&L debacle:

> [Many policymakers] have been led to the erroneous conclusion that RAP is at the root of the abuse and failure in the savings institution business ... Financial institution regulators, supervisors, and accountants must share the blame for allowing unscrupulous managements to take excessive risks while issuing misleading financial statements (Savings Institutions 1987).

The National Commission on Financial Institution Reform, Recovery, and Enforcement (FIRREA) was established by Congress to investigate the causes of the S&L debacle and make recommendations to Congress. Authorized in the 1990 Crime Control Act, the

Commission did not receive funding until October 1991. The commission report will address how egregious accounting practices can be avoided, including the possibility of putting the SEC in charge of accounting procedures. The report also will compare GAAP and RAP procedures and consider the approaches of the FHLBB, the FSLIC, the Internal Revenue Service, and the accounting profession generally. Specifically, it will address asset valuation, including the treatment of gains and losses on assets, the procedures for recording fees and interest income financed by loans, and the definition and treatment of supervisory goodwill. The commission's staff director, James Pierce, stated that a "different accounting system, that the SEC would never allow, was allowed and encouraged" at S&L's. Another commission member, Michael Raoul-Duval, also questions the logic of RAP and said, "Maybe the SEC or FASB should have jurisdiction (FIRREA Commission, 1991).

Costs associated with the S&L crisis have become so large that the Federal Government has developed an organization with the sole responsibility of handling failed S&Ls. The Resolution Trust Corporation (RTC) is managed by the Federal Deposit Insurance Corporation (FDIC), with oversight by the Treasury Department. The RTC has authority over S&Ls that fail or that do not meet the standards of the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

The activities of FIRREA and the RTC underscore the need for research into the adequacy of financial reporting by S&Ls. This study considers whether GAAP/RAP selection or other independent variables are useful in discriminating between S&Ls that survive and S&Ls that fail. The results of the study may be helpful in predicting S&L failure and provide information about the adequacy of financial reporting by S&Ls.

PRIOR RESEARCH

Several empirical studies have been conducted to study factors associated with failure of financial institutions. A 1988 study by the Comptroller of the Currency (1988) showed that management inadequacies were a primary cause of bank failures in the 1980s. Booth et al. (1989) developed a predictive model using quarterly data tapes from the Federal Home Loan Bank Board. Their model

identified independent variables that were useful in distinguishing bad performers up to two years before bankruptcy. Lillien, Mellman, and Pastena (1988) showed that unsuccessful firms have a greater propensity for making accounting changes. Hill and Ingram (1989) report results that showed a significant association between the use of GAAP or RAP accounting and four other variables: SEC regulation, audit firm support for GAAP or RAP, expected tax benefits, and experience in secondary markets. S&L management chose to use RAP when they were pressured by economic influences.

Current accounting rules have been criticized in a recent banking industry study (Thomas, 1992). In *Banking on the Brink,* Roger J. Vaughn, an economic consultant, and Edward W. Hill, an economics professor at Cleveland State University, cite two ways that accounting rules cloud a bank's health: (1) banks are not required to set aside capital to account for their risk of losses if interest rates fluctuate greatly, and (2) banks are allowed to report loans at their original value even though many of their loans have deteriorated (particularly loans on commercial real estate). The study estimates that taxpayers may have to pay $75 to $100 billion to resolve this banking problem. These estimates are much higher than the $39 to $48 billion estimated by the FDIC (Hill, 1992).

DATA AND METHODS

The data were gathered from state-by-state publications of the Sheshunoff Corporation. These publications were obtained from state libraries in Arkansas, Georgia, Mississippi, Oklahoma, and Texas. The name, city, association type (mutual or stock), and two-year comparative financial data were collected for each S&L in each of the five states for 1988 and 1989.

The Statistical Analysis System (SAS) was used to analyze the data. The independent variables were association type, assets, net income, regulatory capital as a percent of assets, and whether the savings and loan used RAP or GAAP. The dependent variable was whether the savings and loan survived from 1988 to 1989. The independent variables were regressed on the dependent variable by LOGIST. The LOGIST software program was used because the dependent variable (survival) and two of the independent variables (GAAP/RAP and mutual/stock) were dichotomous. The following model was specified as:

$$SURVIVAL = B_1 + B_2\, ASSETS_i + B_3\, NI_i + B_4\, REGCAP_i + B_5\, GAAP_i + B_6\, MUTUAL_i + e_i$$

where:

SURVIVAL = the dependent variable (coded as zero for firms that did not survive from the first to the second year of the study and one if the firm did survive);
ASSETS = the carrying value of the assets at the end of the first year of the study;
NI = net income of the savings and loan during the first year of the study;
REGCAP = the regulatory capital of the savings and loan as a percent of total assets at the end of the first year of the study;
GAAP = an independent variable (coded as zero if the savings and loan used regulatory accounting principles and one if the savings and loan used generally accepted accounting principles).
MUTUAL = an independent variable (coded as zero if the S&L was organized as a stock association and one if organized as a mutual).

RESULTS

Table 1 reports the number of S&Ls that failed between 1987 and 1988 by state and in total. Texas suffered the most S&L failures between 1987 and 1988. Of the 273 S&Ls in Texas on December 31, 1987, 83 (30%) failed during the following year. Oklahoma suffered the highest failure rate (37%) of the five states. By comparison, the failure rate in the other three states was comparatively low. In fact, no Mississippi S&Ls failed between 1987 and 1988. The disparity in failure rates suggests that local economic conditions may be an important factor related to failure. During the late 1980s, the oil and gas economy was depressed and in turmoil. The economies of Texas and Oklahoma rely much more heavily on oil and gas than the economies of Arkansas, Mississippi, and Georgia. Problems in the oil and gas industry also affect other industries, such as real estate. Compounding of problems such as these may have contributed to a high failure rate of S&Ls in Texas and Oklahoma.

Table 1. The Number of S&Ls That Survived/Failed from 1987 to 1988

	1987	*1988*	
	Total Number	*Survived*	*Failed*
Arkansas	36	34	2
Georgia	69	65	4
Mississippi	42	42	0
Oklahoma	51	32	19
Texas	273	190	83
All 5 states	471	363	108

Table 2. Correlations of Variables All States

	GAAP	*Mutual*	*Assets*	*Net Income*	*Regulatory Capital*
SURVIVAL	.0977	−.0719	−.0266	.2086	.4121
	(.1071)	(.2363)	(.6612)	(.0005)	(.0001)
GAAP		−.2124	.0951	.0022	.0949
		(.0004)	(.1170)	(.9706)	(.1177)
MUTUAL			−.0705	.0741	−.0586
			(.2460)	(.2225)	(.3347)
ASSETS				−.4993	.0133
				(.0001)	(.8269)
NET INCOME					.4168
					(.0001)

Table 2 provides correlation coefficients of the variables in the study. Consistent with prior research, both net income and regulatory capital were positively correlated ($p < .01$) with survival. Net income was also positively associated with regulatory capital ($p < .01$). The latter finding might be expected because an S&L is able to place itself in a better position with regard to regulatory capital as income increases.

Mutual S&Ls more often used RAP, had lower assets, and reported higher incomes than stock S&Ls. Surprisingly, assets and net income ($p < .01$) were negatively correlated. This finding is counter-intuitive because S&Ls with more assets should be able to produce higher incomes. However, much of these asset values may have been in risky ventures. When these ventures went sour, the S&Ls were left holding the assets. The return on these investments often was less than the return earned by investors. Therefore, some S&Ls with greater assets actually had lower income.

The use of GAAP was positively correlated ($p = .1071$) with S&L survival. That is, firms that survived were more likely to use GAAP than were firms that did not survive.

SUMMARY AND FURTHER RESEARCH

This study provides empirical evidence regarding several independent variables that have been hypothesized to be related to the success or failure of S&Ls. Though the S&Ls that survived in this study reported higher levels of net income and regulatory capital, further research is needed to determine how useful these variables are for predicting failure. Future research may also identify additional variables that were not identified in this study. Further development and testing of the model is needed before any variables can be concluded to be useful in predicting the failure of S&Ls.

Though the results of this study are not conclusive, it does suggest that there are factors other than RAP that are "at the root of the abuse and failure in the savings institution business." S&Ls are characterized by many factors. Future research should consider the type (i.e., productivity) of assets held, the true economic value of the assets and the amount of liabilities, and the impact of national, regional, or local economic conditions. For example, in this study failure rates were much higher in oil and gas producing states. Further research can evaluate the generalizability of this result by considering data for S&Ls in all fifty states. With an expanded sample, a more complete analysis can also be performed.

REFERENCES

Arguments over RAP versus GAAP are misdirected. 1987. *Savings Institutions* (November), pp. 45-47.

Booth, D.E., P. Alam, S.N. Ahkam, and B. Osyk. 1989. A robust multivariate procedure for the identification of problem savings and loan institutions. *Decision Sciences* 20: 320-33.

Comptroller of the Currency, Administrator of National Banks. 1988. *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks* Washington, DC: U.S. Government Printing Office.

Hill, J.W., and R.W. Ingram. Selection of GAAP or RAP in the savings and loan industry. *The Accounting Review* (October): 667-79.

Hill, M. 1992. New book says banks on verge of insolvency. *Cleveland Plain Dealer* (October 6), pp. 1D, 6D.

Lillien, S., M. Mellman, and V. Pastena. 1988. Accounting changes: Successful versus unsuccessful firms. *The Accounting Review* (October): 642-56.

National Commission on Financial Institution Reform, Recovery, and Enforcement. 1992. *Report of the National Commission on Financial Institution Reform, Recovery, and Enforcement*. Washington, DC: FIRREA, September 23.

Savings and Loan Associations of Arkansas. *Sheshunoff Corporation 1989 Reports.*

Savings and Loan Associations of Georgia. *Sheshunoff Corporation 1989 Reports.*

Savings and Loan Associations of Mississippi. *Sheshunoff Corporation 1989 Reports.*

Savings and Loan Associations of Oklahoma. *Sheshunoff Corporation 1989 Reports.*

Savings and Loan Associations of Texas. *Sheshunoff Corporation 1989 Reports.*

Thomas, P. 1992. Accounting rules mask banking losses, bailout 'almost inevitable,' study says. *The Wall Street Journal* (October 6), p. A10.

PERSPECTIVES

THE ACCOUNTING PROFESSION AND FINANCIAL REPORTING:

WHY SHOULD ANYONE BELIEVE US?

David P. Tweedie

ABSTRACT

In 1987 the six British accounting Institutes responded to a request by the Chairman the then Accounting Standards Committee (ASC) for a review of the United Kingdom's standard setting system. At this time the British economy was booming; merger activity was at its height; pressure existed on management to produce good results either to deter hostile bids or to be in a position of having a strong share price to enable their company to take over other companies. The auditing profession was bombarded with ever more complex creative accounting techniques: corporate financiers were inventing new financial instruments, new modes of financing , and new forms of presentation designed to improve the look of the income statement or balance sheet. Recession seemed to be a thing of the past. Those who stood for traditional values were deemed to be standing 'in the

Research in Accounting Regulation, Volume 7, pages 161-182.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

way of progress' and were considered to be old-fashioned and out-of-line with modern thinking. Auditors were reluctant to qualify accounts if the issue under consideration had been accepted by their competitors and auditors who considered qualification were often faced by the prospect of second opinions, opposing statements from learned Counsel or even the prospect of the audit going to tender. Why had this happened and why had the standard setters lost control?

THE LATE 1980S

To understand the problem that existed in the late 1980s, and which to a certain extent still exists, it is necessary to consider the roles and ambitions of the various players in the financial reporting process.

The Preparer

It is, of course, natural for management to present the performance and financial position of its own organization in the most favorable light. Certainly, in the conditions that prevailed in the mid- to late-1980s, it would have been foolhardy to do otherwise. Many companies were under pressure to produce results and if they failed to meet market expectations they would be compared unfavorably with their competitors, some of whom might have used 'financial engineering' to massage their profits. The pressure was, therefore, on companies to adopt creative accounting techniques, especially if their competitors had done so.

Not surprisingly, preparers do not react favorably to any move by a standard setter to inhibit their freedom of action—and particularly in boom conditions. There are various methods of slowing down any standard setting project which may prohibit favored accounting treatments. Obviously, the first is to try to convince the standard setter that its proposals are wrong. If that fails, then field testing will sometimes be requested to engender delay and finally, there may be a request for a later effective date. All of this slows down the process of introducing new requirements, often in the hope that in the meantime other events may lead to a more favorable interpretation of management's existing policies or a more unfavorable view of the standard setters' proposals. These techniques

were employed in the 1980s to slow down the ASC's progress but a more deep-seated difficulty was experienced by the standard setter—the lack of support from the financial community.

The Auditor

In the last decade there has been a noticeable change in the ethos of the auditor as the balance between professionalism and commercialism tipped in favor of the latter. There has been pressure on partners to develop new business and to keep existing clients. Such pressure makes it incumbent on the management of auditing firms to ensure that, above all else, professional standards are maintained and that partners are not penalized for standing firm even if such a stance might mean the loss of a client. Equally, it is incumbent upon rival firms to ensure that such standards are common throughout the profession and that clients are not won by means of a reduction in professional standards.

The tightening of ethical and auditing rules in the United States and the United Kingdom has done much to assist in this direction. The Emerging Issues Task Force (in the United Kingdom, the new Urgent Issues Task Force) has also been of assistance in stamping out the precedent which if adopted by two or three companies and accepted by some of the major auditing firms may well become part of accepted practice and then becomes the baseline for the next practice of an even more dubious nature. In accounting, as Beresford (1990) has commented, Gresham's law, not Darwin's law prevails—bad accounting drives out good.

Commercialism, however, can even be felt in the Task Forces. It has not been unknown for partners in a firm to argue the case for a procedure favored by a client in an attempt to persuade others to the client's point of view when the reasoning is based on some intricate interpretation of some obscure sentence in a standard, or statute or outside literature and fails to pass what Art Wyatt (1987) has called "the smell test." The auditing profession has to be careful—the one quality it has to offer to the outside world is an independent opinion. If the feeling permeates throughout the financial community that that opinion is not worth having then the raison d'être of the auditing profession has to be called into question.

The User

Given the complexity of modern-day accounts, the general purpose financial statements issued by most companies do little to assist the understanding of the nonexpert reader. Instead such readers would have to rely upon press comment or upon the services of stockbrokers and analysts to interpret the accounts for them. How well, then, do analysts undertake their function?

The analysts and the institutional investor must take a certain measure of responsibility for the short-term pressures which, as we have seen, have led management to use creative accounting techniques. The obsession with the bottom line and with gearing ratios has resulted in most of the creative accounting techniques being concerned with massaging both of these measures.

The expert analyst can help the market to become efficient. On the other hand, a weak analyst seems to adopt a simplistic approach to analysis of financial statements, follows fads and appears to have a short-term perspective. Company visits in the United Kingdom are often a great source of information, yet much of the information derived from companies could be of a price-sensitive nature. Company directors may be asked indirectly to confirm the analyst's estimate of future profit—these same analysts frequently oppose the idea of having published forecasts in accounts, as such disclosure might remove their competitive advantage. Given that any respectable financial institution would not deal in a company's share while it was in the possession of price-sensitive information is it appropriate for clients of certain analysts to obtain information ahead of the vast majority of the shareholders? Indeed, the analysts themselves create pressure on management to adopt financial engineering to meet the agreed forecasts as share prices inevitably fall if expectations are not met.

The Standard Setter

The standard setter's role varies in different countries. In the United States for example the FASB is backed by the power of the SEC. In the United Kingdom, until 1990, the ASC had little backing other than the authority of the Institutes. Few accountants were disciplined for failure to obey accounting standards and even audit qualifications could be ignored by the investing community. There is, in addition,

in the United Kingdom a struggle between the standard setter and the legal authorities, given that European Fourth and Seventh Directives enshrines accounting principles in the law. The standard setter in the United Kingdom is, therefore, faced by laws which can be some twenty years old which may well have been useful in the early 1970s but are clearly not so relevant to the needs of the 1990s. There is, however, little that can be done to remove such law—only agreement by the member countries of the European Community (EC) can do that.

One redeeming feature of the law in EC member states, however, is the requirement that accounts show a true and fair view. The true and fair view would generally require compliance with the provisions of the law and with accounting standards but on occasion it would be possible for companies to depart from the detailed provisions of the law (and, for that matter, from accounting standards) if the true and fair view would not be shown without such a departure.

Until 1990, a company's decision to invoke the true and fair override could only be challenged by the auditor. But competitive pressures, and the then relatively low level of interest in a qualified audit report would not necessarily deter management from departing from an accounting standard or the detailed provisions of the law or from adopting a dubious accounting technique.

Since 1990, however, the position has changed in the United Kingdom. The Accounting Standards Board's sister body, the Financial Reporting Review Panel, now has the power to ensure that a true and fair view is shown in the accounts of large companies by examining unusual accounting policies or departures from law or accounting standards and seeking further explanations from the company for the accounting treatments adopted. If the Panel is not satisfied with the explanation it receives it can request that the accounts be restated and reissued. If the company refuses to adopt this course of action, the Panel can then require the company to appear in court and, if the Court agrees with the Panel, the company can be forced to reissue its accounts, suitably amended and the costs of such reissue and the legal costs can fall on the individual directors responsible. Any auditor who had given an unqualified opinion on these accounts would automatically find himself reported to his Institute's Disciplinary Committee. This Disciplinary Committee has been put under increased pressure since the 1989 Companies Act as now auditors of companies are required to be "fit and proper persons"

to under take such tasks and the Accountancy Institutes, having persuaded a reluctant Government to give them the power to discipline auditors, will have to ensure that their disciplinary proceedings have teeth. Indeed, it may well, of course, not simply be the individual auditor who signed the accounts who finds himself before the disciplinary committee, but those in authority in the firm who either overruled his judgment to qualify or agreed with him to allow the departure from law, standards or accepted practice.

The ingredients for a decline in financial reporting were clearly in place in the 1980s. The advent of the Urgent Issues Task Force (following the American example) to remove the bad precedent and to do so rapidly and the introduction of the Financial Reporting Review Panel which can challenge accounts has undoubtedly done much to change the climate of financial reporting in the United Kingdom. Companies and auditors and management are very wary of the adverse publicity that will befall them if the Panel is critical of financial statements. Indeed, while so far the Panel's rulings have not been of too serious a nature, criticism of individual companies has led to share price falls, presumably based on the supposition (not always warranted) that other features of the company's accounting may also be questionable.

THE ADVENT OF THE ACCOUNTING STANDARDS BOARD

A key feature of the attempt to change the elements of financial reporting in the United Kingdom has been the advent of the Accounting Standards Board (ASB). The ASB is quite a different form of committee from its predecessor the Accounting Standards Committee. The Board is under the aegis of the Financial Reporting Council (FRC) which consists *inter alia* of the Chairmen of major British companies, representatives of major City institutions, senior partners of accounting and legal firms, and representatives of the Government, Bank of England and the Stock Exchange. The role of the FRC is to oversee financial reporting in the United Kingdom and to ensure support and obtain funds for the Accounting Standards Board and the Financial Reporting Review Panel. Unlike the ASC, funding comes not simply from the accounting profession, but from the Government, the City and the profession in equal parts and is

of a substantially larger amount, some £3.1m per annum as opposed to some £450,000 for the ASC.

The ASB has two full-time members and seven part-time. It can, on its own authority, issue standards on a six:three vote. In contrast the ASC, while also passing standards by a two-thirds majority, consisted of some twenty-one members but could not issue standards unless, after approving a standard, it received the votes of each of its six sponsoring accountancy Institutes. Any one Institute, therefore, could (and, on occasion, did) prevent or delay the introduction of a new standard.

The ASB has many objectives of which the following three perhaps stand out as the most important.

Accounting Standards Should be Based on Principles Rather Than be a Series of Rules

The ASB is concerned that if some commentators on financial reporting had their way accounting would lack any solid intellectual foundation while judgment would be eliminated and be replaced by a rule book in the search for comparability. While comparability is important the ASB does not believe that it can produce a rule for every situation and is aware that rules can lead to the practice of loopholing, that is, treating standards as legal documents and looking for ways around their requirements. Principles of a more general nature make the spirit of the Board's intentions clear and are more difficult to evade, particularly if broad examples can be given of the way in which the principles should be interpreted thereby bringing in quasi-rules but not eliminating the broad nature of the principle. For example, it is clear that the British standard on leasing is fatally flawed. The standard suggests that finance leases should be capitalized in the lessee's financial statements if virtually all the benefits and risks of the asset in question lie with the lessee. The standard is flawed because the basic principle is explained by a (supposedly) "detailed rule" which states that it can be presumed that all benefits and risks lie with the lessee if the present value of the minimum payments under the lease amount to 90% of the leased asset's fair value. Most of the leasing contracts in the United Kingdom (deliberately?) result in the net present value of these payments amounting to less than 90% of the asset's fair value and, accordingly, very few leases are capitalized in the United Kingdom.

The Need to Have a Consistent Base for Accounting Standards

British accounting standards have no clear conceptual logic. Most have been created by individual working parties operating with their own conceptual frameworks and as a result some of our standards are inconsistent with others and have no common theme running through them. The Board was impressed with the pioneering work undertaken by the FASB in producing a conceptual framework and while we were not prepared to devote the same resources to the project we have examined the FASB's work closely and compared it with the conceptual frameworks introduced in Australia, Canada, and by the IASC. It is clear there is a great deal of common ground (Tweedie 1991).

The Board is in the process of introducing its own conceptual framework (the Statement of Principles) based on seven major chapters, namely:

- The objectives of financial reporting;
- qualitative characteristics of financial information;
- the elements of financial reports;
- recognition;
- measurement;
- presentation; and
- the boundaries of a reporting entity.

These chapters are already giving the Board pause for thought and leading to a questioning of many of our existing practices (and indeed the accounting practices of the international community). While there is little controversy over either the objectives of financial reporting (information for stewardship and economic decision making) or the type of statements required (in the chapter on presentation) the other chapters are going to cause difficulties. For example the Board's view is that the major characteristics of financial information should be comparability, timeliness, reliability, and relevance. Yet it is clear that users cannot have information that is both reliable and relevant: there has to be a trade-off. For example, we can ensure that users have either a reliable 1951 London property cost or a more relevant, but more subjective 1992 property valuation. The indication is that the Board will move toward the latter.

This, of course, gives an indication that the Board may well move toward a form of current value accounting, a theme taken up in the chapter on valuation. Similarly the draft chapters on elements and recognition while following general international practice have caused the Board to consider carefully some of its proposed accounting standards. These chapters adopt the international definitions of an asset (the right to a stream of benefits) and a liability (an obligation that will lead to resources leaving the organization) and the main characteristic of recognition, namely that the asset or liability can be measured reliably. The questions that have arisen concern future obligations. If a contract exists that leads to a binding obligation which can be measured reliably what reason is there for leaving the liability off balance sheet? If this is accepted can any lease contract be left off balance sheet? Similarly, with acquisition accounting (an issue to which I shall return later) the whole nature of the provision of reorganization expenses (presently deemed to be a liability of the acquired company under United Kingdom accounting practice) and their amount has been called into question as many of these provisions are not obligations. The conceptual framework could lead to major changes in British accounting practice.

International Harmonization

The Board is concerned that it does not attempt to introduce standards that would divorce British accounting further from international practice. We would only do so if, having examined international practice, we believed it to be deficient in material respects or it did not apply to the situation pertaining in the United Kingdom. To encourage harmonization the ASB has very close relationships with the FASB, the CICA and standard setters in Australia and New Zealand. In addition, to discuss harmonization of standards in Europe the ASB meets its European counterparts at the European Community's Accounting Advisory Forum which involves the standard setters of all twelve member countries. It is clear that several of the European standard setters are suffering from the restrictions imposed by the Fourth and Seventh Directives and there is an increasing disenchantment with some of the now out-of-date provisions formulated in the early 1970s.

Harmonization of European accounting practice is one thing, European standards are quite another. European standards would

probably be unwelcome in the United Kingdom. A prevailing United Kingdom view is that Europeans should move toward international practice rather than attempt to create a fortress Europe with its own independent set of accounting standards. The IASC has a major role to play here, although its present methods of harmonising on the basis of existing practice leave much to be desired.

Harmonization is a most important issue for national standard setters but a future-orientated harmonization process is preferable to one based on existing practice, particularly when much of existing practice is clearly flawed. In essence, adopting the accounting treatment used by a majority of countries as an international standard is hardly going to bring progress when the minority may have introduced their standards more recently and have developed their proposals after considering the economic situation of the 1990s and the early twenty-first century unlike those who promulgated the majority treatment many years ago. It does not make sense to base international practice on aging standards that clearly are going to cause difficulty in portraying economic reality in the future. The role of the IASC should be to seek out possible answers to our current problems and to obtain agreement from standard setters throughout the world which is the ideal policy to pursue—the standard setters should, to the best of their ability attempt to introduce such a policy as soon as is practicable. To do this, of course, will mean both ceasing to attempt to meet the legal or political difficulties of particular countries in International Accounting Standards and involving standard setters more closely with the IASC. The latter, in itself would be in the interest of the international business community. The danger is that cooperative efforts by national standards setters outside the context of IASC may result in confused signals on the priorities for international harmonization.

SUBSTANTIVE REFORMS IN BRITISH ACCOUNTING PRACTICE

At its earliest meetings the ASB had no written agenda before it. Instead it discussed what it deemed to be the defects of British financial accounting and their possible solutions. The problems fell into three broad categories concerned with: (1) the profit and loss account; (2) the balance sheet; and (3) group accounts.

The Profit and Loss Account

The main problem with the British profit and loss account was the obsession with the bottom line. Fifty-three percent of British companies revealed extraordinary items in their accounts (material items deriving from events or transactions that fell outside the ordinary activities of the company and, therefore, were not expected to occur frequently or regularly) (*Corporate Reporting* May 1991). (In the United States the percentage of companies displaying extraordinary items was 9% [*Accounting Trends and Techniques* 1990].) This U.K. practice had a considerable impact on the profit after taxation and earnings per share—extraordinary items were excluded from both.

Many examples revealed differences in interpretation. Some companies were treating as extraordinary transactions what others in the same industry would show above the line. It was clear that a major overhaul of the profit and loss account was required. The FASB's 1981 exposure draft on *Reporting Income, Cash Flows and Financial Position of Business Enterprises* which later, in modified form, became part of the *Statement of Financial Accounting Concepts No. 5,* "Recognition and Measurement in Financial Statements of Business Enterprises" had made a great impression on many of the Board members. Therefore, we decided to move toward identification of the components of income, namely:

- continuing income;
- discontinued income;
- unusual items (including realized gains);
- prior year items; and
- unrealized gains.

Within the next few weeks the Board intends to issue an accounting standard which will dramatically transform the face of British profit and loss accounts. Extraordinary items will virtually disappear and income would be divided between that from continuing activities and that from discontinued activities (the Board considered the notion of including *discontinuing* income but rejected it as it believed that there was too great a scope for manipulation). Gains and losses on the disposal of businesses and major assets will all be shown above the line—a major change from traditional practice. A new statement

of total gains and losses recognized in the year will be introduced which will display all increases or decreases in net worth other than those resulting from contributions from or distributions to the owners. This statement will remove the incentive for reserve accounting and will reveal *inter alia* major losses on the net investment in foreign currencies in overseas subsidiaries, and revaluation gains and losses on real estate (probably the most important number in British real estate company accounts).

The major concern of the Board is the quality of profit. It believes it to be important to allow the fluctuations of a company's economic performance to be shown, not to be artificially smoothed. The Board believes that all that is important about a company's performance cannot be encapsulated in a single bottom line figure and deems it vital that users consider all components of a company's income if an assessment of future results and cash flow is to be made. To assist users to interpret the results the Board has suggested that management adopt the use of an operating and financial review (similar to the Management Discussion and Analysis in the United States) to indicate those items which are nonrecurring, the sensitivities to risks of various aspects of the business, the problems of ensuring adequate funds for investment activities and in general to inform readers of the financial statements of the major features of the accounts. We have suggested that within this document management discuss what we have termed their revenue investment, that is those expenditures which have been expensed during the year but which can have a major impact on future profit such as training, advertising, research and development, and major repairs and renovations. All these expenditures can of course be switched off in bad years and, without disclosure, would fail to reveal the true quality of the present profits. (The review cannot be in the nature of an accounting standard as it is deemed that interpretive statements fall outside the mandatory powers of the Board.)

In addition, the Board has ensured that a major aspect of the quality of a company's profit will be revealed in that the ASB has abolished the source and application of funds statement and replaced it with a requirement that a cash flow statement should be shown. The emphasis of the source and application of funds statement on working capital disguised weaknesses in a company's cash flow to all but the most percipient user. For example, a major British company failure (Polly Peck) might have been foreseen somewhat

earlier if some users had not been satisfied with its final year pre-tax profit (£l6lm) and its positive funds flow from operating activities (£172m—a result of increases in stock and other working capital)—it has been calculated that the company's negative cash flow from operating activities was £129m! ("County NatWest" 1992).

The Balance Sheet

While the new standard on the profit and loss account rejects the concept of a single line representing an all-embracing measure of a company's performance, standards concerned with the balance sheet will attack the notion that the present gearing ratio fairly reflects the level of a company's borrowings. Three particular problems affecting the balance sheet at present confuse the user of accounts, namely: (a) off-balance sheet financing; (b) asset values; and (c) the distinction between debt and equity. All three areas are at present under investigation by the Board.

Off-balance Sheet Financing

The growth of off-balance sheet assets and liabilities has been a persistent feature of accounting in the United Kingdom since the mid-1980s. The techniques used involve a mixture of circular transactions, removal of legal ownership of the asset and the use of options.

A simple illustration is the sale and repurchase contract which has been used, for example, in the distilling industry when the maturing whisky inventories are sold to financial institutions but are then repurchased when required. The distillery will sell the whisky to say, a bank and give the bank an option to put the whisky back to the distillery at the price the bank paid plus interest on that sum based on normal lending rates up to the date of repurchase. The distillery will have a call option with similar conditions, thus making it obvious that the whisky will return to the distillery and the distillery will pay interest on the amount initially paid by the bank up to the date of the inventory's return. This is in effect no more than a loan secured on the security of inventory (which usually never leaves the distillery).

We believe the substance of a transaction is more important than its legal form and henceforth the former should be shown in financial statements. An exposure draft to be issued this autumn will require preparers of accounts to consider where the benefits and risks

resulting from a transaction lie. If these have not been transferred the assets and liabilities cannot go off-balance sheet.

An issue which has caused major difficulties for the Board has been the nature of nonrecourse finance, and in particular the issue of securitisation where, for example, financial institutions have transferred home mortgages in return for nonrecourse payments while still retaining the income from the mortgages transferred after paying all interest charges. The argument employed by the securitization industry has been that when £100m worth of mortgages have been transferred by a bank to a vehicle company and that company has been financed by, say, £95m worth of debt secured only on those mortgages and by £5m worth of subordinated loan provided by the bank, the bank is only at risk for £5m and should not have to show £100m mortgages and £95m of debt in its balance sheet. This argument is based primarily on the removal of catastrophe risk. Those that believe that asset and liability should both be shown argue that the benefits from £100m worth of mortgages flow in to the initiator of the scheme and interest is paid out on £95m.

The Board is now experimenting with the notion that if the finance is genuinely nonrecourse and there is no legal, moral or commercial risk whatsoever of the finance being repaid then the nonrecourse finance can go off-balance sheet—provided that this fact is acknowledged by all parties and disclosed in the accounts. However, since the benefits flowing to the initial holder of the mortgages relate to the total of the assets securitized a net presentation would have to be shown in the balance sheet, that is, while the asset 'securitized mortgages' would be shown as £5m the composition of that figure would have to be shown on the face of the balance sheet as £100m of securitized mortgages financed by £95m of nonrecourse finance.

A further problem for the Board has been the removal of subsidiaries from consolidated accounts by use of other off-balance sheet techniques. In particular, prior to the 1989 Companies Act companies could avoid incorporating subsidiaries by ensuring that any companies they controlled did not meet the then legal definition of a subsidiary.[1] With the advent of the 1989 Act and its emphasis on control many of these off-balance sheet subsidiaries are being brought on balance sheet. There are still, however, means of avoiding the requirements of the 1989 Act and consequently the Board will be introducing the concept of a "quasi-subsidiary" to ensure that all controlled companies fall within the ambit of the consolidated accounts.

Asset Values

The British balance sheet consists of a mixture of new revaluations (mainly of real estate), valuations of several years ago which have not been updated and historical costs. There is little consistency in the valuation of assets between companies, or even within companies. The lack of regular revaluations blurs the situation and makes it difficult to determine the actual performance of a company during a particular accounting period.

The use of historical cost or irregular revaluation methods:

- enables companies to obtain profits when required through judicious sales of assets held over a considerable period;
- encourages circular transactions enabling companies to realize as profit part of the current value of an asset held at historical cost or outdated value and to repurchase it at some future date;
- enables companies to disguise the real loss of value of their assets by claiming that any diminution in value is not permanent and therefore the asset does not have to be written down;
- distorts the gearing ratio in that companies may borrow £20m secured on an asset worth £30m but shown in the books at its cost of £5m;
- destroys the trend of profits on acquisition once long-term stock and other assets in an acquired company are revalued, thereby reducing profit margins.

Can we really reflect the economic reality of a company's financial position when we account using asset values of many years ago. The British practice in revaluing certain assets on an irregular basis simply adds to the confusion.

A very simple example illustrates the accountant's dilemma. If a house is bought at the beginning of the year cost $100,000 and by the end of the year in which inflation was 5% its market value is $120,000 has a gain arisen? Under historical cost accounting the asset would be shown at $100,000, that is, no gain would be indicated. Under current cost accounting the house would be shown at $120,000, but since another similar house, presumably costing the same, would be required, once more no gain would be recorded (i.e., there would be no change in the physical resources). To someone who did not have a house a gain of $20,000 would be evident and to the

sophisticate a gain in real terms of $15,000 would exist. The two traditional accounting answers are incorrect and the two intuitive answers reflect the situation as it really is.

Toward the end of this year we will have to give the British financial community a choice. The present system of irregularly revaluing assets cannot be policed. We need either to move back to historical cost accounting (thereby reversing the trend in British financial reporting practice) or to a position of revaluing particular assets especially those which cause major fluctuations in profit, namely the disposable assets such as properties (already revalued [irregularly] in the United Kingdom), long-term inventory and quoted investments (for both of which the law requires that current costs be shown in the notes to the accounts). Regular revaluations on an annual basis of these three items would do much to improve comparability of British accounts and remove many of the distortions in profit caused by holding gains from many years past being incorporated in income. In addition, of course, the proposals would assist in ensuring that the balance sheet gave a reflection of a company's financial position more akin to a layman's view of financial position (see Tweedie 1977) than the present historical cost statements.

The Distinction Between Debt and Equity

Before the balance sheet can, however, reflect fairly the company's financial position the ASB needs to clarify the distinction between debt and equity and to determine their true financing costs. Many financial instruments carry a mixture of the characteristics of debt and equity. For example, cumulative redeemable preference shares are shares which ultimately have to be redeemed but whose dividend is fixed and which accumulates if unpaid. For many companies, however, these shares have all the characteristics of debt as if the dividend is not paid after a certain number of years shareholders can enforce payment, thereby putting the company into liquidation. Similarly some debt can be convertible into share capital and is, therefore, also of a hybrid nature.

Many creative accounting schemes have been designed in the United Kingdom to classify debt as equity, for example by assuming conversion after making estimates of potential future share prices (conveniently ignoring any premia due on redemption or supplementary interest to be paid if the debt is not converted).

An exposure draft to be issued later this year will divide share capital into equity (i.e., pure residual equity) and non-equity shares (i.e., those with prior rights) while debt will be divided in to pure debt and hybrid (convertible) debt. This is similar to the mezzanine finance section in the United States balance sheet except that the rules of the EC's Fourth Directive require us to show hybrid debt and hybrid equity separately. All potential costs will have to be accrued on an annual basis to show the full opportunity cost of the instrument, thereby ensuring the profit and loss account reflects a fair rate of interest on the financial instruments.

If the Board's proposals are accepted more assets and liabilities should be shown on balance sheet than hitherto. There should be a more regular revaluation system running through the balance sheet and it should be easier for users to distinguish between debt and equity instruments. The leverage ratio of many British companies could alter quite dramatically in the next few years.

Business Combinations

The balance sheet (and income statement) of groups of companies could also undergo further major changes depending on the outcome of the Board's deliberations on the subject of business combinations. Three issues are inextricably intertwined when dealing with business combinations, namely the debate over acquisition versus pooling accounting; the assessment of fair value under acquisition accounting; and the treatment of goodwill and other intangibles.

Acquisition versus Pooling

The two methods for accounting for business combinations result in entirely different results. Under acquisition accounting the balance sheet of the acquired company is restated to fair values at the date of acquisition, whereas under pooling the book values of the acquired company's assets are left unchanged. Under acquisition accounting the acquiring company adds to its own profit for the period the profit of the acquired company from the date of acquisition. Under pooling the profit of the acquired company for the entire period is brought into the group income statement.

It is clearly difficult to compare the effects of business combinations when two such entirely different methods exist. Most

countries have attempted to limit the use of pooling by the use of various prior conditions. Requirements in the United Kingdom are different from those in the United States: at present pooling can only be undertaken if (broadly) the combination results in an offer for 90% of the acquired company's equity shares of equity shares amounting to over 90% of the consideration. Twenty percent of the equity of the acquired company must not have been held in advance. Both of these conditions can easily be thwarted—the first by the use of placings of shares to enable shareholders of the acquired companies to obtain cash and the second by the sale of the 20% interest in a 'bed and breakfast' deal involving repurchase when all the other shares are acquired.

International practice seems to be centering on a condition that pooling will only be allowed if an acquirer or acquiree cannot be identified. In Australia, however, pooling has simply been banned. It is between these two alternatives that Britain will have to decide. If most of the problems of acquisition accounting could be removed there would be a much greater case for the abolition of pooling thereby allowing only one method for business combinations and enabling greater comparability to exist between companies' financial statements.

Fair Values on Acquisition

At present, in the United Kingdom, the treatment of goodwill means there is an incentive for companies both to provide on acquisition for reorganization provisions deeming them to be liabilities of the acquired company and to write down the acquired company's stock to low levels. These techniques reduce the net worth of an acquired company and increase the goodwill arising on consolidation. In the United Kingdom such goodwill is not amortised in the profit and loss account but is written off directly against reserves. There is, therefore, no downside to excessive provisioning. Indeed, there is a positive upside in that excess provisions can be brought back into income in future years and, assisted by the low stock values in the acquired company, can help the company to maintain a favorable trend of income.

At present, in line with the proposed conceptual framework, the Board has come to the preliminary decision that reorganization provisions designed to capture the cost of changes required by the acquiring company are not liabilities of the acquired company and,

therefore, should not be deemed to be a deduction from its net worth. Similarly, there should be no provision for future losses: these too are not liabilities of the acquired company. The Board's view is that acquiring companies have an unfair advantage in that they can hide all reorganization costs while any acquired company, had it wished to improve its profitability, would have had to charge those costs to its profit and loss account. Under the tentative proposals (similar to the requirements in the United States) both companies would have had to have charged such costs to the income statement.

Similarly, if our valuation proposals are accepted and companies have to revalue real estate, inventory and quoted investments on a regular basis, then of the major tangible assets only plant and machinery would remain to be revalued. There would, therefore, be little distortion to profit unlike the major changes on acquisition that occur at present. This, once again, would enable the true economic effects of acquisitions to be revealed rather than their being dominated by the accounting changes.

Goodwill

It is often said that British companies enjoy an advantage compared to those in America as a result of the British goodwill standard. While in America goodwill has to be depreciated over forty years, in Britain, as mentioned above, no charge need hit the profit and loss account due to goodwill's instant write-off to reserve. On the other hand, in Britain there are suggestions that tax allowances on certain intangibles in the United States give an advantage to American companies and, furthermore, British companies may pay too much for their American subsidiaries because of the United Kingdom's accounting rules.

There are only three possible treatments of goodwill:

1. write off to reserves;
2. retention of goodwill in the balance sheet until it is shown to diminish in value; and
3. retention in the balance sheet with amortization (usually over a fixed period).

The British system of write off to reserves has not been without its drawbacks. In 1984, when the goodwill standard was introduced,

goodwill as a percentage of the net worth of acquiring companies was 11%. Three years later it amounted to 44% of their net worth (Barwise, Higson, Likierman, and Marsh 1989). As a result the net worth of companies, particularly those in the service industries has been severely depleted. These companies have been criticised partly because their raw leverage ratios make them appear to be financially crippled. Additionally, criticisms have arisen from shareholders who have believed (wrongly) that poor investments have been made if goodwill is written off instantly.[2] To combat these criticisms British companies have introduced intangibles, such as brands, into the balance sheet as goodwill surrogates, which has led to the potential for an intangible asset explosion in a country where there is still a great deal of dispute about the valuation bases for intangibles and the reliability of such valuations.

It is clear that management favor retention of goodwill in the balance sheet unless a diminution in value can be seen. Mangement certainly rejected the ASC's ED47 proposals which adopted the international position of writing off goodwill over twenty years. Many companies failed to see any logic in writing down goodwill when the investment on which it is based was increasing in value.

The Board is conducing research into this area to determine whether, in fact, diminutions in value can be detected and if so whether any particular form of tests to determine such diminutions can be devised. Even if the Board does devise tests satisfactory to the financial community and proposes to adopt them as standard practice it will be faced with a legal problem as under the Fourth Directive goodwill must be written off in a systematic manner over its economic life. Whether any tests designed to measure diminution in value would satisfy the 'systematic manner' requirement has yet to be seen.

Equity Accounting

Finally, in connection with business combinations comes the question of associated companies and equity accounting. It has been clear that the requirement for equity accounting when a minority stake (usually more than 20%) is held in a company and significant influence can be exercised has been abused and that companies have been adding a proportionate share of a so-called associate's profit to their own income when such influence is absent. The Board has

only briefly considered this issue but is concerned that equity accounting may be masking the real economic situation.

What is the purpose of equity accounting? Originally it was probably to deal with the quasi-subsidiary, the situation where a company controlled the financial and operating policies of another company which did not meet the legal definition of a subsidiary. Consolidation of quasi-subsidiary companies would resolve this particular problem. Nowadays, companies may be equity accounting simply to boost their own profits. The question has to be asked if that profit cannot be turned in to any form of control over resources, that is, ultimately into cash flow as in a quasi-partnership or a joint venture, should it be allowed to appear in company accounts. I am sure this issue will prove as fraught as some of the others on the ASB's agenda as the Board struggles to interpret what exactly is the financial reality of this particular situation.

CONCLUSION

In the United Kingdom the pressures of the late 1980s have led to a major change in the system of financial reporting—a change that in many respects had already occured some seventeen years earlier in the United States. The ASB has a unique opportunity to start with a blank sheet. In doing so we have to acknowledge the great debt we owe to the FASB for its work on the conceptual framework and its pioneering investigations in other areas.

Britain, in terms of accounting standards, is in an unusual position. It is part of the European Community; it has long-established links to the old Commonwealth countries such as Canada, Australia and New Zealand; it has a long and firm alliance with the accounting work in the United States resulting not only from a similar economic philosophy but from the business links created by our multinational companies and accounting firms. Accounting is an international subject and as we look towards reforming the abuses which have occured in the United Kingdom we are only too well aware of what is happening elsewhere and are grateful for others' experience and wisdom. We intend, as national setters, to have an international outlook. We have, however, to clean up our own backyard. We intend to do so with the help of the ideas of the international community of accountants and in return I hope we will be able to develop new

proposals for others to copy in due course. That ultimately is how all standard setters can reform financial accounting throughout the world and advance the important cause of international accounting harmonization.

NOTES

1. Under the law prior to 1989, a company would be a subsidiary of another if the latter controlled 50% plus 1 of the equity shares of the former or controlled the composition of the former's Board of Directors.

2. The standard states that the write-off to reserves "does not imply an equivalent actual loss in value."

REFERENCES

Barwise, P., C. Higson, A. Likiernian, and P. Marsh. 1989. *Accounting for Brands*. ICAEW.

Beresford, D. 1990. Internationalisation of accounting standards. *Accounting Horizons* (March).

County NatWest, What can you learn from a dead parrot? 1992. *Equity Briefing* (April 8).

Tweedie, D.P. 1977. Cash flows and realisable values: The intuitive accounting concepts? *Accounting & Business Research* (Winter).

________. 1991. The explicit conceptual frameworks compared. *IASC Insight* (October).

Wyatt, A. 1987. Interview. *Barrons* (September 14).

A CALL FOR CHANGE:

COMMENTS BY A. MARVIN STRAIT, 1992 AICPA GOLD MEDAL RECIPIENT, AT THE 1992 ANNUAL MEETING OF THE AICPA

A. Marvin Strait

It is traditional for the recipient of this award to have the opportunity to make a few brief comments. I'd like to share some thoughts about the future and propose something that might be considered controversial. I sincerely appreciate this opportunity, and I promise not to take a lot of your time.

We are granted a license—it's our monopoly, our franchise—to attest as CPAs to the fairness of financial statements prepared in accordance with Generally Accepted Accounting Principles. Attestation to GAAP financial statements is a protected service that, in most states, can be performed only by those that hold the CPA license. The system has served the public and the profession well for over 100 years and has helped make the CPA profession to be among the most respected and trusted in our society.

Research in Accounting Regulation, Volume 7, pages 183-186.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

It is worthy to note that:

- There are 54 different versions of state accounting laws administered by 54 independent state boards of accountancy.
- The attestation to GAAP financial statements is the only service that is "protected" by statute, but CPAs perform many other services.
- There are a decreasing number of CPAs and CPA firms that perform this licensed audit function and the profession, as a whole, is devoting a smaller number of hours to it. In fact, the number of CPA firms that do no auditing is growing.
- This protected attest function is often the most competitive, high risk, low profit service we provide. The other services we perform, those that are "unprotected" and that are peformed by others in the marketplace, generally seem to be more profitable growth areas for our practices.
- Our skills and abilities to analyze, control, report and just make sense out of our increasingly complex world are going to continue to be in ever greater demand. These services do not usually involve a third party reliance, and users do not need the protection of the "franchise" found in our accountancy laws.
- We are presently positioned to be the premier information professionals. In fact, although the letters don't match, the designation CPA should probably stand for "Certified Information Professional."

We all know nothing is forever. Just look at Xerox. If they would have based their future on their one original product, no matter how good that product, they certainly would not be the company they are today. Our profession's basic product, in fact the basis of our license—the GAAP financial statement—is steadily becoming less meaningful, relevant and beneficial. More business decisions are based upon data and reporting on other than GAAP financial statements. Moreover, there are many critical business and investment decisions calling for information that has never been part of GAAP financial reporting. Surely this growing disparity between content and need is what Tom Rimerman, Chairman of the AICPA Board of Directors, had in mind when he formed the Special Committee on Financial Reporting.

The message in all this is that if our primary product—the basis of our license—is becoming less meaningful. We should be vigilant that we are not so tied to it that we also become less meaningful. We all know the story about the railroad industry that assumed and planned its future as if it were in the railroad business. We can all ponder on the kind of world would we have today if, in the late 1800s or early 1900s, the railroads had thought of themselves in the broader context of being in the transportation business.

RECOMMENDATION

It seems to me that we must consider ourselves first and foremost as information professionals. This would lead to a restructuring of our profession. In my mind, an important element in this process would be to give up the licensed monopoly that has been granted us by the state governments. Please understand that this suggestion recognizes our dominance and reputation as *the* auditors and attesters in this society and *that* should never change. The CPA designation is so well regarded and respected in this field, we should be paramount in audit and attest services with or without the government granted monopoly. This recommendation may be controversial, but I believe we must "cut the cord" as a necessary step in positioning ourselves as *the* information professionals.

Lest my suggestion be thought to be revolutionary, we should remember that when I entered the profession, many states protected only the CPA title. These were called "permisive states" since the accountancy law did not restrict attest functions to licensees. Yet, we dominated the market because of the quality of our services. For the past 30 years or so, the AICPA has sponsored legislation that not only regulated the CPA title, but prohibited non-licensees from performing attest services. States with this type of accountancy law were called "regulatory states." The price practitioners paid for this state monopoly has been a tendency for state boards to regulate not only the activities they license a CPA to perform, but all other aspects of his or her practice as well. Thus, CPAs find themselves performing services available in the marketplace under restriction appropriate only to the third party interest found in attest work. This puts the public accounting profssion in an unnecessary competitive bind. We should not

permit ourselves to be governed by outdated regulations which bear little relation to the protection of the public.

I, therefore, recommend that we consider the AICPA being the recognized body to examine and certify candidates as qualified for the CPA designation. This process could be recognized in the state accountancy law by the state board's recognition of the AICPA's grant of designation, and the state law would prohibit anyone not having state board recognition from using the CPA title. The state board would continue to regulate the CPA's work in services with a third party interest and attest engagement, and compilations where there has been third party reliance. But the board would have jurisdiction only over such services. Thus, a CPA offering services also offered by unregulated providers would be able to compete on a level playing field.

In return for giving up our exclusive licensed franchise, we should expect reasonable solutions to the the problems of unreasonable legal liability, including having the same legal protection against personal liability for the acts of others as our corporate clients have; adopting a reasonable standard of proportionate liability which would limit our exposure to any harm caused rather than the deep pocket philosophy of joint and several liability; and finally, requiring that non-client plaintiffs be required to prove some relationship with the CPA akin to contract before there will be liability to the CPA.

I believe that we CPAs have an obligation to pass on a profession to our successors that is as highly regarded and positioned for the future as was the one we inherited. That may be difficult for us to do if we continue to tie the basis of our license to one product as that product continues to become less relevant.

ACCOUNTANCY AND CAPITAL MARKET REGULATIONS IN TURKEY

Yüksel Koc Yalkin

INTRODUCTION

The accounting profession in Turkey has sought for more than half a century to become legally recognized. Activities by members of the profession seeking legislation pertaining to accounting began in 1932. Several drafts of legislation were submitted to the Grand National Assembly. Finally, on June 1, 1989, Act 3568, the Law of Independent Accountancy, Independent Financial Consultancy and Certified Financial Consultancy, or the Law for Certified Consultancy (LCC), was passed.[1] Although LCC had significant deficiencies, the members of the profession welcomed its enactment because it gave legal recognition to the profession.

Before the passage of Act 3568, several studies were undertaken to improve and develop Turkish accounting systems under the

Research in Accounting Regulation, Volume 7, pages 187-197.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

control and guidance of ministerial and other governmental bodies. The systems developed by these studies had provided guidance concerning accounting systems in Turkey.

A review of the historical background of these studies and accounting applications in Turkey is necessary before the legislation affecting Turkish capital markets and the accounting profession can be discussed.

A SYSTEM OF UNIFORM ACCOUNTING

The first study of accounting systems was performed between 1964 and 1968 by the Reorganization Committee of State Economic Enterprises within the Ministry of Finance. Turkish and foreign experts participated in the Committee studies, which considered both accounting theory and accounting applications in Turkey and other countries.[2] Accounting systems in these other countries were also studied and to a great extent adapted for the development of Turkey's accounting system. The Committee established a system of uniform accounting for State Economic Enterprise known as the Uniform Accounting System in Turkey. It consists of the following elements:[3]

1. Accounting concepts and generally accepted accounting principles.
2. Financial statements (balance sheet and income statement); their forms and contents.
3. A uniform chart of accounts.

The Uniform Accounting System was implemented in the twenty-seven Turkish State Economic Enterprises on January 1, 1972. Subsequently, Law 233 required that all State Economic Enterprises utilize this Uniform Accounting System in 1982. All State Economic Enterprises are audited by the High Auditing Board of the Prime Ministry to ensure the proper application of the Uniform Accounting System. This Board is also responsible for the proper development of the system.

BANKS AND INDEPENDENT AUDITS

The Regulation of Independent Auditing Firms issued by the Prime Ministry in 1987 was the first legal step relating to independent

auditing. This regulation required that the financial statements of all banks be audited by independent auditors. The main reasons for this action were than many firms were unable to pay back their bank loans, problems with doubtful credit receivables in banks were increasing, and the number of firms declaring bankruptcy or requiring recovery assistance by the government also was rising.

The Turkish Central Bank and the Undersecretariat of Treasury and External Trade were given the responsibility for enforcing this regulation. The first Turkish auditing firms were organized under this regulation. Since the regulation required the auditing firms to be organized in the form of joint stock companies, foreign auditing firms in Turkey, including the Big Six, were reorganized according to the requirement of this regulation.

THE CAPITAL MARKET BOARD AND INDEPENDENT AUDITING

Turkey adopted free market economic policies in 1980. This action accelerated the enactment of the Capital Market Law (CML) in 1981.[5] According to this legislation, the Capital Market Board (CMB) was organized and began to function in 1982. The CMB has issued several regulations to ensure the proper functioning of a capital market and to protect small investors. Some CMB regulations affect both accounting and auditing. The first regulation required the publication of corporate annual financial statements (balance sheets and income statements) and specified the form, content, and preparation of these statements. It soon became apparent, after the Istanbul Stock Exchange began functioning according to the conditions set by the CMB, that unaudited financial statements have limited value in providing disclosures needed to protect investors. Recognizing this, the CMB issued, in 1987, a regulation that required audits of all joint stock companies.[6] The CMB also requires that audit firms use the joint stock form of company organization. Audit firms are required to perform their audits of corporations according to the Second Audit Regulation issued by the CMB, which prescribes in detail auditing standards, procedure, plans, field studies, and reports.[7] The control of this regulation, which was prepared by representatives of audit firms and CMB, is compatible with U.S. audit standards as well as international audit standards.

In addition, in 1989, the CMB updated the Regulation of Accounting Principles and Standards, which was prepared by representatives of universities, public organizations, and audit firms.[8] The preparers of this regulation considered international accounting standards, U.S. accounting standards, and the Fourth Directive of the European Community. This regulation includes accounting concepts, accounting principles, application standards for financial statements concerning valuation and presentation rules for each statement item, and a standard chart of accounts and application rules relating to the chart.[9]

The CMB requires that all joint stock companies under its regulation prepare and publish their financial statements in compliance with the Regulation of Accounting Principles and Standards. The CMB also requires each auditing firm to perform its audits to ensure compliance with accounting regulations. If the audited financial statements fail to comply with regulations, the audit report is required to include this fact. Then the CMB, which requires the preparation of the financial statements, can publicize this fact and its effects on the financial statements. To date, the CMB has employed this disclosure rule for financial statements of only two corporations. The CMB has established a set of detailed accounting standards for corporations to ensure application of this provisions of the Capital Market Law. As of this time, CMB accounting regulations provide the most developed system of accounting standards in Turkey.

LAW OF CERTIFIED CONSULTANCY (LCC)

The LCC, which establishes a legally recognized accounting profession, became effective on June 13, 1989. This law classified the members of the profession into three categories:

1. Independent Accountants (IA).
2. Independent Accountants and Financial Consultants (IAFC).
3. Certified Financial Consultants (CFC).

Independent accountants keep accounting records for firms and individuals and prepare financial statements, tax returns, and other documents that are requested of public organizations.

To qualify as an IA one must be a high school graduate or have two years of college and complete an accounting internship period of four or six years. IAs represent the largest group of the profession and serve primarily in accounting task-oriented functions in private practice.

The functions of independent accountants and financial consultants (IAFC), in addition to performing accounting functions, include preparing financial statements, tax returns, and other official documents. They also perform advisory and auditing services.

The requirements for the IAFC designation include four years of undergraduate study in law, economics, public finance, business management, banking, public administration, and political science or graduate education in these fields for those who had the undergraduate studies in other fields. To become an IAFC, one must also complete a two-year internship program and pass the professional examination. Certified financial consultants (CFC) perform advisory and auditing services in addition to approving financial statements, tax returns, and other documents as required by the Ministry of Finance and other governmental bodies. The requirements to become a CFC include at least ten years of professional experience as an IAFC and passing the CFC examination.

IAFCs and CFCs may perform independent audits, and CFCs may also perform the attest function and provide consultation functions. The LCC and the related regulation place responsibility and liability for approved statements and documents jointly on the CFC and the corporation audited. Since Turkish accounting firms have no insurance arrangement, the attest function involves a personal risk to individual CFCs. IAFCs and CFCs who perform independent audits are considered the CPAs of Turkey.

IAFCs and CFCs as the leading members of the profession may practice their profession independently in private offices or in firms established by shareholders (partners) who carry the same title. A CFC who works in a firm and who signs an attestation report shares joint responsibility with the client for the attestation. In other words, the auditing firm, as an entity, is not responsible for the personal attestation function performed by its partners.

The LCC requires separate chambers (or societies) for IAFCs and CFCs in each province if certain conditions exist. Each organization should have at least twenty-five members. The representatives of

these organizations elect the governing bodies of the Turkish Union for Independent Accountants, Financial Consultants, and Certified Financial Consultants. The Turkish Union is the senior organization of the accounting profession.

The LCC included eight transitional articles to be in effect during this period, in order to regulate the establishment of the profession. According to the provisions of these articles, the Temporary Board that first regulated the organization of the profession operated within the Ministry of Finance and functioned from June 1989 until September 1990.

The Temporary Board studied the existing qualifications of the members of the accounting profession and determined which members would be granted the certificates of IA, IAFC, and CFC without undergoing the required training or taking the professional exam.

In addition, the Temporary Board issued the regulations specified by the LCC and formed both the IAFC and CFC organizations. Finally, when the Turkish Union was organized in September 1990, the Temporary Board had completed its duties, and its functions were transferred to the Turkish Union. However, a majority of the actions of the Union must still be approved by the Ministry of Finance.

The studies on accounting standards and a chart of accounts which were started by the Temporary Board were not completed during its tenure. The Ministry of Finance decided to complete these studies and established an accounting commission consisting of representatives of the Turkish Union, universities, the Capital Market Board, related ministries and governmental bodies, auditing firms, and large public and private corporations. The commission was divided into two committees, one responsible for accounting standards and the other for a chart of accounts.[10] These committees worked between October 1990 and August 1991 and completed their studies covering the following topics: accounting concepts, generally accepted accounting principles, accounting standards, financial statements (form and content), and a chart of accounts and its explanations. The Ministry of Finance is proposing a law to the Grand National Assembly that would make accounting systems developed by these committees compulsory for all firms throughout the country.

A recent amendment to the Capital Market Law (CML) which was submitted to the Grand National Assembly contains an article amending the agreement between the representatives of the Turkish

Union and the Capital Market Board (CMB). According to the proposal, an Accounting and Auditing Standards Board consisting of nineteen members representing universities and other institutions should be established.

ACCOUNTING ISSUES

Accounting issues affecting the profession in Turkey can be divided into two areas at this stage of the profession's development: those related to the accounting profession and those related to accounting applications.

Issues Related to the Accounting Profession

Recognition of Foreign CPAs

An issue of importance to the accounting profession pertains to the situation of foreign certified public accountants (CPAs). Foreign CPAs can operate as IAFC only if they meet the requirements for this category of the profession and their home countries reciprocate and allow Turkish IAFCs and CFCs to perform these professional services in their home countries. The Prime Minister, upon the recommendation of the Ministry of Finance, has the authority to grant practice permission to foreign CPAs.

Most foreign audit firms in Turkey have been organized in two different ways according to the provisions of the LCC. The independent accountancy and financial consultancy (IAFC) firms were organized by partners of foreign firms who are IAFCs. The certified financial consultancy firms (CFC) were established by partners qualified as CFCs.

Exceptions Concerning Some Members of the Profession

The Law of the Profession (No:3568) granted the title of IAFC and CFC to some individuals in the transition period who were not required to meet the training and professional examination criteria if these individuals met certain requirements. In addition, the law grants a permanent exception by permitting "grandfathering" of certain members of the law, economics, public finance, business management, accounting, banking, public administration, and

political sciences faculties and to tax auditors and public bank inspectors who meet certain requirements.

Tax auditors and public bank inspectors who have eight years of service and associate professors, per se, may request using the title of IACF without having additional training or taking the professional examination. In addition, tax auditors who have ten years of service and full professors, per se, in the mentioned fields may request the title of CFC without having additional training or passing the professional examination.

These waiver provisions have raised concerns among some members of the profession and could be problematic in the future.

Authority for Accounting and Auditing Standards

In Turkey the ultimate responsibility for setting and determining the application of auditing and accounting standards is still in question. Because it regulated corporations that register their securities on the stock exchange, the Capital Market Law (CML) seems to be the authority for corporations and auditing firms that have to audit their financial statements.[11] The CMB, however, had this type of authority before the accounting profession was legally recognized. Some believe that it still governs accounting and auditing standards. The limit of authority between the public sector (government) and the private sector (profession) is the focus of this concern.

Additionally, the Ministry of Finance believes that it also has this type of authority. Because tax laws in Turkey require the valuation of financial statement items for tax purposes, members of the Ministry of Finance believe that the establishment and enforcement of accounting and auditing standards are their responsibility. In addition, the Ministry of Finance basically had the responsibility for writing the legislation affecting the accounting profession and also had governmental authority over the profession during the transition period. Furthermore, the law of the profession (Law for Certified Consultancy) specifies the following:

1. The training and professional examination qualifications are waived for the tax auditing staff of the Ministry of Finance, who may use the IAFC and CFC titles.
2. The chambers (societies) obtain their legal authority from the Ministry of Finance.

3. The Ministry of Finance may request that the Ministry of Justice reorganize the governing bodies of the chambers (societies) if they do not follow the provisions of the law.
4. Ministry of Finance has the final authority on the matters affecting the chambers. The decisions of the Ministry are put in effect by the chambers without changes. For example, the Ministry of Finance sets final professional fee schedules and approves the final version of some standards.

Issues Concerning Accounting Applications

The Turkish Union has not yet established a mechanism for standard setting or research related to practice. Therefore, accounting problems arising from the application of tax legislation provisions and accounting regulation by the Capital Market Board, especially on the valuation of various financial statement items, cannot be resolved easily. The following two issues provide examples of problems unresolved at this time.

An important accounting issue affecting companies involves the recognition of the costs related to employee termination or retirement payments. Turkey's existing social legislation requires companies to make lump-sum payments to employees whose employment is terminated by retirement or other reasons, except misconduct. The companies' liability for these payments increases from year to year since these payments are based on the duration of employment and the latest salary (with some limits). Tax legislation does not consider provisions for this liability as a tax-deductible expense and therefore most companies recognize the costs for this obligation on a "pay-as-you-go" cash basis. According to CMB's accounting regulation, however, companies were required to provide for this liability as of January 1, 1988. In addition, the provisions for prior service must be recognized over a term of five to ten years. All pension provisions are generally recognized as nonoperating expenses.

The second issue relates to the capitalization of fixed assets. Tax legislations requires companies to include the interest and foreign exchange loss or profit of the cost of fixed assets on the date these assets were placed in use. After that date tax legislation allows two options for accounting of these expenses: charging them (1) to the cost of the related fixed assets or (2) to current period expenses.

The CMB agreed with the rule of capitalizing interest and foreign exchange loss or profit before the fixed assets were put in use. However, the CMB, for the sake of comparability of financial statements, requires companies to record such expenses as current expenses after the date the asset is put in use.

CONCLUSION

The accounting profession in Turkey has been legally recognized and organized only in recent years. Independent audits can be performed by IAFCs and CFCs. In addition, CFCs perform tax audits subject to liability and share the joint responsibility with the companies audited.

The Turkish Union, the national professional organization, has not yet undertaken to set standards for practice. However, its newly established committees intend to conduct research on accounting and auditing issues.

The question as to who among the government agencies, tax authorities, or professional groups, has the authority to establish and enforce accounting and auditing standards, has yet to be resolved.

NOTES

1. Law of Independent Accountancy, Independent Financial Consultancy and Certified Financial Consultancy (June 1, 1989, Act 3568). [Sebest Muhasebecilik, Serbest Muhasebeci Mali Musavirlik ve Yeminli Mali Musavirlik Kanunu (1.6.1989 ve 3568 sayili)]
2. The author of this paper worked as one of the consultants to this committee.
3. The AICPA publication utilized by the experts and consultants to the committee was *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* by Paul Grady (New York: AICPA, 1965).
4. Regulation of Independent Auditing Firms (January 16, 1978 and No. 19343) [Bagimsiz Denetim Kuruluslarina Iliskin Teblig (16 Ocak 1987 tarih ve 19343 sayili Resmi Gazete].
5. Law of Capital Market (July 28, 1981 and Act 2499) [Sermaye piyasasi kanunu (28.7.1981 ve 2499 sayili)].
6. Regulation of Independent Auditing for Capital Market (December 13, 1987 and 19663) [Sermaye Piyasainada Dis Denetleme Hakkinda Teblig (13 Araalik 1987 Tarih ve 19663 sayili resmi gazete)].
7. General Rules of Independent Auditing Firms and Auditors (June 18, 1988 and No. 19846) [Bagimsiz Denetleme Kuruluslari ve Denetcilerine iliskin Genel Esaslar (18 Haziran 1989 Tarih ve 19846 sayili resmi gazete)].

8. This commission performed its function through two committees: Accounting standards and standard code of accounts. The author of this article was the chairperson of the accounting standards committee.

9. Regulation of Financial Statements and Reports for the Capital Market (January 29, 1989 and No. 20064) [Sermaye piyasasinda Mali Tablo ve Raoirkara Ukusjub Teblig (29 Oack 1989 tarih ve 20064 sayili resmi gazete)].

10. The chairperson of the accounting standards committee was the author of this paper.

11. Capital Market Law, articles 11 and 16 [Sermaye Piyasasi Kanunu, madde 11 ve 16.].

STATEMENT ON SENATE BILL 165 ON THE 150-SEMESTER-HOUR REQUIREMENT FOR PRACTICE AS A CERTIFIED PUBLIC ACCOUNTANT BEFORE THE SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE OF THE SENATE OF OHIO NOVEMBER 13, 1991

Robert K. Elliott

Good morning, Mr. Chairman and Committee members. My name is Robert K. Elliott. I am a partner in KPMG Peat Marwick and Assistant to the Chairman. I am also a member of the Board of

Research in Accounting Regulation, Volume 7, pages 199-208.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

Directors of the American Institute of Certified Public Accountants (AICPA)—the more-than 300,000 member professional association for CPAs in public practice—and a member of the Accounting Education Change Commission—an independent national commission sponsoring reform of the education of professional accountants in America. However, I am speaking today on behalf of only KPMG Peat Marwick, not these other organizations.

KPMG Peat Marwick is the United States practice of KPMG, a worldwide public accounting and consulting frim with more than 77,000 personnel, of whom about 450 are located in the state of Ohio. Each year, KPMG hires about 6,000 recent college and university graduates, of whom about 70 practice in the state of Ohio.

SUMMARY OF KPMG PEAT MARWICK'S POSITION ON THE 150-SEMESTER-HOUR REQUIREMENT

KPMG Peat Marwick's position on the 150-semester-hour educational requirement to become a Certified Public Accountant is briefly summarized as follows:

- We strongly support a 150-semester-hour requirement to practice as a Certified Public Accountant in the State of Ohio (as well as all other states).
- We will employ graduates of 150-semester-hour programs when and as they are available on a state-by-state basis.

BACKGROUND

Position of Largest International Accounting Firms

KPMG Peat Marwick and the other large international public accounting firms jointly issued a position paper on the education of accountants in 1989. In this paper, the firms expressed concern about the quality of accounting graduates available to the public accounting profession and the effectiveness of accounting education. The firms stated:

> Today's business world is more dynamic and complex than ever before. Advancing technology, proliferating regulations, globalization of commerce

and complex transactions make the environment in which public accountants practice extremely challenging. Successful practitioners must develop and apply a wide range of professional capabilities to serve the business community.

The firms specified the capabilities required of accounting graduates who will be practicing in this more complex environment of the 1990s and beyond. Specifically, they called for:

Skills for public accounting:

- Communication skills
- Intellectual skills
- Interpersonal skills

Knowledge for public accounting:

- General knowledge[1]
- Organizational and business knowledge
- Accounting and auditing knowledge

Although the paper did not specifically address the 150-semester-hour question, the education it describes clearly cannot be shoe-horned into the traditional four-year curriculum.

In addition, the firms (often referred to as the "Big-6") have issued a letter of support[2] for the "AICPA/NASBA Guide for the Implementation of the 150-Hour Education Requirement"[3] dated April 1991. The Big-6 letter recommends that each state use "curriculum neutral legislative [language]" and delegate to the state boards of accountancy the rulemaking power to specify an appropriate educational threshold for entry into the profession within the overall 150-semester-hour requirement.

Public Accounting Profession's Position

The public accounting profession at large supports the 150-semester-hour requirement, as documented by an AICPA member vote in 1988, in which 82 percent of its members balloted to require a 150-semester-hour education as a condition of membership in the AICPA by the year 2000.

KPMG Peat Marwick's Position

KPMG Peat Marwick is fully in accord with the Big-6 and AICPA positions described above and strongly supports the 150-semester-hour educational requirement for public accounting, as well as the AICPA/NASBA implementation guidelines.

THE CURRENT MARKET FOR ACCOUNTING GRADUATES

Some have asked why, if KPMG Peat Marwick and the other Big-6 firms support the 150-semester-hour requirement, they do not simply hire more graduates with masters degrees (masters of business administration—MBAs—or masters of accounting), which arguably would provide the educational breadth described above.

The answer is different for each of the two degree types.

Masters of Business Administration

There are three principal reasons we do not meet our hiring needs by employing solely or largely MBAs:

- There are simply not enough MBAs to supply even a fraction of our professional personnel needs.
- MBAs—at least at the best universities—are prepared to become general managers, not accountants. This education creates demand for the graduates to go into general management positions, and this demand bids up the price of MBA graduates relative to undergraduate accounting majors. In some cases, the starting salary differential between MBAs and bachelor's degree holders is two to one. However, the extra value to us as public accountants is not twice as great. Thus we cannot afford to pay this large differential to more than a relatively modest fraction of our new hires. If and when the differential narrows, we would hire more MBAs (as we did historically when the differential was smaller)—but, as noted above, we could never fulfill our large personnel needs solely from this source.

- A bachelor's degree plus an MBA generally requires about 180 semester hours, which is more than the 150-semester-hour requirement that KPMG Peat Marwick and the public accounting profession supports.

Masters in Accounting

Many masters in accounting programs are given at colleges and universities that also grant four-year degrees in accounting. In many cases, the four-year graduates—seeing a relatively small salary differential for the master's degree—seek employment upon receipt of their bachelor's degrees. All too typically, the best graduates are snapped up by employers at that point. Those obtaining no employment offers are most prone to continue to the fifth year (and the master's degree) in order to enhance their employability. Unfortunately, these less attractive graduates merit relatively little salary differential, leading to a vicious circle effect: a small salary differential for five-year graduates leads the best students to get jobs after four years, which depresses the salary differential for five-year degrees, which discourages students from taking a fifth year.

A legislated 150-semester-hour requirement will (1) remove the incentive for the best four-year students to skip the additional year of education and (2) will be more sharply targeted for a career in public accounting than the MBA degree.

More importantly, a 150-semester-hour requirement will prepare a new generation of Certified Public Accountants that can more effectively serve our society's increasingly demanding public accounting needs—including, most especially, the all-important audit function.

RECOMMENDATIONS TO THE STATE OF OHIO

KPMG Peat Marwick recommends that the legislature of the State of Ohio

- enact the 150-semester-hour educational requirement as a prerequisite for licensure as a Certified Public Accountant, but

- leave the specification of details about the form and content of the curriculum to the Accountancy Board of Ohio, as recommended in the AICPA/NASBA implementation guidelines.

APPENDIX A

Big-6 Letter to Accountancy Board of Ohio Endorsing "AICPA/NASBA Guide for the Implementation of the 150-HOUR Education Requirement"

Mr. Robert H. Carroll, Chairman
Accountancy Board of Ohio
Grant Thornton
1600 Atrium One
201 E. Fourth Street
Cincinnati, Ohio 45202

Dear Mr. Carroll:

As major employers of accounting graduates, we are frequently asked our opinion of the 150-hour education requirement. Recognizing the significance of this development and the large number of states that will consider legislation in the next two years, it is timely to jointly reaffirm our views expressed earlier in our paper, "Perspectives on Education: Capabilities for Success in the Accounting Profession."

Our perspective on the 150-hour education requirement is shaped by three factors. First, the need to attract outstanding college graduates who have both the technical knowledge and educational breadth to be successful in the profession. Second, the need to maintain the present momentum of educational innovation. And, third, the importance of uniformity in entrance and licensing requirements among the states, thereby facilitating the mobility of new entrants and licensed CPAs.

We believe the practicing profession's objectives can best be met by adopting the recommended legislative language and the implementing rules and regulations included in the "AICPA/NASBA Guide for the Implementation of the 150-Hour Education Requirement," dated April 1981. We support this joint position of NASBA and the AICPA and encourage adoption of their

recommendations in each state that implements the 150-hour education requirement.

The suggested AICPA/NASBA curriculum-neutral legislative approach provides the flexibility needed to meet the changing needs of the profession, and the recommended Board rules specify an appropriate education threshold for entry into the profession. Adoption of these recommendations would:

- Reaffirm the importance of education breadth; and
- Permit continued curriculum innovation and reform such as is currently taking place under the leadership of the Accounting Education Change Commission.

The profession has the opportunity to achieve greater uniformity in education and licensing requirements through a consistent implementation of the 150-hour education requirement We believe it is especially important that the profession have a consistent standard for licensure.

In summary, we support the efforts of NASBA and the AICPA to define specific educational requirements for entry into the profession. We are hopeful that, by sharing our views, we can help facilitate consensus and a uniform implementation of the 150-hour education requirement

Sincerely,

Lawrence A. Weinbach
Arthur Andersen & Co., S.C.

Peter R. Scanlon
Coopers & Lybrand

J. Michael Cook
Deloitte & Touche

William L. Gladstone
Ernst & Young

Jon C. Madonna
KPMG Peat Marwick

Shaun F. O'Malley
Price Waterhouse

APPENDIX B

Excerpts from Oral Testimony

Mr. Elliott: An earlier witness testified that additional education for accountants will drive up starting salaries, leading to increased costs to consumers of CPA services. This reasoning assumes that CPAs merely add up their costs, tack on a profit, and send the bills. Anyone who thinks that way is living in a dream world. The market for CPA services is very competitive, and we cannot charge our clients any more than our services are worth—regardless of our costs. Why then do we support additional education, knowing that it will increase our costs? The answer is that better educated personnel are more effective and more efficient. They are able to deliver equal services in less time or better services in the same time.

* * *

Mr. Elliott: We believe that the additional hours made available by extending the education of accountants should be devoted to educational breadth, not additional technical content. Constant changes in business conditions as well as legal and professional requirements mean that technical knowledge rapidly becomes obsolete. There's no point spending more time teaching it to students. Rather, higher education needs to turn out "learning machines"—persons who can and will continuously refresh their knowledge and skills throughout their professional careers. The educational breadth that we favor is far more likely to enhance students' "learning to learn" skills than is more technical content. More technical content might increase the percentage of students passing the CPA exam, but that exam is merely a measure of fitness for entry to the profession, and in the longer run, accountants with continuous learning skills are far more likely to provide better CPA service to the public.

* * *

Senator Horn: An earlier witness pointed out that adding a year to the course of studies of all accounting students will increase the State of Ohio's subsidies to them by many millions of dollars a year. How can you justify this burden on Ohio taxpayers?

Mr. Elliott: Let me answer that in two parts, Senator Horn. First, subsidizing education is the best investment that taxpayers can make. It is well established that better educated workers are more productive, more successful, and more highly compensated. This not only improves American competitiveness, but it results in higher future tax revenues that repay the subsidies many times over. Second, although you can divide total State expenditures on higher education by the number of students and calculate an average subsidy per student, it is not appropriate to apply that average to all students—because not all students require the same levels of support. For example, accounting students don't require laboratories, studios, theaters, gymnasiums, or stadiums. In most institutions, the tuition paid by accounting students fully covers their costs, and there is, in fact, no subsidy.

* * *

Senator Ney: Mr. Elliott, you have testified that KPMG pays higher salaries to 150-hour graduates than 120-hour graduates. But when all accounting graduates have 150 hours, you'll have no further reason to pay them a differential. Won't you then just pay them the same as you pay 120-hour graduates today? In other words, won't the graduates lose the salary advantage?

Mr. Elliott: Senator Ney, we compete in a market for talent. If we require more education and don't pay the students for their investment, they'll go into other professions and lines of business. We must pay full value to attract our share of the best students.

Senator Ney: But I doubt they'll become, say, doctors rather than CPAs.

Mr. Elliot: It's true that some children want to become doctors from an early age, and some want to become CPAs, and they're going to do it, no matter what. But many college students are still trying to decide on careers. As they decide, they'll consider the costs and benefits. At the margin, differential pay will make a difference, and prices are set at the margin.

Senator Horn: Won't additional accounting education drive up the cost of services to small businesses who just need tax or accounting service, not an audit?

* * *

Mr. Elliott: The 150-hour requirement would apply only to those sitting for the CPA exam. There are plenty of non-CPA accountants who can provide tax and accounting service. You don't need to be a CPA to practice in those areas, and those who insist on CPAs presumably think they are getting something for any premium in price.

Senator Horn: If additional education is necessary only for the audit function, why require it of all CPAs? What would you think of a two-tier CPA designation—one tier for audits, the other for tax and accounting services?

Mr. Elliott: There is no need for a two-tier system. The sole legislative justification for the CPA license is to protect members of the public who rely on the audit report. A person providing tax and accounting services does not need the CPA license.

Senator Horn: But wouldn't I as a businessman want the assurance that the person I hire for tax service is highly qualified, and doesn't the CPA designation show that?

Mr. Elliott: Yes, it does, but such "credentialing" is not the purpose of the CPA license.

NOTES

1. General knowledge is described in the paper as follows:

> For the good of the profession and society as a whole, education for accounting must include a sufficiently large, broad and deep general education component to yield a level of knowledge that is characteristic of a broadly educated person. This general knowledge covers a number of factors: an understanding of the flow of events in history and different cultures in today's world; the ability to interact with diverse groups of people and at the highest levels of intellectual exchange; a sense of the breadth of ideas, issues and contrasting economic, political and social forces in the world; [and] experience in making value judgments.

2. A copy of the letter as issued to the Accountancy Board of Ohio, is included as Appendix A.
3. NASBA is the National Association of State Boards of Accountancy.

BOOK REVIEWS

Unaccountable Congress: It Doesn't Add Up

by Jospeh J. DioGuardi
(Regnery Gateway, Washington, D.C.; 1992; 128 pages; $17.95)

Reviewed by **Alfred R. Michenzi**

This book gives a first-hand account of the author's two terms in office as a member of the House of Representative of the United States of America. He spent twenty-two years as an accountant and partner at the public accounting firm of Arthur Anderson & Co., and was the first CPA ever elected to Congress. During his campaigns and based on his background as a CPA, he promised to "illuminate the dark fiscal corners of Washington with the light of sound accounting and financial management." Much of the text discusses how Congress and the Executive branches of government disguise and hide fiscal reality from the electorate.

Although the book is rather short, it contains a great deal of information about the budgetary and financial activities of Congress. The key premise of the book is that both Congress and the Executive branches must use clear and acceptable, accrual accounting methods. The author, from the time he arrived in Congress until his retirement, steadfastly called for the replacement of the cash basis accounting methods by accrual accounting. Example after example shows how Congress and the Executive branches use cash-basis accounting to hide from the electorate such things as the future costs of legislation (the related debt and promises of future payments) and the long-term value of capital assets purchased.

Research in Accounting Regulation, Volume 7, pages 211-222.
Copyright © 1993 by JAI Press Inc.
All rights of reproduction in any form reserved.
ISBN: 1-55938-692-4

The author also points out that Congress, as a deliberative body, has exempted itself from many legislative actions which the private sector must comply with on a ongoing basis. These include such items as:

- The Social Security Act of 1935
- The National Labor Relations Act of 1935
- The Civil Rights Act of 1964
- The Freedom of Information Act of 1966
- The Ethics and Government Act of 1978
- The Civil Rights Restoration act of 1988

Congress requires the citizenry to comply with these laws. Compliance has both economic and social consequences but Congress experiences none of these consequences.

This book should be required reading of all individuals interested in government. All students enrolled in a governmental accounting course or a political science course dealing with government budgets and funding should read this text. It offers a view of the fiscal responsibility (and irresponsibility) of government that will make all think critically of how our elected leaders respond to the country's needs. The author has put the citizens of America on notice that they must call for responsible and sound accounting when elected officials deal with the finances of the country.

Business Behavior and Information

Edited by Yuji Ijiri and Isao Nakano
(Carnegie Mellon University Press; 1992; 200 pages)

Reviewed by **Nandini Chandar**

The Kobe University, Kobe, Japan, in cooperation with the Carnegie Mellon University organized an international conference on "Business Behavior and Information" in November 1991. This book is a collection of the seven papers that were presented at the Kobe Forum by faculty members from the two universities.

These papers provide the reader with some interesting macro and micro perspectives on the relationship between information and behavior. The interdisciplinary nature of the paper adds interest. The

editors state that the papers have been published as revised versions, after incorporating the comments and suggestions of conference participants.

An interesting feature is that the presenters and commentators came from diverse backgrounds including accounting, economics, management policy, and information systems. This accounts for the different perspectives and approaches adopted in dealing with the subject. The editors provide useful introductory remarks in order to integrate these perspectives and to provide a common framework for their analysis.

First, they classify the papers according to whether each dealt with intrapersonal or interpersonal behavior in relation to information. The paper titled "Conservatism in Integrating Information: Implications for International Management" by T.W. McGuire and N.P. Malone considers intrapersonal behavior from the viewpoint of the cognitive sciences, specifically with respect to information under uncertainty. They utilize research in the psychology of decision making and analyze the biases involved in human judgment under uncertainty.

The others take an interpersonal interorganizational approach in analyzing a "subject-object-subject relationship, in which two subjects are linked by the object called information." These six papers are further classified along two dimensions: (1) whether the two subjects are assumed to be cooperative or noncooperative, and (2) whether the subjects are involved in equal or unequal relationships (e.g., as leader-follower). Using this two-dimensional classification, the editors state that "the function of information may be perceived as one of reducing the competitive aspects and promoting the cooperative aspects of the relationship."

H. Itami assumes a cooperative environment and then looks at the function of information in this environment. He suggests that information stimulates the creation of an "interactive field" which increases the accuracy and efficiency of decision making. The remaining authors assume the existence of conflicts in the environment.

Ijiri's paper focuses on the subjectivity and the internationalization of information, particularly the role of the accountability function of information in promoting cooperation in the management and the firm. Two authors look at noncooperative and unequal organizational settings and analyze the role of information in increasing

cooperation. H. Yamaji looks at "The Modern Function of Accounting Disclosure" as reducing distrust and conflicts in organizations. This paper also highlights the historical part played by the disclosure of accounting information in dissolving conflicts inherent in noncooperative relationships. H. Yoshihara argues that conflicts arise due to a lack of local managers' participation in the management of overseas subsidiaries of Japanese firms. In order to reduce conflict, proposals include using English in overseas subsidiaries and promoting locals to top management positions so that they get access to more important information in decision making.

The papers by Sunder and Shimomura adopt a more macroeconomic approach in looking at the effect of information on market price and economic equilibrium. Sunder looks at the issue of insider trading and argues that although insider trading increases the Pareto optimality of market prices, market imperfections make it "difficult to discriminate between normal flow of information to the market and flow of information that violates the property rights of some individuals, especially the rights of the small investors." Sunder also discusses public policy toward insider trading together with its regulation. He evaluates various criteria for assessing insider trading policies.

Shimomura, a professor of International Labor Relations, performs an economic analysis of falsified information in a setting of conflict between capital and labor groups. His basic message is that "resource allocation involving falsified information is not only Pareto-suboptimal but also paradoxical in the sense that the well known proposition concerning gains from trade no longer holds with regard to such a resource allocation."

The collection provides useful information for academics interested in this area of research but who were unable to be present at the conference. However, the topic addressed at the forum is too broad to be adequately covered by the presentation of only seven papers. Also, to the extent that the viewpoints expressed were those of academics from just the two universities, diversity of opinions and views is not represented.

On the whole the papers make interesting reading and are sure to be useful to various disciplines in providing some insights into a very important subject. To accountants in particular, the subject is especially relevant in assessing their role as providers of information.

Changing Fortunes

by Paul Volcker and Toyoo Gyohten
(New York: Times Books, 1992; $25.00 U.S.; $31.50 Canadian)

Reviewed by **Barbara Uliss**

Changing Fortunes is a descriptive chronology of events related to the world economy from the 1944 agreements at Bretton Woods to early 1992. The selected events are recalled and described by two distinguished and successful economic statesmen, Paul Volcker, who retired as chairman of the Federal Reserve Board in 1987, and Toyoo Gyohten, whose career spanned years of service in the Japanese finance ministry. They were members of the often closed circles of powerful financial figures who influence both fiscal and monetary policy in their own countries and, together, set financial policy which governs the interaction of nations in the industrialized world. The book was compiled from notes from a series of lectures on which the authors collaborated in a seminar at the Woodrow Wilson School at Princeton University, where both men are alumni.

The text presents the reader with separate commentary from each of the two men. Volcker's thoughts are followed by a separate section written by Gyohten in the introduction and each successive chapter. The book is supplemented with remarks on the debt crisis of the 1980s by William R. Rhodes of Citibank, Angel Gurria of the Mexican Finance Ministry, and Manuel Guitian of the International Monetary Fund. It also includes a glossary, bibliography, chronology of events, and supplementary financial statistics supplied by Princeton research scholars.

In the introduction, both men establish a theme which is pervasive not only in this book, but in contemporary discussion, focusing on the position of the United States with regard to other nations in the world. They address the decline of the United States in stature from its position as world leader and guardian at the end of World War II from two perspectives. First, they acknowledge the gradual reduction of the U.S. economic hegemony evidenced by the continuing decline in the value of the U.S. dollar relative to world currencies, along with low rates of growth in both savings and productivity, and rapidly increasing trade deficits. This decline made it increasingly difficult for the Bretton Woods agreements, in which world currencies were pegged to the U.S. dollar, to be sustained

beyond 1973, and documents a reduction in the country's relative economic strength. Second, and in defense of the United States, is Volcker's observation that this decline is to a great extent relative, reflecting improving conditions for competitor countries rather than simply deterioration in the U.S. position. Indeed, a portion of the change is a measure of success for U.S. policy. The United States emerged intact after World War II, in the midst of economic competitors who faced extensive rebuilding. Volcker points out that, "The postwar growth of our trading partners was in fact encouraged as a deliberate act of American policy. Moreover, we still have the highest standard of living and an unmatched capacity for leadership." He encourages the United States to avoid turning inward and instituting protectionist practices in reaction to perceived economic decline, but rather to continue to use its capacity for world leadership to influence the shape of a new world order. Both men point out the need for adjustment in relationships and political understandings among major economic powers which reflect their new economic positions and the changes in international responsibilities they imply.

Volcker and Gyohten agree on the importance of volatility in currency exchange rates and the resulting effects on the world economy, related difficulties in managing those effects, and planning how one's country should react to them. Their careers continually demanded that they deal on behalf of their country, often defensively, with economic and political problems stemming from changes in exchange rates. The problem of exchange rate volatility has been "solved" in different ways at different times in the history of the industrialized world, first with the gold standard, then with the post-World War II Bretton Woods agreements, then with attempts to use institutions such as the International Monetary Fund and World Bank, all in concert with international diplomacy. None of these cures have been sufficient or lasting. In their comments in the concluding chapter, both men express their hope, rather wistfully, for a way to provide stability for international currency exchange rates. Volcker suggests possible increases in regional stability. This could be accomplished with arrangements based on strong currencies and national leadership within regions by economic powers; the United States in the Americas, Germany in Europe, and Japan in East Asia. He also suggests the eventual creation of a powerful world central bank with its own currency as a theoretical alternative to the type of benign and dominant national power exercised by the United

States in the Bretton Woods era. Gyohten dreams of stabilizing exchange rates with an agreement among the three major currency countries (the United States, Japan, and Germany) to "remove all restrictions on the use of their currencies, pledge they will have no exchange controls and no capital controls—and then agree to make all three currencies common legal tender in each others' countries." This would leave the ranking and valuation of the three currencies to the market. Both men envision the stabilization of exchange rates as necessary for the stabilization of global growth in trade and investment. Volcker points out that volatile exchange rates increase risks and make business activities more difficult. Both also recognize the strength of economic forces against stabilization of exchange rates associated with the current treatment of currency as a commodity in world markets. In currency markets, traders profit from increased volatility. Volcker points out that because there is no sure and costless way for businesses to hedge against the risks of volatile exchange rates, the only sure winners are currency traders and those who invent and sell the new instruments for managing those risks.

One of the things which makes this book so interesting is that it is a report by insiders of the details of what is generally a private process, and includes descriptions of their thoughts and strategies at the time, as well as ex post evaluations of what might have been done differently and better. The editor's note states, "I have spent a lifetime as a journalist observing many of the events in this book, and it has been an illumination for me to hear them described from the inside by two of the men who made them." Many of the events described were conducted informally and confidentially, with high-level officials in the countries involved directing policy according to political as well as monetary and economic concerns. Although it is argued that this privacy allows candid discussion and in some cases prevents panics in currency markets, final negotiated agreements did not always have the broad support of people affected by, but outside of the process. Gyohten argues in favor of more open disclosure of proceedings such as G-7 meetings so that agreements will be reached based on negotiations open to the public. Global treaties and agreements would then be subject to the discipline of both national and also world opinion and politicians creating them would be held more broadly accountable for their content. He acknowledges this notion of agreements being judged by a "global jury" is idealistic, but would provide policy more acceptable from a global point of

view. In a related observation, Volcker notes that problems with lack of support from above for positions negotiated by economic operatives is less common in many other countries than in the United States because the heads of state of those countries have very often served in treasury ministries.

This book provides a look at often private proceedings and events which have defined the world economy. It makes accessible the thoughts and strategies of two men who have played important roles in these events, and who continue to be respected for their insight in the search for solutions to global problems. It provides readers with new insights to apply as they watch the activities of current world policymakers and evaluate the actions taken on their behalf.

Protecting Investors: A Half Century of Investment Company Regulation. SEC Staff Report 1504

(Extra Edition) May 29, 1992 (Federal Security Law Reports: CCH (ISSN: 162-1084) $25.00, Chicago) XXXVII, 525 pages.

Reviewed by **Gary John Previts**

This study by the SEC's Division of Investment Management recommends changes in the regulations regarding investment companies. The Investment Company Act was passed in 1940 and amended in 1970 and in some respects it has failed to keep pace with financial market changes, particularly with regard to unnecessary regulation relating to new "products." The study seeks in turn to promote investor protection, encourages innovation and facilitates competition and capital formation. The staff recommendations relate to:

- *Investment Company Governance:* Boards of Open end companies should consist of a majority of "independent" directors.
- *Advertising:* Including "off the page" direct selling should be allowed without statutory prospectus distribution to investors.
- *Fees:* Prominently displayed UFIC (Unified Fixed investment Company) fees should be set as a single fee without further sales charges or redemption fee.

- *Retail Price Maintenance:* SEC authority should be eliminated so as to permit competition by price to create efficient distribution by companies.
- *Private Funds:* Formation of a "new" class of unregulated private funds composed exclusively of "sophisticated" investors should be permitted.
- *Structured Financing:* Securitized or Collateralized financing entities (e.g., backed by residential mortgages, credit card or other financial assets) are Investment Companies under the law but are not permitted to register under the law, and therefore should be exempted from 1940 Act coverage.
- *Pooled Investment Vehicles* (PIVs) *For Employees Benefit Plan Assets:* Where these are directed by participants they should be exempted from registration under the securities laws, provided they require semiannual Exchange Act reports to shareholders, for the underlying investment vehicles to plan participants.
- *Internationalization:* Non-U.S. investment companies should be permitted to sell shares in the United States upon demonstrating "that they are subject to regulation in their home country which provides substantially equivalent investor protection."

The study consists of thirteen chapters, five chapter appendixes, and an Executive Summary, all arranged in three parts as follows:

Part I The Scope of the Investment Company Act
- Chapter 1 The Treatment of Structured Finance under the Investment Company Act
- Chapter 2 Private Investment Company Exceptions
- Chapter 3 Pooled Investment Vehicles for Employees Benefit Plan Assets

Part II Removing Barriers to Cross-Border of Investment Management Services
- Chapter 4 Internationalization and Investment Companies
- Chapter 5 The Reach of the Investment Advisors Act of 1940
- Chapter 6 Performance Based Advisory Compensation

Part III Regulation of Investment Companies
- Chapter 7 Investment Company Governance
- Chapter 8 The Sale of Open-End Investment Company Shares
- Chapter 9 Investment Company Advertising
- Chapter 10 Variable Insurance
- Chapter 11 Repurchase and Redemption of Investment Company Shares
- Chapter 12 Affiliated Transactions
- Chapter 13 Procedures for Exemptive Orders

Each chapter has its own brief introduction and summary of recommendations section which assists in developing the reader's understanding of the study.

Since the origins of the mutual fund/investment company movement in the 1920s, purchasing shares of investment company units (ownership) by investors of modest means who sought to pool and diversify their investment—has grown from $0 to over $1 trillion in investment company assets.

Since 1980, the "structured" finance industry (CBO's and mortgage obligations) has become a major facet of the financial markets. The staff argues that 1940 Act causes distortions in the operation and growth of this aspect of the market by enforcing "distinctions that do not reflect economic reality."

Each chapter ends with a specific recommendation to amend the law, establish a commission rule or to act to include or to exempt particular entities. The study seeks to identify new competitive means and to encourage international flow of investment funds as a way to expand and assist capital markets developments on a global scale.

My sense is that the study is "deregulatory" in its substance and comprehensive in its form.

POWERSHIFT

by Alvin Toffler

(New York: Bantam Books, 1991; 611 pages; $6.99, paperback edition)

Reviewed by **Stephen J. Young**

Alvin Toffler's latest book, *POWERSHIFT*, is the last in a trilogy of books about the future of the world economy and politics.

Through carefully reasoned speculation, Toffler generates a plausible and intriguing script for the twenty-first century.

The book opens by discussing sources of power in society. The three main sources identified are violence, money, and knowledge. An advanced economy is described which increasingly depends on the knowledge, rather than buying industrial power, of its citizens to generate wealth. Growth industries are now computer software and drug manufacturing; in the past it was steel and automobiles. The vision is one of a post-industrial world; a world consistent with the thesis of Toffler's second book, *The Third Wave*.

The ramifications of this "powershift" from traditional sources of power (ie., violence, wealth) to those with knowledge in an industrial society are explained in detail. Toffler contends that this shift has, in fact, been going on for decades, but has been unleashed by recent advances in computing power and communications.

An example that is briefly described is the massive changes in financial markets in the 1980s. Deregulation alone cannot account for the globalization of securities markets and the wide range of new financial products being offered. The availability of timely information and massive increases in computing power has enabled trading on a scale unheard of in the past. Financial markets are fundamentally different from any time in the past.

The availability of instant and accurate information will fundamentally change the way business is done in every industry. The changes in financial markets are merely an example. Businesses are beginning to rethink the way they operate. Until recently, much of the new technology, say point of sale data, was used mainly to improve record-keeping and inventory procedures. Only now is the information available being used to change product prices rapidly or print coupons to adjust to consumer demand instantly.

This increase in pace, this fundamental change in concept, has major ramifications for every sector of the economy. Toffler spends little time directly analyzing the accountant's role in this process. However, since accountants deal directly in information, understanding its increasing importance is critical for the profession and its regulators. All industries have to redefine their products for the information era to remain competitive, and accountancy is no exception.

The later chapters deal with the political changes currently taking place. Events around the world are analyzed within the information

revolution framework. Plausible explanations for the collapse of the Soviet Empire are articulated. Current unemployment trends and the changes in relative pay structure in the 1980s are also noted. Employment statistics do seem to confirm Toffler's assertion that employees will increasingly be hired for their brains and not their brawn.

Although the book's thesis is one of optimism and future potential, it is also filled with dark warnings and concerns. Toffler makes no attempt to hide the pain that a transition to a new type of economy will cause. The increasing gap between the knowledge "rich" and knowledge "poor" in society is of great concern. A large underclass in society cannot be ignored and will demand protection and resist change. Noting the increasing violence and intolerance world-wide, it sometimes appears that the author himself wonders whether our current political ideals will survive this conflict.

The book includes a list of the most important assumptions upon which this future society is based. This is a valuable addition because it allows the thoughtful reader to analyze the merit of the author's assumptions.

In all, the book is very well constructed. The scenario created by Toffler is one of political and social upheaval centered on economic change. Given Toffler's reputation as a futurist, I had very high expectations for *POWERSHIFT*. I was not disappointed.

ISBN: 1-55938-692-4