RESEARCH IN ACCOUNTING REGULATION

Editor: GARY JOHN PREVITS

Associate Editors: LARRY M. PARKER
ROBERT ESKEW

Volume 8 • 1994

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MAIN PAPERS

AN EXPLORATORY CONTENT ANALYSIS OF TERMINOLOGY IN PUBLIC ACCOUNTING FIRMS' RESPONSES TO AICPA PEER REVIEWS

Wanda A. Wallace and Karen S. Cravens

ABSTRACT

Despite peer reviewers' issuance of an unqualified report, the AICPA oversight committee has frequently called for particular voluntary actions to be taken by the reviewee. Related communications between the peer reviewee and the AICPA become a part of the public file. This research explores the nature of such public files through content analysis, both in a computerized form and in a more informal subjective analysis form. All non-boilerplate AICPA cover letters accompanying SEC Practice Section (SECPS) public files for the period from 1980 through the first quarter of 1986 are the population

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The findings suggest that the AICPA cover letter and accompanying reviewee's response, though much shorter than the peer review report and related letter of comments, are reasonable surrogates for such detail in the public files. Of interest in evaluating the regulatory process is the finding that reviewees' response letters that have been removed by the AICPA from the public files to "prevent any confusion on the part of the public as to the purpose of such letters" were far more likely to contain competency-related findings.

The public files for the SEC Practice Section of the AICPA related to peer review include the peer review report, the letter of comments, a response by the peer reviewee, and a cover letter from the AICPA. In some cases, an iterative set of correspondence is filed, depicting follow-up reviews due to concerns of either the peer reviewer or the AICPA, as well as disagreements that may arise between the reviewee, reviewer, and the AICPA Committee which exercises oversight of the program. While others have considered the nature of information in public files by focusing on the peer review reports and letters of comment (e.g., see Wallace and Wallace 1990a), to date, little attention has been directed to the other types of correspondence present. Yet, in the course of performing such past research, it has been observed that the cover letter from the AICPA frequently takes on other than a boilerplate format and may lead to some interesting disclosures about the peer reviewee (Wallace 1989).

Specifically, it has been observed that despite the peer reviewer's issuance of an unqualified report, the AICPA oversight committee has frequently called for particular voluntary actions to be taken by the reviewee. Past research has referred to this as an "uncertain" sort of report package (Wallace 1991). Given the peer reviewee is paying for the process, various means of enhancing quality control, beyond material deficiency findings, are no doubt of interest to the CPA firm. Moreover, it may be the case that when marginal judgment calls arise, this sort of modification is a sort of compromise among the parties to achieve the desired remedial action without the issuance of a qualified report. This may facilitate more effective and consistent oversight action by the AICPA in the face of some predictable inconsistency in the judgments made by peer reviewers in diverse settings. In such cases, one might form an expectation that interesting communications could evolve between the peer reviewee and the

AICPA, either prompting the position taken by the AICPA or responding to the requests put forward by such a committee. This highlights the importance of the use of the actual words of the communication. The overall tone of the document will be formed by the use and combination of specific words. Through the tone of the correspondence, both parties will derive their own interpretation of the peer review and subsequent actions or findings. Because the public files contain only summary reports, one must rely on the letters in the file to formulate an overall assessment of the quality and effectiveness of the peer review.

The objective of this research is to explore the nature of such public files through content analysis, both in a computerized form and in a more informal subjective analysis form. This methodology will allow a somewhat objective assessment of a very subjective process—interpretations and tone created by the use of words. In this manner it is possible to draw conclusions from qualitative materials relating to disclosure issues. This type of analysis has the potential to apply to the use of words in any disclosure setting. To make such a task feasible, a core "interesting" sample was targeted. Specifically, all of the AICPA cover letters for the population of AICPA public files for the SEC Practice Section (SECPS) from 1980 through the first quarter of 1986 that differed from a boilerplate format were identified. These were 26 in number, but since two related to revisits, 24 comprise the primary data set for analysis. For these 24 sets of cover letters with reviewee responses, the text was typed and subjected to a computerized content analysis. Due to the limitations of such word-count oriented programs, we also identified expected content from an inferential perspective and then read the data set twice to determine a reasonably consistent subjective coding process.

MOTIVATION

It is our belief that such detailed analyses serve a number of purposes. First, if the AICPA continues to require member firms to include in the public files their response to peer reviewers and the oversight process of the AICPA, then closer scrutiny of such aspects of public files would seem merited. They may well contain evidence as to the nature of the oversight process, the degree to which that process adds specific corrective action steps to the recipient of unqualified, modified, or adverse reports, and the degree of adversarial interplay between reviewees and the AICPA. Because the quality review process will be administered by a number of state and regional bodies, with some oversight also provided by the AICPA (Huff and Kelley 1989; McCabe 1993), a better understanding of past experiences of the peer review program may enhance the types of information that are gathered (although public files are not expected to be made available for such programs).

Reviewers of public files may get one impression from a peer review report, another from the letter of comments, and yet a third from the response of the reviewee. Then, a fourth complication and perspective is offered by the AICPA whenever other than a boilerplate letter is transmitted to the peer reviewee. Little doubt exists that these last two communications may well alter an initial impression formed by readers of peer review reports. It is also possible that an examination of the reviewee response alone will provide a comprehensive evaluation of the peer review report, in which case a more succinct, yet useful information source is available. We examine whether responses address most of the findings mentioned in the letters of comment.

Reviewees' responses to report findings could identify areas of disagreement with peer reviewers and unusual mitigating circumstances. Moreover, the responses may validate concerns identified by the reviewers. Given the nature of the peer review process, past research has observed that historical files fail to achieve commonality and consistency (Wallace and Wallace 1990b) among the reports and their corresponding letters of comment. Such lack of comparability would seem to intensify the importance of the reviewee response to the public's evaluation of the firm and the quality of the review process. The perceived importance of the response process is evidenced further by the announcement by the AICPA in *The CPA Letter* (AICPA 1994) that a firm had been terminated from the AICPA's Quality Review Program "because the firm failed to revise its letter of response to its quality review, thereby failing to cooperate with the entity administering the review."

Of course, the reviewee responses are not directly comparable and are likely to have a tone that, in part, is influenced by the nature of the findings and type of peer review report received. This supposition is examined. The composition and style of the response letter will contribute to the overall impression created by that letter, regardless of its content. In light of such a range of possible variation in responses, a content analysis would appear to be the appropriate methodology for exploratory inquiry as to the nature of these public filings. This also allows an investigation as to the degree to which these filings might be expected to potentially influence public opinion, as well as that of various members of oversight groups (assuming an analogous "response by reviewer" mechanism in the quality control process).

From the practitioner's point of view, the overriding motivation for analyzing reviewee responses is to provide a framework as to how practitioners *should* formulate a response to peer review reports. Does this response have any effect on the AICPA or the public? What is the typical response by firms receiving nonstandard AICPA cover letters?

OBJECTIVE

The objective of the study is to analyze the composition of the peer reviewee's response letter to provide a basis for anticipating public reaction. The analysis also suggests guidelines as to how practitioners should respond to peer review reports. This type of consideration is appropriately somewhat separate from the content of the letter. As a wide range of individuals will view the letters, each may draw different conclusions, depending on their backgrounds and prior beliefs. Their judgment and intuition will be more apparent in the interpretation of style and tone, rather than in analysis of factual conditions. A secondary objective is to examine the relationship of the cover letter from the AICPA to the reviewee response letter. A third objective is to explore the interrelationship between these correspondence documents in the public file and both the type of peer review report issued and the number of findings listed in the accompanying letters of comment.

RESEARCH DESIGN

The research design consists of a descriptive analysis of 24 peer reviewee response letters to the AICPA (see Appendix for an illustrative letter), and separate consideration of the two filings related only to revisits, that is, to comments from a secondary reviewer. Specifically, we observed that these two second reviewers agreed with initial reviewers; one letter referred to 561 "borderline problems" while the other was comparably shorter in length and less descriptive as to findings. Our inference is that guidelines on the degree of appropriate redundancy in second reviewers' reports and specification of scope could be helpful. Obviously, with only two observations, these suggestions are tentative. We now turn to our focus on the 24 letters in the population. The descriptive materials included with these 24 letters permitted tabulation of the type of firm, state location, size of letter, and nature of AICPA cover letter. The Appendix contains examples of acknowledgment letters by the AICPA: one that is within the set of 24 letters and a "boilerplate" example from the population of all peer review filings. Frequency analyses were generated based on codings for findings, responses, and actions. The data were analyzed using a variety of nonparametric and parametric tools to describe possible patterns in the type of findings, nature of response or action, and nature of peer review report issued, as well as the total findings in the letters of comment.

Content analysis is a research technique for making replicable and valid inferences from data to their context and can be applied to language or unstructured forms of communication, both textual and numerical (Krippendorff 1980; Weber 1990). Kassarjian (1977) describes applications of the tool to marketing. Accounting applications include Frazier et al (1984), Hoskin et al (1986), McConnell et al (1986), Tinker and Neimark (1987), Smith (1988), Wallace and Smith (1991), and Previts et al. (1993). Natural languages provide some direction on uses of adverbial stance and what such use is intended to communicate. "By stance we mean the overt expression of an author's or speaker's attitudes, feelings, judgments, or commitment concerning the message. Adverbials are one of the primary lexical markers of stance in English...[and are divided in this research] into six semantic categories." (Biber and Finegan 1988, 1).

Biber and Finegan (1988) use cluster analysis in analyzing 410 texts of written and spoken British English to formulate styles that emerge from the use of the adverbial stance types, distinguishing the incidence of use by the type of communication (e.g., editorials in contrast to interviews, broadcasts, and telephone conversation). This literature is drawn upon in our analyses; the microcomputer software package used was WordCruncher, capable of developing word lists and quantifying the frequency of specified word groups.

Caveats

It is anticipated that letters may be vastly different in style and yet convey the same impression through a similar tone. The coding of "tone" is done through reading and interpretation. Much of this type of analysis is so subjective as to invite considerable room for disagreement. Use of content analysis imposes an objective framework on the inquiry. The content analysis reporting approach is similar to that in Wallace and Smith (1991)—a study of FASB lobby letters. Yet, even this methodology requires some cautions to the reader: (1) many of the keywords are not used in the expected context—these will be eliminated in the research process; (2) there often is a heavy repetition of words within a document due to a particular author's style, sometimes creating noise in the count metrics reported herein; and (3) the adverbial stance types will help to establish an overall tone, yet we supplement this list with our own set of words geared to the subject matter (based on the authors' familiarity with the peer review process). Because this inquiry is exploratory in nature, such analyses do not have the same type of support as is available from the linguistics literature for the adverbial analysis. However, corroboration for such subjective judgment as to which findings are more severe (see Table 1) is provided by the significant relationship of severity indicated by our coding of the response letter to the actual type of peer review report (chi-square 13.41_8, significant at .10 and Cramer's V of .53). Note that chi-square tables facilitate identification of patterns within the data set other than linear associations and do not require rigorous assumptions common in parametric analysis. Chi-square statistics identify the existence of a pattern, while Cramer's V (or the 2 x 2 phi statistic) indicates the strength of such a pattern in terms of relative descriptive power (Srikantan 1970).

Additional Comments

It should be noted that the reviews are a team process, yet the reviewee response may be a group response or an individual effort. The team findings will be an amalgamation of different perspectives, influenced by overall guidelines. Presumably, the team has reached a reasonable consensus for items listed in the report. However, the amount of detail provided with the findings may influence the

Table 1. Profile of the Database and Key Interrelationships

State in Which Peer Reviewee is Located					
	Frequency	*Percent*		*Frequency*	*Percent*
Unidentified	6	25.0	Mississippi	1	4.2
Colorado	1	4.2	Ohio	1	4.2
California	4	16.7	Virginia	1	4.2
Maryland	1	4.2	New Jersey	1	4.2
New York	1	4.2	Oregon	1	4.2
Texas	5	20.8	Pennsylvania	1	4.2

CPA Firm Size	*Frequency*	*Valid Percent*	*Cum Percent*
Smaller than the largest 15 but within the largest 30 CPA firms	2	8.3	8.3
Smaller than the largest 30 but within largest 60	2	8.3	16.7
Smaller than largest	20	83.3	100.0

Nature of Cover Letter	*Frequency*	*Valid Percent*
Accepts Documents—No Adjustment	1	4.2
Accepts With Understanding Firm Voluntarily Complies With Suggestions	5	20.8
Accepts After Revisit	3	12.5
Accept With Agreement For Reviewee Request	1	4.2
Accept With Qualification—Single Overall Action (Revisit) [A]	5	20.8
Accepts With Multiple Conditions Attached and Descriptive Information Included [B]	3	12.5
Does Not Accept A Portion	1	4.2
Code [A] above plus Addition of Letter Format Attached to Indicate Response	4	16.7
Code [B] above plus Addition of Letter Format Attached to Indicate Response	1	4.2

Words (*Number of Words in the Response by Reviewee*)

Mean	586.458	Std. Dev.	375.161	Median	518.000	Mode	96.000
Range	1391.000	Minimum	96.000	Maximum	1487.000		

Pages (*Number of Pages in the Reviewee's Response*)

Mean	2.917	Std. Dev.	1.603	Median	2.625	Mode	2.000
Range	6.750	Minimum	.750	Maximum	7.500		

Restates (*Degree to Which the Response by the Reviewee Restates the Findings*	*Frequency*	*Valid Percent*
No Substantial Restatement of Findings	17	70.8
Partial Restatement of Findings	2	8.3
Restates—If Findings of the Review are restated in the text of the Reviewee's Response Letter	5	20.8

(*continued*)

Table 1. (Continued)

Findings: Sum of the 15 Findings Per Reviewee Letter–Descriptive Statistics

Mean	5.542	Std. Dev.	3.021	Range	13.000
Minimum	1.00	Maximum	14.00		

Types of Findings, Timeliness of Actions Cited, and Nature of Response (Tone) Communicated in the Reviewees' Letters

	Frequency	*Valid Percent*
Finding 1: Liaison With Client (Acceptance and Continuance Concerns)		
Immediate Response	1	4.2
No Timing Specified (in future, etc.)	2	8.3
In Progress	1	4.2
Detailed Immediate Response	2	8.3
No Timing Specified for Both Findings	1	4.2
Tone: Acceptance.		
Finding 2: Audit Steps Performed		
Immediate Response	1	4.2
No Timing Specified (in future, etc.)	4	16.7
In Progress	4	16.7
Immediate Response to Both Findings	1	4.2
In Progress to One Finding and Immediate Response to Second Finding	1	4.2
Tone: Acceptance.		
Finding 3: Documentation of Audit Work		
Immediate Response	2	8.3
Unclear, Hedged Response	1	4.2
No Timing Specified (in future, etc.)	4	16.7
In Progress	2	8.3
Detailed Immediate Response	1	4.2
No Timing Specified for Both Findings	2	8.3
No Timing Specified on One Finding and Detailed Resistance—No Action on Other	1	4.2
Detailed Resistance—No Action on One Finding and In Progress on Other Finding	1	4.2
Tone: Acceptance of nine findings; defensiveness on four findings; disagreement with one finding.		
Finding 4: Training/Competency of Staff–Consultation With Specialists		
In Progress	3	12.5
Detailed Immediate Response	1	4.2
No Timing Specified (in future, etc.) on Both Findings	1	4.2
No Timing Specified on One Finding and Detailed Immediate Response on the Other Finding	1	4.2
Tone: Defensive on one finding; others accepted.		

(*continued*)

Table 1. (Continued)

	Frequency	*Valid Percent*
Finding 5: Supervision of Work		
Immediate Response	2	8.3
No Timing Specified (in future, etc.)	2	8.3
In Progress	2	8.3
Detailed Immediate Response	2	8.3
Tone: Defensive on one finding; others accepted.		
Finding 6: Review of Work		
Immediate Response	1	4.2
Unclear, Hedged Response	1	4.2
No Timing Specified (in future, etc.)	1	4.2
Detailed Resistance, No Action	1	4.2
Detailed Immediate Response	2	8.3
Tone: Defensive on one finding and resistant on two findings; others accepted.		
Finding 7: Section Related Standards		
Immediate Response	1	4.2
No Timing Specified (in future, etc.)	3	12.5
In Progress	2	8.3
Detailed Resistance—No Action	1	4.2
No Timing Specified for Both Findings	1	4.2
In Progress on One Finding and No Timing Specified on Other Finding	1	4.2
Tone: Resistant on one finding; acceptance of others.		
Finding 8: Planning of Audit (Including Budgets & Staff Review-Post Facto; Also Includes Advancement)		
Immediate Response	4	16.7
Unclear, Hedged Response	2	8.3
No Timing Specified (in future, etc.)	5	20.8
In Progress	2	8.3
Detailed Immediate Response	1	4.2
Tone: Defensive on two findings; acceptance of others.		
Finding 9: CPE Requirements		
In Progress	1	4.2
Detailed Immediate Response	1	4.2
Tone: Acceptance.		
Finding 10: Reporting		
Immediate Response	2	8.3
No Timing Specified (in future, etc.)	1	4.2
Detailed Resistance—No Action	1	4.2
Detailed Immediate Response	1	4.2

(*continued*)

Table 1. (Continued)

	Frequency	*Valid Percent*
Immediate Response on One Finding and No Timing Specified on the Other	1	4.2
Immediate Response on One Finding and In Progress on the Other	1	4.2
Detailed Resistance—No Action and No Timing Specified (in future, etc.)	1	4.2
Tone: Defensive on three findings and resistant to one finding; acceptance of others.		
Finding 11, Internal Inspections		
Immediate Response	1	4.2
Unclear, Hedged Response	1	4.2
No Timing Specified (in future, etc.)	6	25.0
In Progress	3	12.5
Detailed Resistance—No Action	1	4.2
Detailed Immediate Response	1	4.2
Immediate Response on Both Findings	1	4.2
Detailed Immediate Response on Both Findings	1	4.2
Tone: Defensive on two findings, hedged response on one finding, and resistant on one finding; others accepted.		
Finding 12: Independence		
Immediate Response	1	4.2
No Timing Specified (in future, etc.)	3	12.5
In Progress	2	8.3
Detailed Immediate Response	3	12.5
Tone: Defensive on two findings and one hedged response; others accepted.		
Finding 13: Membership		
Immediate Response	1	4.2
No Timing Specified (in future, etc.)	1	4.2
Tone: Acceptance.		
Finding 14: Firm Guidelines (and Quality Control Documents and Manuals)		
Immediate Response	1	4.2
No Timing Specified (in future, etc.)	1	4.2
Detailed Resistance—No Action	1	4.2
No Timing Specified on One Finding and Detailed Immediate Response on the Other Finding	1	4.2
Tone: Evasive on one finding; others accepted.		
Finding 15: Prior Review Points		
Detailed Immediate Response	1	4.2
Tone: Defensive		

(*continued*)

Table 1. (Continued)

		Frequency
LGFIRM	Acronym for All CPA Firms in Largest 60 CPA Firms Domestically	4
INDEP	Acronym for All Reviewee Letters Containing at Least One Finding Pertaining to Independence Considerations	9
AUDIT	Acronym for All Reviewee Letters Containing at Least One Finding Pertaining to Audit Steps Performed	11
REPORT	Acronym for All Reviewee Letters Containing at Least One Finding Pertaining to Reporting Issues	8
COMPET	Acronym for All Reviewee Letters Containing at Least One Finding Pertaining to Training/Competency of Staff—Consultation With Specialists	6
PRIOR	Acronym for All Reviewee Letters Containing at Least One Finding Pertaining to Prior Review Points	1
SEVERE	Acronym for the Number of Findings Described in the Reviewee Letters Related to Independence, Audit Steps Performed, Reporting Matters, Competency Issues, or Prior Review Points	8

		Valid			*Valid*
Value	*Frequencies*	*Percent*	*Value*	*Frequencies*	*Percent*
0.0	6	25.0	3.00	3	12.5
1.00	8	33.3	4.00	2	8.3
2.00	5	20.8	Mean 1.458	Std. Dev. 1.250	

SEVEREW	Acronym if the number of SEVERE findings exceed two for a Reviewee Letter	5
ACC	Acronym for Nature of Response Being a 1 or a 2, accepting	21
DISAGREE	Acronym for Resistance in Nature of Response (Disagreement)	3
DISAGRE1	Acronym for Resistance (Disagreement), Evasiveness, or Hedged Response as the Nature of the Reviewee's Response	4
CA	Acronym for State in Which Peer Reviewee Is Located	4
ACCEPT	Acronym for Nature of Response By Reviewee: Acceptance Either With No Elaboration or With Elaboration	6
RESTATE	Acronym for Partial or Full Restatement of Findings in the Text of the Reviewee's Response Letter	7
RESIST	Acronym for the Nature of Action (Timeliness) Being Detailed Resistance—No Action	4
Use of adverbials	*in Communication*	
HONEST1	Acronym for coding all cases with at least one incidence of the adverbial HONEST	5
GENERAL1	Acronym for coding all cases with at least one incidence of the adverbial GENERAL	7
SURE1	Acronym for coding all cases with at least one incidence of the adverbial SURE	15

(*continued*)

Table 1. (Continued)

		Frequency
ACTUAL1	Acronym for coding all cases with at least one incidence of the adverbial ACTUAL	5
MAYBE1	Acronym for coding all cases with at least one incidence of the adverbial MAYBE	3
AMAZ1	Acronym for coding all cases with at least one incidence of the adverbial AMAZING	8
VOLUNTAR	Acronym for AICPA's Cover Letter Citation of "Voluntary Action" Having Been Agreed To By Peer Reviewee	5
INSPECT	Acronym for AICPA's Cover Letter Citation of "Inspection"	6
REVISIT	Acronym for AICPA's Cover Letter Citation of "Revisit"	6

Chi-square$_{df}$ (*Phi for 2x2 or Cramer's V*)			Chi-square$_{df}$ (*Phi or Cramer's V*)		
LGFIRM			COMPET		
HONEST	6.32_{3}*	(.51)	GENERAL	7.27_{3}*	(.55)
SEVERE			RESIST		
SURELY	24.96_{16}*	(.51)	COMPET	3.60_{1}*	(.52)
MAYBE	13.96_{8}*	(.54)	SURELY	12.00_{4}**	(.71)
AMAZING	14.20_{8}*	(.54)	HONEST	6.32_{3}*	(.51)
GEN1	10.93_{4}**	(.67)	ACTUALLY	6.32_{3}*	(.51)
SEVEREW			AMAZING	6.96_{2}**	(.54)
INDEP	2.85_{1}*	(.45)			
AMAZING	4.73_{2}*	(.44)			
ACC					
INDEP	3.07_{1}*	(.49)			
ACTUALLY	7.64_{3}*	(.56)			
DISAGREE					
HONEST	9.24_{3}*	(.62)			
GENERALL	6.25_{3}*	(.51)			
SURELY	8.76_{4}*	(.60)			
ACTUALLY	7.64_{3}*	(.56)			
DISAGRE1					
COMPET	3.60_{1}*	(.52)			
HONEST	6.32_{3}*	(.51)			
CA					
SURELY	7.80_{4}*	(.57)			
AMAZING	5.23_{2}*	(.47)			
RESTATE					
INDEP	3.03_{1}*	(.45)			
ACTUALLY	8.54_{3}**	(.60)			
ACTUAL1	5.10_{1}**	(.57)			

* .10 significance level

** .05 significance level

*** .01 significance level

reviewee's response. Similarly, the words used by the composer of the correspondence will reflect that individual's perspective.

EMPIRICAL FINDINGS

The Nature of the Peer Reviewee Response Letter

A profile of the database and key interrelationships are reported in Table 1. An analysis of demographic information from the response letters indicates that there is a wide degree of geographical diversity represented in the sample, with some concentration in Texas and California. To some extent, this diversity may influence the use of particular words in practice. The overwhelming majority of firms in the sample are of smaller size than the 60 largest CPA firms across the nation. As reported in Wallace (1991) 337 of the 351 filings for this time frame were by peer reviewees that were not members of the Big 15. The cover letter descriptives will be discussed in a later section of this paper. The size of the response letter (as measured by the number of words and pages) varies greatly and, as can be expected, is significantly correlated with the number and severity of findings cited (see Table 2). However, most respondents do not merely restate the findings of the review in a redundant fashion in their response letter—avoiding general size distortions—but instead cross-reference findings when describing their corrective action (e.g., see the Appendix). Further evidence that restatement of findings does not indicate the nature of the response by the reviewee is provided by a chi-square analysis which, while significant at a .04 level (30.19_{18} and .79 Cramer's V), displays no apparent pattern relative to "accept" or "qualified acceptance" points of view by respondents. This result is consistent with our interpretation that such a trait tends to reflect primarily the reviewee's writing style.

The types of findings cited by the reviewee in the response letter were divided into 15 categories. It is important to note that peer reviewees may not respond to all of the findings in the review report. This analysis is based only on findings mentioned in the response. The majority of findings pertain to documentation of audit work, planning of the audit—including staff advancement, reporting, internal inspections, and audit steps performed. The most severe findings were defined as independence, audit steps performed,

Table 2. Correlation Analysis of Data Set
($n = 24$)

	WORDS	*PAGES*	*FINDINGS*	*SEVERE*	*HONEST*	*GENERAL*	*SURELY*	*ACTUALLY*	*MAYBE*	*AMAZING*	*TOTFIND*
WORDS	1.0000										
PAGES	.9739**	1.0000									
FINDINGS	.6138**	.6315**	1.0000								
SEVERE	.4836*	.5080*	.8291**	1.0000							
HONEST	.0856	.0327	.1827	.0609	1.0000						
GENERAL	.5289*	.4465	.2203	.1082	.2143	1.0000					
SURELY	.6715**	.7379**	.4024	.3209	.1902	.4045	1.0000				
ACTUALLY	.4164	.4419	.1213	.2875	−.0187	−.1931	.1126	1.0000			
MAYBE	−.0182	−.0961	.0561	.0419	.1294	.2490	−.0667	−.1513	1.0000		
AMAZING	.7934**	.7656**	.6279**	.4152	0.0	.3188	.5817*	.1669	.1444	−1.0000	
TOTFIND	.4980*	.4705	.8211**	.6921**	.2165	.2278	.2151	.2267	.3223	.4724*	1.00

Notes: * Significant at −.01
** Significant at −.001

reporting matters, competency issues, or prior review points. Seventy-five percent of the sample contained at least one severe finding, and 20% contained more than two severe findings. The actual review report must be examined to determine the total number of findings for a firm. This was done for the sample at hand, and the correlation between the number of findings mentioned in the reviewee's response to the total number of findings in the letters of comment accompanying these reviewees' peer review reports is .82 (significant at better than a .001 level; this and other correlations are reported in Table 2). Note that for the total files for this period the peer review reports' findings can be described as follows: 0 findings (10%); 1-3 (50%); 4-6 (29.5%); 7-9 (8%); 10-15 (1.5%); and 16-22 (1%) of the 351 filings—this number excludes the single adverse report in the files for this time frame (Wallace 1991—this same source, along with Wallace and Wallace 1990a, elaborate on the types of findings for the population of peer review filings and can be reviewed for comparative purposes).

There were six possible responses and seven possible actions to each of the findings in the response letter. The nature of the response indicates the tone of the reviewee with respect to the finding. The nature of the action pertains more to the timeliness of the reviewee's intended actions. Coding of actions was not dependent on the response. In general, independence findings are accepted by the reviewees, while there is more disagreement with findings related to training/competency of staff or consultation with specialists. Restatement of the findings is prevalent in responses to both of these types of findings. Therefore, it seems likely that restatement of findings in the text of the letter is more directly related to personal style than to the type of response or finding.

Responses with respect to the timeliness of intended actions are generally succinct. For most findings, where the reviewee agrees with the conclusion, a brief mention is made as to timeliness. Respondents often use the phrases "in progress" or "in the future" or state that the action has already been completed. Clearly, the first two phrases are rather vague, yet convey the respondent's willingness to take action. Often the finding may be of the type where a detailed timetable is not required. Although it seems possible that the reader might infer a greater degree of cooperation from a longer, more detailed response as to the timing of the action, those receiving more severe findings nonetheless lack detail in their timeliness responses.

Adverbial Stance Types

One way to analyze the response letters is to consider the overall tone of the letter as determined by adverbial stance types. Biber and Finegan (1988) provide a comprehensive description of the key words and communication associated with six major adverbial stance categories, as referenced earlier (see Table 3). We also compared the use of adverbials in the response letters to use in other forms of communication (Table 4). Biber and Finegan (1988) defined the clusters and provide the statistics for different types of communication, described earlier. Not surprisingly, many of the adverbials are significantly correlated with the size of the letter. Logically, this supports the notion that the shorter responses will use fewer adverbials. Most of the responses employ "surely" adverbial stance types, which indicate seclusion from dispute when used along with "actually" adverbials, or indicate affirmation. This combination of adverbials also denotes familiarity or an attempt to maintain a convincing tone. Used alone, the "surely" adverbial stance can also signify concession of points to the reader as part of a larger persuasive argument. The prevalence of these adverbial stance types in the response letters seems to confirm the expected nature of the comments: peer reviewees try to justify any departures from normal procedures. The firms wish to convey confidence in their actions and persuade the reader. In contrast, use of the "maybe" adverbial stance type would suggest hedging or questionable assertions. Only a very small portion (8%) of the sample employs this adverbial.

The "generally" adverbial stance may be used in presentation to make a proposition more readily acceptable. This adverbial is found in approximately one-third of the sample and is not necessarily used in the restatement of findings. Therefore, most reviewees seem to use this adverbial to persuade the reader to accept their argument. Use of the "amazingly" adverbial stance may serve to evoke an opposite tone to that created by the "generally" adverbial. This stance type expresses the author's attitude toward the content of the document. In this sample, the most prevalent key words in the "amazingly" adverbial category are "expected" and "appropriately." Rather than indicating the reviewee's amazement with the findings, these words seem to emphasize that the response justifies the reviewee's actions. Interestingly enough, this is the only adverbial stance that is significantly correlated with the findings listed in the response.

Table 3. Adverbial Stance Types

Categories	*Key Words Associated With Category*	*Communication Associated With Category*
Honestly	truth, truthful, truthfully, truly, truthfulness, mildly, frankly, honestly, frankness, honesty, literal, frank, honest, literally, bluntly, candidly, flatly, blunt, candid, seriously, strictly, personally, serious, seriousness, personal, literally, metaphorically, confidentially (strict)	Expressing manner of speaking
Generally	briefly,crudely, generally, brief, crude, general, broadly, roughly, simply, approximately, essentially, essence, nominally, basically, fundamentally	Expressing approximation, generalization, typical, or usual case
Surely	certain, clear, certainly, clearly, certainty, definitely, indeed, obviously, plainly, surely, sure, of course, admittedly, assuredly, avowedly, decidedly, incontestably, incontrovertibly, indisputably, indubitably, undoubtedly, unquestionably, unarguably, undeniably, doubt, question, evidently, manifestly, patently, doubtless	Expressing conviction or certainty
Actually	actually,actuality, really, realistic, reality, factually, fact	Expressing actuality, emphasis, greater certainty/ truth than expected
Maybe	arguably, allegedly, conceivably, likely, maybe, perhaps, possibly, presumably, purported, reportedly, reputedly, supposedly, apparently, seemingly, formally, hypothetically, ideally, officially, ostensibly, outwardly, superficially, technically, theoretically, theory (apparent, purported, reputable)	Expressing possibility, likelihood, questionable assertions, hedging
Amazingly	amazingly, astonishingly, curiously, astonishment, distress, funnily,	Expressing attitudes toward the content

(*continued*)

Table 3. (Continued)

Categories	*Key Words Associated With Category*	*Communication Associated With Category*
	incredibly, ironically, oddly, remarkably, strangely, suspiciously, unexpectedly, typically, expected, appropriately, inevitably, naturally, predictably, understandably, unnaturally, predicted, annoyingly, delightfully, sadly, disappointingly, disturbingly, justly, refreshingly, regrettably, rightly, fortunately, regret, regretfully, unfortunately, happily, luckily, surprisingly, unhappily, unluckily, tragically, amusingly, conveniently, hopefully, mercifully, preferably, significantly, thankfully, unaccountably, interestingly (convenience, curiosity)	independent of its epistemological status

Source: Biber and Finegan (1988).

Overall, there are a larger number of significant relationships between the use of the more positive, persuasive adverbials, and the more severe findings. This suggests that the peer reviewee realized the need to dissuade the reader from forming a negative impression of the firm. It is critical to recognize that the response is directed to the AICPA and not to the general public. The firms must believe that their response can have an effect on the evaluation of their firms. There are strong correlations between the use of these adverbials and disagreement with the findings. For example, the chi-square statistic quantifying the relationship between disagreement and use of the terms honest, generally, surely, and actually are all statistically significant with Phi or Cramer's V values from .51 to .62, as reported in Table 1.

The Nature of Cover Letters

It is possible that the AICPA cover letters may be the first exposure that the reader has to the peer reviewee in the public files. A quick perusal of this one document can alert the reader to potential uncertainty in the findings or responses. Similarly, this cover letter can set the tone for the reader's subsequent impressions of all other information in the public file. Interestingly, the nature of the cover

Table 4. Comparison of Peer Reviewee Response Letters to Other Forms of Communication

Cluster 1

Secluded from dispute

Characterized by SURELY and ACTUALLY adverbials

These invite affirmation and seclude certain assertions from polite dispute. The invited affirmation solicits listener empathy and agreement concerning major assertions and hence is common in editorials, interviews, and public speeches. The use of the phrase "of course" politely acknowledges those addressees who already know the information being asserted yet provides it for those who do not, while marking the idea as generally accepted by knowledgeable persons. This approach encourages acceptance and minimizes the need for supporting evidence. Generally this style presents assertions as beyond polite dispute and thereby secluded from direct contradiction.

Surely	63%
Actually	21%

Other Forms of Communication With Same Range of Incidence:

Spontaneous Speeches	60%

Cluster 2

Highly interactive conversation mode; face-to-face exchange

Characterized by ACTUALLY adverbial

Emphasizes strong feelings about certain propositions and encourages solidarity with the listener.

Actually	21%

Only Incidence in Other Forms of Communication:

Face-to-face Conversation	5%

Cluster 3

Emphatic shared familiarity

Characterized by ACTUALLY and SURELY adverbials

Strives to maintain a convincing and engaging dialogue in situations, with little motivation and opportunity for careful argumentation. Shared familiarity is emphasized through "you know" wording.

Actually	21%
Surely	63%

Other Forms of Communication With Same Range of Incidence:

Face-to-face Conversation	58%
Telephone Conversation	60%

(*continued*)

Table 4. (Continued)

Cluster 4

Faceless

Characterized by the virtual absence of adverbials

Does not mark attitudes or commitment towards the message but attempts objectivity. It avoids both explicit expression of opinion and any indication of conviction or doubt.

All adverbials are well represented in the database, suggesting that the purpose of the letters is to reflect a certain attitude or commitment.

The lowest incidence in communication forms reviewed was:

Prepared Speeches	17%

Cluster 5

Emphasis of individual position

Characterized by ACTUALLY adverbial

Represents a mildly emphatic style capitalizing on shared familiarity.

Actually	21%

Other Forms of Communication With Same Range of Incidence:

Interviews	50%
Prepared Speeches	33%

Cluster 6

Generalized content

Characterized by GENERALLY adverbial

Represents a subclass of the academic, literate, faceless style, although when inadequate evidence is available for academic exposition, the presentation as a general case may make a proposition more readily acceptable. Usually the argument builds from specifics to a general case.

Generally	29%

Highest Range of Incidence in Other Forms of Communication:

Official documents	27%

Cluster 7

Cautious

Characterized by MAYBE adverbial

Reflects careful assessments of likelihood concerning specific assertions or conclusions in relation to existing evidence. Conviction is commonly linked with a direct caution as to its tentativeness. Uncertainty or caution is more common in written than spoken texts.

Maybe	8%

Other Forms of Communication With Same Range of Incidence:

Adventure Fiction	35%

(*continued*)

Table 4. (Continued)

Cluster 8
Concession to reader/listener
Characterized by SURELY adverbial
A moderately confident style whereby the SURELY adverbials perform the specialized function of conceding points to an addressee as part of a logical progression in a persuasive argument.

Surely	63%

Highest Incidence in Other Forms of Communication:

Broadcast	38%

Source: Adapted from Biber and Finegan (1988).

letter (as described in Table 1) is significantly associated with the type of peer review report issued (chi-square is 37.05_{18}, significant at .005, with Cramer's V of .88). Less than absolute acceptance prevails for other than unqualified peer review reports.

Even though all of the cover letters in our sample are departures from the standard form, they are still rather brief. It is critical that the cover letter be considered in conjunction with the entire public file and not unduly influence the reader's judgment. The cover letter also provides information distinct from other items in the public file. Casual readers may look to the cover letter to condense the report. Also, readers may not have other means to determine the final resolution of the peer review.

The majority of the cover letters indicate acceptance of the peer review report, with an understanding that the firm will comply with suggestions for certain actions or submit to a revisit. Several of the letters do not specify the actions or areas of concern. Letters outlining these actions and the firm's response are eventually placed in the public files. However, the reader may infer that these concerns are not as severe as those mentioned specifically in other cover letters. Letters that enumerate multiple areas of action seem to warrant even greater concern when compared to the briefer letters.

Many of the cover letters also note a change in 1984 in the language of the letter by which a firm indicates agreement to undertake these corrective actions voluntarily. The cover letter then states that the firm's acceptance of the corrective actions mentioned will not be placed in the public files, because the acceptance was worded according to previous guidelines. The AICPA justifies this action so as to "prevent any confusion on the part of the public as to the purpose of such letters." The cover letters include attachments with an illustration of the revised standard form of the letter. It appears that there is an even greater chance of misinterpretation when the original response is not included in the public files. The only indication of the firm's voluntary compliance is in the cover letter. Of particular interest is the chi-square result that a relationship exists between competency-related findings and this use of standard letter forms in lieu of the reviewee's response (16.00_9, significant at a .07, with Cramer's V of .82). Because competency questions strike at the heart of a professional's livelihood, it appears that problems have arisen in past communications between the AICPA Committee and affected firms.

Even though our sample is comprised of nonstandard responses, there is a general trend in the wording of the cover letters. The words "accepted" and "agreement" all appear frequently, creating an overall favorable impression of the outcome of the peer review. Yet, the word "understanding" appears so often as to reinforce that the results from most of the peer reviews were not standard, and the Peer Review Committee requires additional action.

The cover letters were also analyzed for key phrases subjectively determined by the researchers as affiliated with the peer review process, as reported in Table 5. The primary implication of this analysis is that the AICPA is the focal point of the process. The actual inspection report is commonly noted, along with an overall recognition of the importance of quality control. Preissuance concerns are fairly firm specific, with minimal frequency in the population. The Ethics Division is mentioned in only one cover letter. This issue would most likely be more prevalent if the cover letters overall did not convey a favorable impression. The words "change or changes," "revised," and "revisit" commonly appear, reinforcing the notion that these are nonstandard responses. The reviews required additional action from the peer reviewees. Of interest is the reference to "voluntarily" wording in only two cover letters.

Table 5. Relative Incidence of Subjectively Determined Terms of Interest in Cover Letters

		Cover Letter																							
Key Word	*Total*	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*	*16*	*17*	*18*	*19*	*20*	*21*	*22*	*23*	*24*
Change/Changes	7	40	0	0	0	0	0	0	0	0	0	0	4	0	0	3	0	0	0	0	0	0	0	0	0
Committee (AICPA)	43	43	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Committee (Other Types of)	48	7	4	0	0	0	0	0	0	0	0	0	0	0	37	0	0	0	0	0	0	0	0	0	0
Committee's (AICPA)	8	5	0	0	0	0	0	0	0	0	0	0	0	0	0	0	3	0	0	0	0	0	0	0	0
Ethics Division	2	0	0	0	0	0	0	0	0	0	0	0	2	0	0	0	0	0	0	0	0	0	0	0	0
Inspection Report	13	2	0	0	0	0	0	0	0	1	0	0	0	0	0	0	0	3	1	0	2	1	2	1	0
Preissuance	3	0	0	0	0	0	0	0	0	2	0	0	0	0	0	0	0	1	0	0	0	0	0	0	0
Preissuance with SEC	1	0	0	0	0	0	0	0	0	1	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Quality Control (of firm)	9	0	0	0	0	0	3	0	2	2	1	0	0	0	0	0	0	0	1	0	0	0	0	0	0
Quality Control (more general reference)	13	2	0	0	0	0	1	0	0	0	0	0	0	1	1	0	1	1	0	1	1	1	1	1	1
Revised	3	0	0	0	0	0	0	0	2	1	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Revisit	7	0	0	0	0	0	0	1	0	0	0	0	0	0	2	1	0	0	1	0	0	0	0	0	2
Team Captain	3	0	0	0	0	0	0	1	0	0	0	0	0	0	0	2	0	0	0	0	0	0	0	0	0
Voluntarily	23	11	0	0	0	0	0	0	0	0	0	0	12	0	0	0	0	0	0	0	0	0	0	0	0
Voluntary	2	1	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1

Note: No reference appeared to "quality control document" and no occurrence of the word "committee" appeared in proximity to the word "disagree."

CONCLUSION

The results indicate that the content of disclosure documents in terms of the use of words has the power to convey additional meaning. Words set the tone of a document which in turn influences the reader's perception of the facts presented in the document. With such disclosure documents as peer review files, the reader has a limited range of possibilities from which to draw impressions. These impressions are even more critical in the context of the peer review process because it is, in theory, a judgmental function. Firms receiving nonstandard AICPA cover letters appear to carefully select persuasive language of a positive nature, indicative of timely future action. Reason exists to believe reviewees' and the AICPA's letters will influence the AICPA and the public. This study would seem supportive of decisive action by the AICPA, such as that cited earlier regarding termination of a firm that would not revise its response letter to quality review findings.

Content analysis provides an objective means to analyze this qualitative, subjective information. Accounting and auditing are often perceived as mechanistic functions where the power and meaning of words are of little use. This study highlights the importance of actual words in the peer review process. Analysis of the content of the disclosure document does provide additional information. This methodology should also apply to other accounting areas involving disclosure. Recent work considering disclosure language by analysts, companies in MD&A sections of annual reports, and lobbyists in letters to standard setters should be expanded to consider disclosure practices in press releases, regulatory filings, congressional hearings, and other settings of importance to policy decision makers and those involved in practice and education.

APPENDIX

Illustrative Letter from Peer Reviewee and AICPA

Member of the American Institute of Certified Public Accountants
SEC and Private Companies Practice Sections
Re: Peer Review-No. XXX

Gentlemen:

In response to the Letter of Comments we received from the Review Team dated YYY, please be advised of the following:

Finding: The firm's quality control policies and procedures, as outlined in the quality control document, state "all reports... are reviewed by appropriate supervisory personnel prior to the issuance of the report." We noted instances where this review was not adequate to prevent frequent departures from generally accepted accounting principles and/or inadequate disclosures in a substantial majority of engagements reviewed. However, nothing came to our attention which would require the application of the provisions of Statement of Auditing Standards No. 1 Section 561.

Reply: The firm currently is using a twenty-eight (28) page disclosure checklist developed by the New Jersey State Society, which is updated to provide for current pronouncements on an annual basis. In addition, training sessions have been scheduled to review disclosure requirements with all professional personnel with particular emphasis being made on disclosures indicated on the MFC's prepared by the Peer Review Team during our recent review. In addition, all in-charge accountants, including engagement partners have been instructed to expand their review of workpapers to ensure complete and adequate disclosure of all required footnotes. The Review Department has expanded its review process to ensure enough time to provide for a thorough review of disclosure requirements. Certain managers, supervisors and partners whom we consider to have strong technical skills, and appropriate authority are being utilized, when necessary to supplement the time required in the pre-issuance report review process, to guarantee compliance with disclosure requirements.

Finding: The firm's quality control document states that "all engagement working papers...are reviewed by appropriate supervisory personnel prior to the issuance of the report."

On certain engagements workpapers were missing, audit programs were not completed, checklists were missing, audit procedures performed were not documented, workpapers were not signed, and audit conclusions were not documented. Through discussions with engagement partners we were satisfied that sufficient procedures had been performed to form a basis for the issuance of a report.

Reply: The firm has taken many steps to ensure a more effective and efficient review of working papers. It has been re-emphasized to all that not only have the standards of the firm and the profession been met, as we feel they always have, but that the working papers contain sufficient documentation, to support this. Specific steps either already implemented or that are currently being implemented to ensure this are:

1. The scheduling partner, other partners, and in-charge accountant have been instructed to budget more time at the conclusion of the engagement to provide sufficient time for an in-depth review in the field of all workpapers to ensure:

(a) that the workpapers are complete, with all open items resolved.
(b) that sufficient evidence and conclusions reached are sufficiently documented.
(c) that all letters required have been obtained, i.e., engagement, representation, legal, et al.
(d) an evaluation of internal control has been documented.
(e) that all generally accepted accounting principles and all generally accepted auditing standards have been followed (including disclosure requirements).
(f) there is sufficient documentation to support the opinion, and the workpapers are ready for review by the engagement partner.

2. It has been emphasized to the engagement partners that their review is the most critical, since they are familiar with both the engagement and the client's business.

3. The final review by the Review Department has been expanded to include more key areas.

4. In addition, the firm has purchased Fast CPA, an audit software package program, from McGladrey, Hendrickson and Pullen which has already been implemented on many engagements and is currently being implemented on many more, which, as a part of the program, automatically documents a significant part of the audit process such as analytical review, etc.

To more properly educate the various levels of firm personnel, we have purchased from the A.I.C.P.A. the following video programs:

1. Video Capsule on SAS 41 entitled "Working Papers." This has been and will be presented to new personnel during their first week staff training.
2. Video Flex entitled "Working Paper Preparation" to be presented to all staff personnel.
3. Video Flex entitled to "Working Paper Review." This CPE program is for all in-charge staff including managers, supervisors, partners and the Review Department.

Several presentations of the above programs have already been made.

Finding: The firm's quality control policies and procedures, as outlined in the quality control document, state "the committee reviews the compliance files for completeness and resolves any exceptions as to compliance with the firm's independence policies and procedures. We noted instances where the disposition of exceptions noted on independence questionnaires completed by employees were not documented.

Reply: Although the disposition of exceptions was not noted on the individual independence questionnaires, it was demonstrated that anyone listing an independence exception, did not work on that particular client. The one instance where an independence exception was found to be not an independence problem was documented with a memo indicating the staff person could work on that particular client. In the future, all independence exceptions will be documented as to their disposition.

We would like to take this opportunity to thank the Review Team, the Peer Review Committee and the Public Oversight Board for the helpful observations made during our most recent Peer Review.

Very truly yours,

Sample Response Letter from AICPA

Dear XXX:

At its YYY meeting, the SECPS Peer Review Committee discussed the action requested of your firm in connection with the acceptance of its YYY peer review report. In light of the facts brought to its attention in your letter of YYY, the Committee voted to agree to your request that you submit a copy of your YYY inspection report to the Committee by YYY.

Your firm's agreement to take this action voluntarily demonstrates its commitment to the objectives of the Section. A copy of this letter will be placed in the public files of the Division for CPA Firms.

Sincerely,

Technical Manager
Quality Control Review

Boilerplate Letter from Technical Manager of Quality Control Review

Dear Mr. XXX:

It is my pleasure to notify you that on YYY the SECPS Peer Review Committee accepted the report on your firm's peer review, the accompanying letter of comments, and your response to the letter. Those documents will now be placed in the public files of the Division for CPA Firms.

As you know, the reviewers' opinion was unqualified. The Committee asked me to convey its congratulations to the firm.

Sincerely,

Technical Manager
Quality Control Review

ACKNOWLEDGMENT

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AN EMPIRICAL INVESTIGATION OF PROBLEM AUDITS

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ABSTRACT

This research is motivated by the continuing concern among regulators, the public, and the acounting profession about the role of auditors in the financial reporting process. Auditors have an obligation to develop norms of competence and ethical conduct while society has the right to continually monitor auditors to ensure they are meeting those obligations. This paper analyzes "problem audits" and concludes that when a client pays large audit fees, is in good financial condition, is management-controlled, and the engagement is either in the first year or beyond the fifth year, the auditor is more likely to fail to detect and/or report a misrepresentation by management. This view of audit failures was tested using publicly available data. Implications for auditors and regulators are discussed.

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INTRODUCTION

There has been continuing public and regulatory concern regarding the quality of financial reporting and the auditor's role in the financial reporting process (see, e.g., U.S. Senate Subcommittee Reports 1976, 1977; AICPA 1978; Securities and Exchange Commission 1979). The National Commission on Fraudulent Financial Reporting (1987), more popularly referred to as the Treadway Commission had, as one of its major objectives, the examination of the role of the independent public accountant in detecting fraud, with specific emphasis on "whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced," and "whether changes in auditing standards and procedures—internal and external—would reduce the extent of fraudulent financial reporting."

Such public concerns are consistent with Gaa's (1992) characterization of auditing as a contract between society and the public accounting profession. In this contract, society allows auditors to organize and practice their profession and grants, for example, the exclusive right to audit public companies; in return, the profession agrees to establish norms of competence and ethical behavior which will help to ensure socially responsible performance. On a continuing basis, we expect society to inquire and the profession to provide evidence as to how well the profession is "holding up its end of the bargain" (p. 14). Gaa's view of this social contract is that auditors have a moral obligation to "act in the interest of all members of society, and not just in their (own) self-interest" (p. 15) and that whether they actually behave this way is an empirical question.

This paper focuses on problem audits and can be viewed as an attempt to provide empirical evidence on the question of how well the auditing profession is holding up its end of the bargain. Problem audits are defined as instances of financial statement misrepresentations that are not detected or are not contested by the auditor. If, in fact, the auditors are acting strictly in accordance with their social contract, we would expect these problem audits to be somewhat random events. We suggest, however, that such problems arise because of a number of factors in the audit environment that affect the auditor's willingness to contest such misrepresentations and/or the auditor's ability to detect them in the first place.

The remainder of this paper consists of three sections. In the first section we characterize the audit as a function of the competence and independence of the auditor. We then provide a conceptual discussion about the situational variables that might affect the auditor and how we expect those variables to be related to problem audits. The second section explains how we chose our samples and measured the explanatory variables. The final section discusses the results, the limitations, and the policy implications of the research.

THE AUDIT ENVIRONMENT

Watts and Zimmerman (1981) have argued that the probability of an auditor reporting a financial statement-related problem depends on (1) the skill and effort of the auditor and (2) the honesty of the auditor.[1] The first condition refers to the auditor's competence; the likelihood of detection of a problem would be a function of such competence. The second condition is the auditor's independence with respect to a given client; the likelihood of reporting a problem that is detected would be a function of the independence of the auditor. An auditor has to be both competent and independent if financial statement misrepresentations are to be detected and reported.

The Watts and Zimmerman argument suggests that a failure to detect problems is a function of auditor competence alone. This argument is consistent with the professional auditing literature which has generally considered auditor skill, effort, and related issues such as due care to be distinct from the concept of independence. Shank (1978), on the other hand, adds another perspective to this analysis by suggesting that "the lack of a strong sense of independence, for example, might result in hurrying through the audit, thus violating the due care standard." An auditor who is not independent and who, therefore, does not expect to report even if a misrepresentation is detected, may find it cost-efficient to put less than adequate effort into the audit. That is, he or she may perform a minimum audit, enough to provide evidence of some effort for protection against potential lawsuits, but perhaps not enough to detect errors or irregularities. Thus an auditor's prior disposition not to report problems may include, in effect, a decision on how much effort to spend on the audit. If such effort is minimal, the resulting failure to detect, usually attributed to lack of competence, may in fact be an independence problem.

Based on the above analysis, an auditor's ability to detect and report misrepresentations in the presence of some of the situational variables characterizing the audit environment can be considered to be a function of two effects: (1) the impact of these variables on the auditor's ability to detect misrepresentations, and (2) the impact of these variables on the auditor's inclination to report misrepresentations. Because the situational variables can create both effects, in any particular instance, it may not be possible to specify whether it is a lack of competence or a lack of independence, or a combination of the two, which has led to the final outcome, namely, the release of financial statements with misrepresentations.

Detection effects arise from variables that affect the complexity of the audit in terms of the audit procedures to be used, the volume of work, and so forth. An example would be the size of the audit client. The audit of a large client can be more complex and might make it more difficult to detect misrepresentations than in the audit of a small client.

We characterize the second effect (the one that affects an auditor's willingness to report) as a function of the economic incentives of auditors. The approach in this study adopts Antle's (1984) view of the auditor as an economic agent making self-interested decisions. The economic incentives are created by circumstances that go beyond the narrow and very specific auditor-client relationships prohibited by the SEC and AICPA independence rules.[2] The situational factors identified in this study are empirically linked to the broader measure of auditor independence suggested by Shank which includes both the failure to detect misrepresentations and the failure to report them when detected.[3] Again, using client size as an example, an auditor may be less willing to report misrepresentations if it could result in the loss of significant client revenues.

By portraying the auditor as a rational, expected utility maximizer, we expect the auditor to report misrepresentations when the expected utility of reporting exceeds the expected utility of not reporting. For example, failing to report a misrepresentation could result in lawsuits and dimunition of reputation. Reporting, on the other hand, could result in loss of specific client revenues. The variables considered in this study relate to such considerations as the economic value of the client, the probability of detection of errors or irregularities, the probability of termination by the client, and the probability that an unreported misrepresentation will be detected by a third party.

The results of this study show that problem audits, as we define them, are more likely to occur when clients (1) pay large audit fees, (2) are management-controlled, (3) are in relatively good financial condition, and (4) either have a new auditor or have been audited by the current auditor for more than five years. The rationale for the choice of the variables and the predicted relationships are described below. Because the rationale is developed on the basis of the two types of effects described earlier, the choice of the variables will be justified below for both the economic incentives effect and the detection effect.

Revenues from Client

1. *Economic incentives effect.* An auditor who has detected a misrepresentation and wishes to report it faces the possibility of being fired by client-management. As an executive from a large accounting firm has said (*Wall Street Journal*, May 12, 1983), "Once you give a qualified report you always have a cloud over you. Two years later it may happen that you're fired, but ostensibly for some other reason." An auditor's decision to report a misrepresentation would depend on the likelihood that termination would result and the economic impact of that termination. The costs of termination include the loss of fees from the client. The prospect of losing a client who contributes a substantial amount of revenues could reasonably be expected to affect the auditor's decision.

In addition to lost revenues, there are search costs involved in finding new clients. While recurring costs may be routinely incurred to attract new clients, such costs would be increased when large clients are lost. In addition, some of the costs of maintaining the practice tend to be related directly to the number of clients rather than the volume of audit work involved. For example, when clients are geographically dispersed, there are costs to coordinating activities (Benston 1980) which may be more directly related to the number of clients. When a single client who is the source of large revenues is lost, two or more new clients may be needed to replace the revenue potential of the lost client, leading to higher coordination costs without a proportional increase in revenues. Thus, it is proposed that, ceteris paribus, an auditor will be less likely to take actions which would jeopardize the auditor-client relationship when that client pays large audit fees.

2. *Detection effect.* Clients from whom auditors get substantial fees or revenues are also likely to be larger and/or more difficult to audit.[4] In such a situation it is more likely that, despite adhering to due care standards, the auditor will fail to detect one or more financial statement errors. This provides another reason why an auditor may fail to report financial statement misrepresentations by large audit clients.

Based on the two effects described above it is hypothesized that

Hypothesis 1. The greater the revenues from an audit client, the greater the likelihood that an auditor will fail to detect and/or report a misrepresentation.

Owner Versus Management Control

1. *Economic incentives effect.* While the potential loss of fees upon termination by a big client may motivate an auditor not to report a misrepresentation, the decision to terminate is made by the client, considering its own cost-benefit trade-offs.[5] From the auditor's perspective, the greater the likelihood of termination, the greater the incentive not to report.

Based on prior studies, Dhaliwal et al. (1982) have suggested that managers of large corporations with diffuse ownership have considerable discretion in guiding the affairs of their firm, in contrast to owner-controlled firms where the owners can more readily motivate and monitor the behavior of managers. In management-controlled firms, management may have greater discretion in appointing and terminating auditors. Therefore, the auditors of these firms are likely to perceive the probability of their being terminated as greater, if they choose to report a misrepresentation by management.

2. *Detection effect.* Management-controlled firms are less likely to be constrained by their own internal control systems and may, therefore, make it more difficult for auditors to detect errors, irregularities or misstatements that they have effected.

Based on the two effects described above, it is hypothesized that

Hypothesis 2. The probability of an auditor's failure to detect and/or report a misrepresentation is greater in management-controlled client firms than in owner-controlled client firms.

Financial Condition of Client

1. *Economic incentives effect.* In a study of actuaries' perceptions of factors affecting auditors' liability, Schultz and Gustavson (1978) found that financially weak clients are perceived as being more likely to be sued. They argue that the probability that an auditor's work will be scrutinized by third parties is low unless some catastrophic event (such as a business failure) occurs. Similarly, in an empirical analysis of auditor liability, St. Pierre and Anderson (1984) found that financial difficulty of clients was associated with lawsuits against auditors. When an auditor fails to detect and/or report misrepresentations made by such clients, because of the greater likelihood of scrutiny by the public, it is more likely that the auditor's failure to report would be discovered. Such public damage to the auditor's reputation and the possibility of being sued by creditors and shareholders should cause an auditor to be more willing to report the misrepresentations of clients who are experiencing significant financial difficulty.

2. *Detection effect.* It can be argued that client companies that are in financial trouble have more incentive to misrepresent in order to make their financial condition appear better than it actually is. Knowing this, the auditor should exert more effort in the audit, thereby increasing the probability of detection.

Based on the two effects described above it is hypothesized that

Hypothesis 3. The weaker the financial condition of an audit client, the lower is the probability that the auditor will fail to detect and/or report a misrepresentation.

Duration of Auditor-Client Relationship

1. *Economic incentives effect.* While an audit involves considerable learning costs with a new client, the learning effect leads to significant cost efficiencies after the first few periods because of the accumulated knowledge of, and familiarity with, client operations. Thus the later periods in the auditor-client association would be periods of relatively stable and positive cash flows. The likelihood of losing these cash flows could be a significant influence in motivating the auditor to not report misrepresentations in the client's financial statements. Thus the length of the auditor-client

relationship can create economic incentives for the auditor to choose a particular reporting option. Additionally, the first year of the audit has some unique characteristics. Despite the high initial start-up costs, it might be in the auditor's best interest to avoid an early disruption of the relationship with a new client whose full future revenue potential is still an unknown.

2. *Detection effect.* When an auditor has been with a client for a considerable period of time, familiarity with the client's operations and books, as well as with client personnel, may lead the auditor to expect few/no problems in the audit and therefore do a minimal, or less than adequate, audit. For this reason, more financial statement errors may go undetected in later years resulting in more problem audits. On the other hand, lack of familiarity in the first year may make it more difficult to detect problems.

Based on the two effects described above it is hypothesized that

Hypothesis 4. Problem audits are more likely to occur in the first year of an audit and in the later years of an auditor-client relationship and less likely to occur during the intervening time period.

In the next section, we discuss our research approach, sample selection issues, and how we operationalize the explanatory variables discussed above.

RESEARCH APPROACH

Our intent is to distinguish a sample of problem audits from a sample of audits for which there is some evidence that auditors detected errors or misrepresentations and intended to report them. Reporting, of course, would also include actions to induce the client to correct errors or to remove misrepresentations. We test the conceptual model that problem audits are a function of the situational factors discussed in the preceding section.

Sample Selection

Although our discussion of hypotheses refers to problem audits in terms of a probability (i.e., as a continuous variable), the actual outcome is dichotomous: either it meets our definition as a problem or it does not. In operationalizing the dependent variable, this study uses a dichotomous measure by using two samples. The first sample consists of problem audits; the second sample consists of certain clients who experienced a change of auditors.

Figure 1 presents a framework to help us identify the appropriate populations from which to sample. This framework analyzes the outcomes of various combinations of auditor and client-management decisions or actions.

Given that management makes a misrepresentation, there are two possible paths (labeled Path 1 and Path 2) by which the misrepresentation may appear in published financial statements. First, the auditor could fail to detect the misrepresentation (Path 1). Path 1 is more likely when the auditor audits less intensively or is less competent. Second, the auditor could detect the misrepresentation but decide not to report it (Path 2). It is assumed that a misrepresentation appearing in the financial statements becomes public knowledge only if it is discovered and revealed by an outside party. These cases will be referred to as *reported problem audits.* Empirically, it is difficult to distinguish between the two possible reasons that the auditor did not report the misrepresentation. Figure 1 also shows that if the auditor detects a misrepresentation and decides to report it, management must either correct the misrepresentation, accept a modified opinion, or replace the auditor. Each of these outcomes is consistent with the auditor acting independently. However, while auditor changes and qualified opinions are both publicly observable outcomes, it is generally not possible to identify cases in which management agrees to correct the misrepresentation before the financial statements are issued. Finally, while they may be observable, qualifications for errors or misrepresentations by public companies are extremely rare.

The sample of cases used for this study is drawn from the boxes labeled "Reported Problem Audit" and "Change Auditor" in Figure 1. Figure 2 presents the sampling plan which we used to identify companies for our database. As described below, this study uses large auditor-public client pairs and focuses on auditor responses to attempted misrepresentations.[6] In Figure 2, box *1* represents a reported problem audit. Box *2* is an unreported problem audit, not systematically identifiable with publicly available information. These two boxes exhaust our possible sources of problem audit cases. For

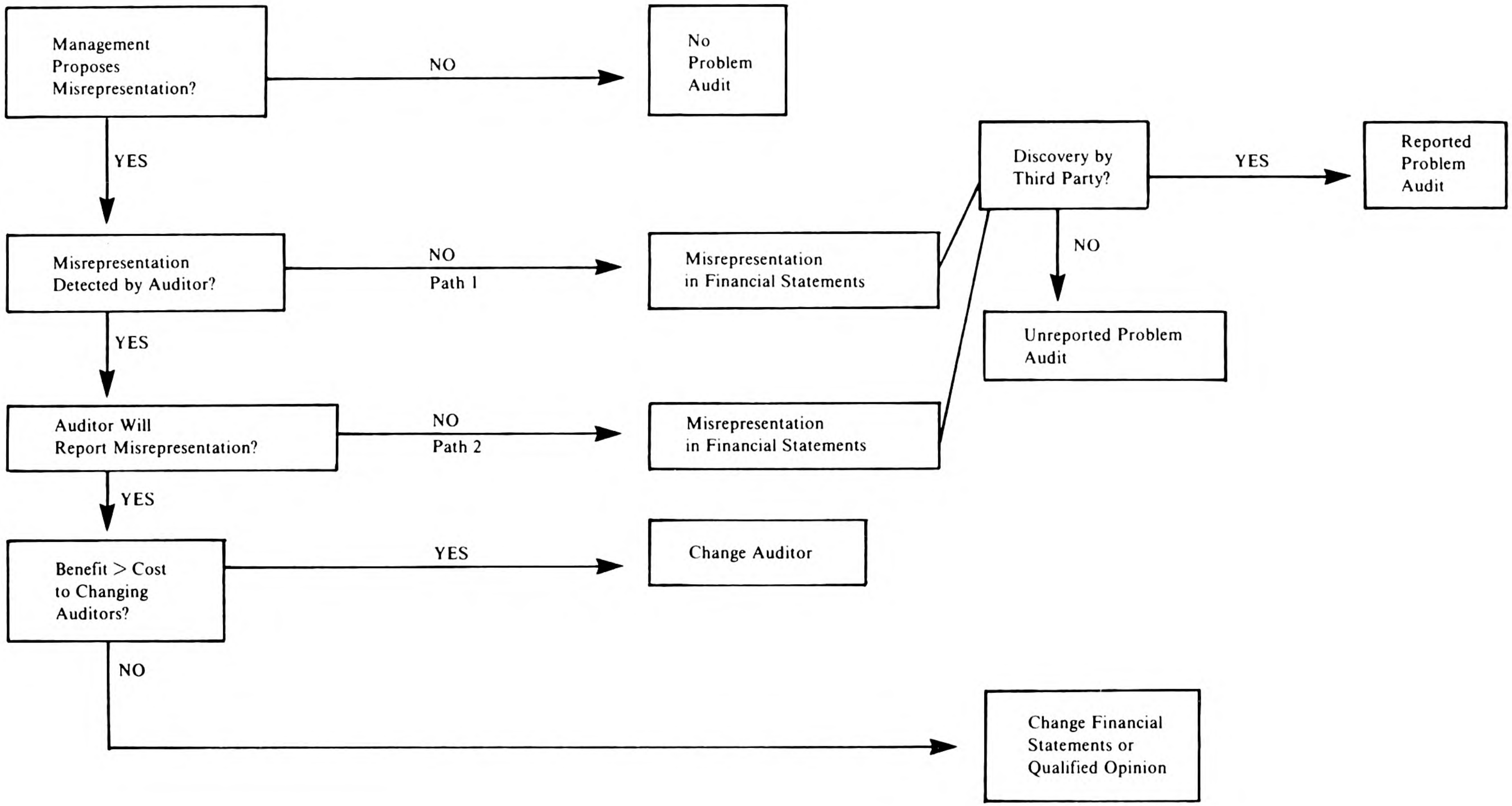
Management
Proposes
Misrepresentation?
NO
No
Problem
Audit
YES
Misrepresentation
Detected by Auditor?
NO
Path 1
Misrepresentation
in Financial Statements
YES
Auditor Will
Report Misrepresentation?
NO
Path 2
Misrepresentation
in Financial Statements
YES
Benefit > Cost
to Changing
Auditors?
YES
Change Auditor
NO
Change Financial
Statements or
Qualified Opinion
Discovery by
Third Party?
YES
Reported
Problem
Audit
NO
Unreported Problem
Audit

Figure 1. A Framework of Auditor-Management Decisions

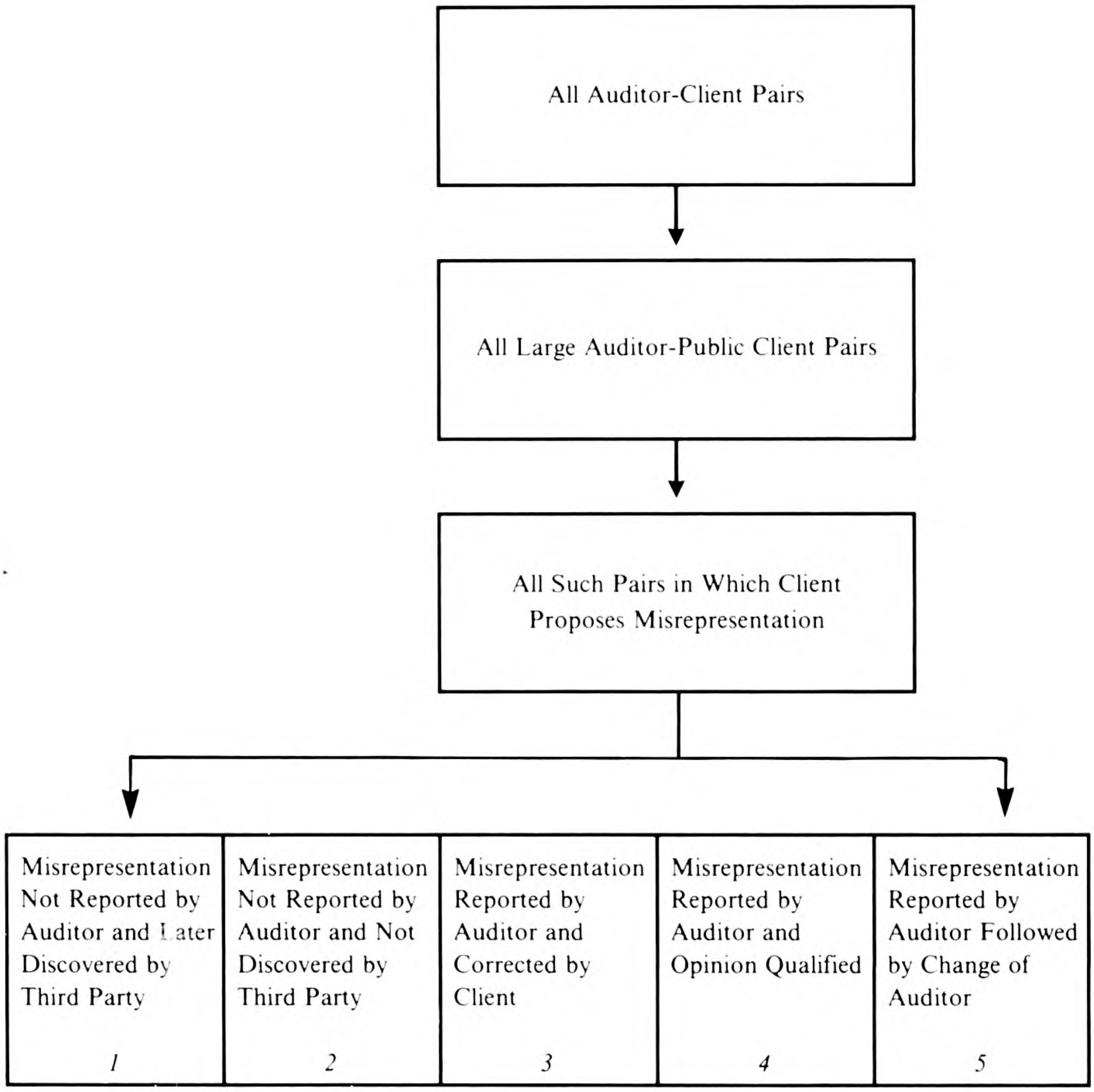
All Auditor-Client Pairs
All Large Auditor-Public Client Pairs
All Such Pairs in Which Client Proposes Misrepresentation
Misrepresentation Not Reported by Auditor and Later Discovered by Third Party
1
Misrepresentation Not Reported by Auditor and Not Discovered by Third Party
2
Misrepresentation Reported by Auditor and Corrected by Client
3
Misrepresentation Reported by Auditor and Opinion Qualified
4
Misrepresentation Reported by Auditor Followed by Change of Auditor
5

Figure 2. Flowchart of Sampling Plan

the second group, every case that is not a problem audit would theoretically qualify for inclusion. But, as noted earlier, we are looking only at cases involving client misrepresentations. While boxes *3*, *4*, and *5* would represent all nonproblem audits in this restricted population, we must restrict ourselves to box *5*. We cannot reliably identify cases represented in box *3* and, while box *4* cases would be identifiable, it is not common for the SEC to accept financial statement filings with reported misrepresentations in them. However, the cases in box *5*, in addition to being easily identifiable, also encompass those instances where the auditor has apparently taken such exception to some management reporting option that the auditor's response has led to termination of the auditor-client relationship. The cases in box 5, therefore, constitute the sample against which we contrast the problem audits.

Problem Audit Cases

The problem audits in this study are represented by instances where the Securities and Exchange Commission had ruled that financial statements filed with it by a registrant contained misrepresentations. A sample of such cases was identified from the SEC Docket, a weekly publication which provides details on all administrative, civil and criminal actions taken by the SEC. Of all those cases involving reporting companies listed in the Docket, only those companies were included for which data could be collected on the independent variables. Cases were restricted to the clients of the 18 largest CPA firms from 1977 to 1984. First, only during this period were companies required to report in the proxy statements the amount of fees paid for nonaudit services as a percentage of the total audit fees paid. Because the information on nonaudit fees is necessary to compute the total revenues from the client, the restriction to the 1977-1984 period was necessary. Second, the restriction to the largest 18 CPA firms was necessary because total audit firm revenue (including public and private clients) was available in the *Public Accounting Report* (*PAR*) for this period only for these 18 accounting firms.

A further restriction was to limit the sample to clients who had filed proxy statements for the year prior to the SEC action. The 81 cases that satisfied these requirements will be referred to as the Problem Group. The types of misrepresentations within the Problem Group vary widely and are described in the SEC reports as over/understatements of revenues and expenses; omissions, false statements, and inadequate disclosures; over/understatements of assets and liabilities; and misinterpretations of GAAP. A complete list of the companies in this group and the type of misrepresentations involved is provided in Appendix A. The list includes companies of varying sizes, prominence, and industry concentration.

Nonproblem Audit Cases

The sample for this group comes from the cases in box 5 of Figure 2. This group is hereinafter referred to as the Change Group. In order to maximize the probability that change was due to a conflict between management and the auditors, the sample was restricted to instances in which either (a) the reason given for the change (by either or both parties) was a disagreement between client and auditor; or (b) the change immediately followed a year in which the client received a qualified (subject to) opinion. The sample was taken from *PAR* from February 1978 to September 1984. As for the problem audit cases, we further restricted the sample to cases involving the largest 18 CPA firms and public clients with complete data. The sample included 78 auditor changes.[7]

The Explanatory Variables

Revenues from Clients

Client total revenues are the sum of audit and non-audit revenues from a particular client. Audit revenues were estimated as a square root function of client assets (Simunic 1980). Nonaudit revenues were obtained from proxy statement information. A distinction was made between audit and nonaudit revenues because of the persistent, if anecdotal, belief in the accounting literature that nonaudit services are more profitable and hence more attractive to the auditor. Support for this belief had been found by Simunic (1984) who concludes tentatively that audit fees are higher for clients who also purchase management services from their auditor. However, the resulting measures of audit revenue and nonaudit revenue were so highly correlated in our sample data that they could not be examined separately.[8]

Control

The extent of management control was operationalized by adapting the Dhaliwal et al. measure. A company was classified as manager-controlled if no outsider (nonmanager) held more than a 5% interest in the company's stock. All other firms were classified as owner-controlled.

Financial Condition

The measure of financial distress used in this study is based on the loan classification model developed by Dietrich and Kaplan (1982). This model measures the probability of loan default as a function of the debt to equity ratio, the fixed charges coverage ratio, and a three-year sales trend. Lower scores for the dependent variable indicate a company which is a good financial risk. Conversely, higher scores reflect greater financial distress. Data on the financial variables used in the Dietrich and Kaplan model were obtained from the annual reports of the sample companies.

Length of Auditor-Client Relationship

To operationalize this variable, client firms were classified into one of three categories. The first category was for first year audits; the second was for relationships of two to five years, inclusive; and the third category was for relationships of more than five years. This classification of auditor-client relationships is consistent with the empirical findings of Levinthal and Fichman (1988).

ANALYSIS AND DISCUSSION OF RESULTS[9]

Table 1 presents summary descriptive information about the firms in the two samples. As an initial indication of the soundness of our hypotheses, univariate tests were conducted for each of the independent variables. For the continuous independent variables (client revenues and financial condition), *t*-tests showed that the mean measures in the Problem Group and Change Group were significantly different ($p < 0.01$). For the categorical measures (management control and auditor tenure), chi-square tests indicated that the two groups were significantly different on both independent variables ($p < 0.01$ for the tenure variable; and $p < 0.05$ for the control variable). In all cases the differences were in the hypothesized direction. In other words, for each of the situational variables that we specified, the Problem Group is significantly different from the Change Group.

To test all the hypotheses and each of the independent variables simultaneously, we used probit analysis, a statistical technique that is appropriate in instances where the operational measure of the dependent variable is dichotomous (McKelvey and Zavoina 1975). This analysis provided strong support for our hypotheses. Each of the estimated coefficients on the independent variables has the predicted sign, and all are significantly different from zero at conventional significance levels except for the owner-manager

Table 1. Sample Descriptive Data

	Problem Group (n = 81)	*Change Group (n = 78)*
Client Total Revenues ($ millions)		
Mean	1.36	0.21
Minimum	0.04	0.02
Maximum	10.08	1.80
Financial Distress Score*		
Mean	-3.7	−0.8
Minimum	−67.7	−30.8
Maximum	3.8	10.9
Control (# of instances)		
Management Control	48	32
Owner Control	33	46
Auditor Tenure (# of instances)		
First Year Audit	8	5
Two to Five Years	6	36
More than Five Years	67	37

Note: * Lower scores indicate better financial condition.

control variable. In general, the empirical results support the hypothesized model of problem audits. The explanatory power of the probit model (pseudo $R^2 = 0.355$) is quite high given the admittedly noisy measurement of the variables we examined. In addition, the probit model correctly classifies 79% of the sample.

DISCUSSION

This research was motivated by the continuing concern among regulators, the public, and the accounting profession about the role of auditors in the financial reporting process. A theoretical analysis of the impact of situational variables in the auditor-client environment was developed. It was hypothesized that when a client contributes a substantial amount of revenues to the auditor, is in good financial condition, is management-controlled, and has engaged the auditor for either a very short or a long period of time, the auditor is more likely to fail to detect and/or report a misrepresentation by management. This view of problem audits was empirically tested using publicly available data. The results of the statistical tests are consistent with the hypotheses regarding the impact of revenues, financial condition, and tenure. The empirical results for the management-control variable are in the hypothesized direction but not significant. Model validation procedures indicate that the model is rather robust.

A limitation of this analysis is that the independent variables, which are treated as exogenous (size of audit fees, client financial condition, client control by management, and auditor tenure), might more properly be treated as endogenous. By making these variables exogenous, the analysis fails to incorporate fully the incentives of investors and management to respond to the auditor's strategic behavior. As a result, it is possible that the statistical association which is reported may reflect these omitted incentives in addition to those captured by the model.

It is also possible that the empirical results could not be extended to other audit situations because of the sample selection procedures. While the target population of interest is the population of all auditor-client pairs, the three successive reductions outlined in Figure 2 could have biased the results. The first reduction was necessitated for data availability reasons and, consequently, inferences from this study must be restricted to the reduced population of all publicly held clients of the largest CPA firms. The second reduction in Figure 2 was required by the fact that the model focuses on the actions of an auditor given that the client has decided to misrepresent. While the investigation of management incentives and ability to misrepresent is both interesting and important, it is beyond the scope of this paper. At this point, inferences can be drawn only to that population where management attempted a misrepresentation.

The final reduction in Figure 2 is in the choice of the Problem and Change groups. The Problem Group consists of a nonrandom sample of all those cases in which a misrepresentation was not reported by the auditor. In fact, the SEC made the selection of this group for this study and any biases in their investigation and action policies represent biases in the sample. In particular, we must consider whether the SEC selection is biased in favor of the hypotheses. The results of this study would be weakened by evidence that the SEC investigates and pursues large companies that are management controlled, that are in good financial condition, and that have had the same auditor for less than two or more than five years. However, there is evidence to suggest that the actual profile of SEC targets is quite different from this. In an exhaustive study of SEC actions, using both public and insider information, Shapiro (1984) characterizes

SEC targets as smaller companies in financial difficulty. There is also anecdotal evidence from former SEC Academic Fellows that suggests that action is taken against companies when the probability of the SEC prevailing is high. This occurs most often when the company is smaller and is audited by a smaller CPA firm. In summary, there appears to be no reason to suspect that the SEC selection process is biased in favor of this study's hypotheses.

On the basis of these results, the above caveats notwithstanding, it seems reasonable to view problem audits as related to variables in the audit environment which affect both the complexity of the audit and the economic incentives facing a rational auditor. The data support the idea that while auditors may sometimes be prevented from doing an effective audit because of circumstances in the audit environment which are not controllable by them, they may also have been associated with problems as a result of actions taken after weighing the costs and benefits of decisions to detect and report misrepresentations by management.

What are the implications of this study for the profession and for the agencies charged with monitoring the contract between society and the accounting profession? Most readers will probably stop short of concluding that the auditors associated with the problem audits in this study did anything wrong. That is, they may not have violated any of the technical or ethical norms of conduct in the professional literature; and they may not have violated any of the securities laws.[10] On the other hand, it would be difficult to deny the apparent dissatisfaction with the current social contract on the part of many regulators and investors. As Gaa (1992) notes, the profession (as do regulators) promulgates norms for the conduct of its members. Over time, those norms and rules must satisfy society that the profession is meeting its obligations. The results of this study may suggest a need for rexamining some of those rules.

Both the AICPA and the SEC have proscribed certain relationships between auditors and clients. Gaa (1992) characterizes these relationships as direct conflicts of interest and notes that many relationships with potential or latent conflicts of interest are allowed. Our results that connect audit fees and the length of the auditor-client relationship with problem audits are relevant here. Perhaps we need to be more explicit in the kinds of relationships that may interfere with independence. The perceived problem of long-term relationships which has already generated support for mandatory auditor rotation has empirical support in this paper. This should be tempered, however, by the fact that our results also support the AICPA's contention that first-year audits are a problem as well.

The result that problem audits are also associated with healthy firms also points out a framing problem in the AICPA technical literature. Discussions of risk analysis always point out the inherent risk of a firm whose performance is below industry standards, but they do not point out the risk that auditors may become complacent with clients in good financial condition.

Finally, we believe our results will have instructional value to the profession. Auditing is not an activity that provides immediate feedback as to the quality of performance. Individuals or even firms may find it difficult to learn or adapt without such feedback. Studies like this one, however, can compile information across many engagements over several years. Profiles of the problem audits can be valuable in assessing the risks of different audit engagements.

APPENDIX A

Problem Group Firms

1.	Aeronca	Overstatement of inventory.
2.	AES Technology Systems	Misleading disclosures regarding sales, including overstatement of sales.
3.	Aetna Life & Casualty	Timing of tax loss carryforward benefits recognition; accounting method boosted earnings.
4.	Alpex Computer	Various accounting irregularities leading to falsification of financials.
5.	AM International	Inflation of profits by improper adjustment to allowance and accrual accounts.
6.	American Bakeries	Inadequate and misleading financial disclosures.
7.	Ashland Oil	Illegal payments disclosure violations.
8.	Associated Dry Goods	Use of accounting method to understate true debt picture and overstate earnings.
9.	Barden	Wrong revenue recognition methods.
10.	Beatrice Foods	False recording of questionable discounts relating to dairy rebates and discount lending.
11.	Bethlehem Steel	Inadequate disclosures regarding improper payments.
12.	Burroughs	Improper accounting leading to misstatement of earnings.
13.	Chronar	Overstatement of revenues and earnings.
14.	Clabir	Improper accounting re: marketable securities.
15.	Clark Oil & Refining	Improper record of payments leading to false and misleading filing.

16.	Coleco	Material understatement of expenses and overstatement of earnings.
17.	Colonial Penn Group	Inadequate disclosure of insurance reserves and of change in accounting methods.
18.	Comserv	Improper revenue recognition to inflate revenue and earnings.
19.	Continental Illinois	Overstatement of profits by maintaining too low loan reserves.
20.	Covington Brothers	Misleading financial statement disclosures.
21.	Crown Cork & Seal	Misstatements in accounts receivable; improper records.
22.	Data Access Systems	Improper recognition of sales.
23.	Datametrics	Overstatement of revenues.
24.	Datapoint	Overstatement of sales.
25.	Digilog	Failure to disclose certain losses.
26.	Empire of Carolina	Improper disclosure regarding diversion of funds.
27.	Exxon	Debt reduction method questioned.
28.	Financial Corp. of America	Improper valuation of loan portfolio.
29.	First Chicago Corp.	Improper boosting of reported earnings and valuation of foreign loans.
30.	First Penn Corp.	Improprieties in stock trading and disclosures regarding gone bad.
31.	Flight Transportation	Overstatement of revenues.
32.	Florafax International	Overstatement of earnings.
33.	Flow General	Omission of material financial disclosures.
34.	Franklin Mint	Improper reporting of sales and earnings.
35.	Gamble Skogmo	False disclosures of financial condition.
36.	Gelco	Improper accounting for unit trade allowance.
37.	General Dynamics	Failure to recognize losses on Navy contracts.
38.	Grumman Corp.	Questionable payments and inadequate disclosures.
39.	Gulf Energy	False and misleading statements to boost stock sales.
40.	H.J. Heinz	Income smoothing practices.
41.	Heinicke Instruments	False financial disclosures in annual reports.
42.	HI-G	Earnings, assets and net worth misrepresented.
43.	Hospital Corp. of America	Failure to disclose amounts received under foreign contracts.
44.	ITT	Improper foreign payments.
45.	Intrawest Financial	Overstatement of earnings.
46.	Itel	Failure to write off certain losses.
47.	J.C. Penney	Improper interpretation of accounting rule on leases.
48.	KMart	Improper interpretation of accounting rule on leases.
49.	Kellogg	Debt reduction method questioned.
50.	Koracorp	Overstatement of receivables.
51.	Litton Industries	Delayed recognition of losses accumulating in prior years.
52.	LTV	Improper inventory valuation.
53.	McCormick	Inflation of revenues.
54.	McClouth Steel	Incorrect use of equity method; other misrepresentations regarding earnings and investment values.
55.	Michigan National	Inadequate loan loss reserves; inadequate disclosure of real estate transactions.

56.	Mobil	False and misleading disclosure regarding transactions with president's son.
57.	Modular Computer	Improper revenue recognition and understatement of expenses.
58.	Nucorp Energy	Improper accounting and stock manipulation practices.
59.	Occidental Petroleum	Questionable payments; inadequate disclosure of material facts.
60.	Peabody International	Improper deferral of costs.
61.	Petro-Lewis	False financial disclosures.
62.	Ronson	Improper inflation of income.
63.	Rusco Industries	Failure to disclose certain transactions involving use of corporate funds.
64.	Sam P. Wallace	Improper foreign payments.
65.	Saxon Industries	False financials—nonexistent inventories.
66.	Scottish S&L	Financials deviating from GAAP—improper deferral of losses.
67.	Seafirst	Violation of financial disclosure requirements with respect to losses.
68.	Seatrain Lines	Inadequate disclosure of rebates to shipping customers and of liabilities.
69.	Southeast S&L	Financial statements deviating from GAAP—improper deferral of losses.
70.	S.W. Bankshares	Inadequate loan loss reserves.
71.	Stauffer Chemical	Non-GAAP methods in inventory valuation and revenue recognition.
72.	Tandem Computers	Overstatement of revenues.
73.	Tandy Brands	Overstatement of assets and earnings.
74.	Telex	Lax accounting controls leading to misleading disclosures.
75.	Textron	Concealing questionable foreign payments.
76.	U.S. Surgical	Overstatement of earnings.
77.	Utica Bankshares	Understatement of loan loss reserves.
78.	Vornado	Inadequate disclosures of inventory.
79.	Wheeling-Pittsburgh	Improper financial disclosures.
80.	Wickes	False and misleading disclosure of financial condition.
81.	Zondervan	Substantial financial reporting inaccuracies.

APPENDIX B

Analysis and Model Validation

Tables B1, B2, and B3 present additional statistical information relevant to our data analysis. Table B1 presents a correlation matrix for the independent variables and reveals no multicollinearity problems which might hinder interpretation of the analyses described below.

Table B1. Correlation Matrix

	REV	*FDS*	*CTL*	*TEN1*	*TEN2*
REV	1.000				
FDS	−0.062	1.000			
CTL	0.141*	−0.038	1.000		
TEN1	−0.122	−0.132*	0.113	1.000	
TEN2	0.288***	0.013	0.071	−0.410***	1.000

Notes: * $p < 0.10$
** $p < 0.05$
*** $p < 0.01$
REV: Total fees paid to auditor
FDS: Financial distress score
CTL: 1 (management controlled) if no outsider holds 5% ownership; 0 otherwise
TEN1: 1 if first-year audit; 0 otherwise
TEN2: 1 if auditor-client relationship exceeds five years; 0 otherwise

As an initial indication of the soundness of our hypotheses, univariate tests were conducted for each of the independent variables. For the continuous independent variables (REV and FDS), *t*-tests showed that the mean measures in the Problem Group and Change Group were significantly different ($p < 0.01$). For the dichotomous measures (CTL, TEN1, and TEN2), chi-square tests indicated that the two groups were significantly different on both independent variables ($p < 0.01$ for TEN1 and TEN2; and $p < 0.05$ for CTL). In all cases the differences were in the hypothesized direction.

To test all the hypotheses and each of the independent variables simultaneously, we used probit analysis, a technique that is appropriate in instances where the underlying metric of the dependent variable is continuous while the operational measure of it is dichotomous (McKelvey and Zavoina 1975). This description fits the dependent variable in this study. The probit results are reported in Table B2. Each of the estimated coefficients on the independent variables has the predicted sign, and all are significantly different from zero at conventional significance levels except for the owner-manager control variable (CTL). In general, the empirical results support the hypothesized model of audit failures.

The results can be viewed from two perspectives. First, the primary test of the hypotheses involves the tests of significance of the coefficients of the individual independent variables. This criterion is important given that we posit a view of audit failures which specifies factors believed to influence the likelihood of failures. Because all of the signs are as predicted and the coefficients are generally

Table B2. Dichotomous Probit: Problem Group ($n = 81$) vs. Change Group ($n = 78$)

Independent Variable	*Predicted Sign*	*Probit Coefficient (t-statistic)*
REV	+	1.4900 (4.0230)***
FDS	−	−0.0499 (−1.9600)**
CTL	+	0.1805 (1.7351)*
TEN1	+	1.4645 (3.1768)***
TEN2	+	0.9667 (3.1644)***
CONSTANT		−1.6115 (−5.4321)***

Notes: * $p < 0.10$
** $p < 0.05$
*** $p < 0.01$
Log likelihood function = −71; chi-square = 78.48 ($p <$ 0.001). Pseudo R^2 = 0.355. Proportion of correct classifications = 0.79

statistically significant, the results confirm the hypothesized relationships. A second perspective on the results concerns the explanatory power of the probit model. First, the log likelihood ratio statistic of −71, as reported in the bottom of Table B2, indicates that the hypothesis that all probit coefficients are zero is rejected at the 0.01 significance level. Second, the pseudo R-square value of 0.355 in Table B2 can be considered to be relatively high given the relatively small number of variables in the model and given the admittedly noisy measurement of those variables. In addition, the probit model correctly classifies 79% of the sample as opposed to 51% using a naive prediction model.

Model Validation

The following procedures were performed to test the strength and robustness of the results. First, the revenue variable REV, which is an absolute measure, was replaced with two alternative, relative measures of revenue. The first relative measure (REVF) is the ratio of total revenue from the client to total revenue of the accounting firm. Audit firm revenues were obtained from the Public Accounting Report. The second relative measure (REVO) is the ratio of revenue from a specific client to the total revenue of the specific audit firm office that handled the audit. Revenues of a particular office of an accounting firm were estimated as a percentage of total audit firm revenues. The percentage was the ratio of professional staff in the office to the total number of professional staff in the auditing firm (obtained from AICPA's Membership Directory 1981). In both cases the probit results were consistent but slightly weaker with the alternative measures of the revenue variable.

Second, a jackknife procedure was used to test the strength and robustness of the results. This method provides an assessment of the stability and significance of results without requiring a large sample (Miller 1964) through sample reuse. The essence of the approach is to partition out the effect of a particular subset of the data on an estimate derived from the total sample (Crask and Perreault 1977). The total sample was divided into nine subsets with Problem Group and Change Group cases drawn at random. The probit analysis was repeated nine times with systematic deletion of a different subgroup each time. This yielded nine different pseudo values for each independent variable. The average of the pseudo values was the jackknife coefficient for each variable. Each jackknifed coefficient was divided by its associated standard error to give a *t*-value. Table B3 presents the jackknife coefficient and the associated *t*-value and significance level for each of the independent variables. The results

Table B3. Jackknife Procedure for Robustness of Probit Results: Problem Group ($n = 81$) vs. Change Group ($n = 78$)

Independent Variable	*Predicted Sign*	*Jackknife Coefficient (t-statistic)*
REV	+	1.3233
		(3.509)***
FDS	−	−0.0432
		(−1.450)*
CTL	+	0.1888
		(0.729)
TEN1	+	1.3334
		(2.839)**
TEN2	+	0.9482
		(3.184)**

Notes: * $p < 0.10$
** $p < 0.05$
*** $p < 0.01$

of the jackknife analysis indicate that the coefficients for the independent variables are relatively stable. As compared to the Table B2 probit results, the jackknife results in almost every case show a slight reduction in the coefficient and in the *t*-statistic, with a somewhat larger reduction in the *t*-statistic for the management control variable (CTL).

NOTES

1. DeAngelo (1981) uses a similar conceptualization. Johnson and Lys (1990) refer to the probability of detecting an error as expertise and the probability of revealing a detected error as integrity. All of these are consistent with the norms of competence and ethical behavior described by Gaa (1992).

2. For example, the AICPA independence and integrity ethics rulings (101 and 102) consider that independence is impaired if the auditor acquires any direct or a material indirect financial interest in the client; has any material joint investment with any client, officer, or stockholder of the client; and is a trustee of any trust or executor of any estate having direct or material indirect interest in the client, and so forth.

3. Prior conceptual studies on independence (Goldman and Barlev 1974; Nichols and Price 1976) which form the basis for this approach have not been empirically tested. Prior empirical tests (Lavin 1976; Firth 1980; Shockley 1981), on the other hand, have all been limited to examining users' perceptions of the independence of auditors.

4. Size, of course, is a simplistic measure of detection difficulties. Loebbecke et al. (1989) cite well over fifty indicators that affect the probability of the existence of material irregularities and fraud. Similarly, Cogliatore and Berryman (1988) discuss the detailed, firm and industry-specific knowledge necessary to detect misstatements.

5. A framework of auditor-management decisions is presented in Figure 1, to be discussed later.

6. We are using a partial equilibrium approach which ignores the interesting but difficult questions surrounding the reasons managers attempt misrepresentations given their knowledge of possible auditor strategies.

7. *PAR* reported over 1,000 auditor changes involving the largest 18 CPA firms during this period. Of these, 165 were judged by the authors to unambiguously represent disagreements between auditor and client. Our sample of 78 represented all such changes for which data requirements were met.

8. In retrospect, therefore, our restriction to clients filing proxies with this information was not necessary. Future research should use a broader sample.

9. For a detailed discussion of the statistical analysis and model validation techniques, please see Appendix B.

10. In fact, Feroz et al. (1991) report that SEC accounting and auditing enforcement actions rarely result in punitive actions against large CPA firms.

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COST-BENEFIT ANALYSIS AND ACCOUNTING REGULATION

Steven Maijoor

ABSTRACT

A large number of publications in the 1970s and 1980s on accounting regulation suggested cost-benefit analysis as an area of further research. The expectation was that a cost-benefit-analysis could help in the assessment of the social value of accounting regulation. In the past two decades, only a small number of cost-benefit studies have been published in the accounting literature. This paper discusses the problems and limitations of the cost-benefit technique. The discussion will focus on three aspects of the cost-benefit analysis: the potential Pareto criterion, revealing preferences of individuals, and the distributional effects of accounting regulation.

This paper consists of the following sections. The first section discusses why cost-benefit analysis is an important area of research. The second section provides a short overview of published cost-benefit studies

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of accounting regulation. The third section discusses the main problems and limitations of cost-benefit analyses. Finally, the fourth section provides a summary, conclusions, and gives suggestions for further research.

REASONS FOR COST-BENEFIT ANALYSES

The main rationale for cost-benefit research stems from the debate on the desirability of accounting regulation. The central issue of the debate is whether "market failures" and "externalities" exist in an unregulated accounting information market. If there are market failures, an unregulated environment would be inefficient and government intervention could lead to a Pareto superior change in the economy. *A priori* arguments for and against the existence of market failures have been given. Arguments for accounting regulation are based on the public good problem, the information asymmetry problem, the speculation problem, and the problem of redundant information production (see, e.g., Beaver 1980; Cooper and Keim 1983; Easterbrook and Fischel 1984). It is argued that these problems can lead to the underproduction or overproduction of accounting information in an unregulated market. Arguments against accounting regulation assume the possibility of private consumption of accounting information and sufficient incentives for firms to disclose accounting information (see, e.g., Benston 1976; Leftwich 1980). Finally, some argue that both market failures *and* regulatory failures may exist and that contracting costs are inherent in every institutional arrangement (see e.g., Watts and Zimmerman 1986).

The debate on the desirability of accounting regulation is inconclusive (Easterbrook and Fischel 1984; Beaver 1989, 193). There is a lack of empirical results and a priori reasoning does not provide clear solutions for the regulation problem. Both proponents and opponents of regulation are very successful in producing convincing arguments for and against accounting regulation.

As a result of the dissatisfaction with the inconclusive results of the debate, there is a demand in the accounting regulation literature for empirical research. The investigation of unfulfilled demands for accounting information due to its public good characteristics has been proposed and investigation of costs and benefits encouraged.

Benston (1976), Leftwich (1980), and Watts and Zimmerman (1986, 162) argue that every institutional arrangement of the market for accounting information (free market or regulated market) has its specific costs and benefits. In this situation, the choice of a particular solution should be based on the specific costs and benefits of the institutional arrangement.

COST-BENEFIT STUDIES CONDUCTED

There are not many empirical results from cost-benefit analyses of accounting regulation and the methods used to measure costs and benefits are very diverse (Espahbodi and Hendrickson 1986). Three groups of cost-benefit studies can be distinguished.

First, a number of studies tried to establish *perceptions* of costs and benefits of accounting regulations. For example, Butterworth and Falk (1984) used questionnaires to measure the perceived costs and benefits of Canadian Accounting Standards. They conclude that the respondents questioned (on the basis of cost-benefit considerations) the desirability of accounting standards that required detailed information. Another example of a study in this area is McKinnon (1984).

A second group of studies try to measure the actual costs of accounting regulation for firms. Bastable (1977) investigated the costs for firms of disclosing replacement cost data. Using questionnaires he concludes that "society paid a multimillion-dollar figure for the rule requiring replacement cost data." The Advisory Committee on Corporate Disclosure (SEC 1977) and Philips and Zecher (1981) investigated the costs for U.S. firms of producing 10-K, 8-K, and 10-Q reports. Benston (1984) examined the costs of the "Line of Business Program" of the Federal Trade Commission in the United States. The commission estimated the costs of providing lines of business information assuming that compliance costs are positively correlated with the number of lines of businesses. Benston (1984) questions this assumption with empirical results that do not support this relationship.

A third group of studies does not actually measure costs and benefits of accounting regulation, but gives an overview of the various categories of costs and benefits and the empirical evidence that is available on these categories. Examples of studies in this area are

Philips and Zecher (1981, chapter 3) and Easterbrook and Fischel (1984, section 4). The empirical evidence, for example, provided in these studies concerns: (1) voluntary disclosure of accounting information, (2) the stock price effects of accounting regulation, and (3) the number of fraud cases before and after the passing of accounting regulation. The evidence presented in these studies does not provide conclusive results.

Finally, there is an unusual study by Espahbodi and Hendrickson (1986) which, in contrast to the previous studies, does explicitly apply the cost-benefit technique. The study attempted to estimate the present value of future benefits and costs of three alternative accounting inflation measurement models. The evidence of Espahbodi and Hendrickson suggests that according to the cost-benefit criterion, general price-level adjusted information yielded the best results.

PROBLEMS AND LIMITATIONS OF COST-BENEFIT STUDIES

In this section, three problems of the cost-benefit technique are discussed that limits its value as a decision-making framework for accounting regulation: (1) the efficiency criterion is not inherently superior to other criteria and its choice is a political decision, (2) market prices are needed to reveal the preferences of individuals before and after a change in accounting policy, and (3) distributional effects of accounting regulation are not included in the analysis.

The Efficiency Criterion

The frequently proposed cost-benefit analysis for the evaluation of accounting regulation is based on the potential Pareto criterion (Espahbodi and Hendrickson 1986). The potential Pareto improvement and actual Pareto improvement are frequently suggested criteria for evaluating accounting regulation (see, e.g., Sunder 1988; Verrecchia 1982). An actual Pareto improvement implies that the implementation of accounting regulation makes no member of society worse off and at least one becomes better off. The actual Pareto improvement criterion circumvents the problems of interpersonal utility comparison because it only judges government intervention that does not harm any individual. The actual Pareto improvement criterion is straightforward and easy to apply. However, it is difficult to give an example of a government policy that does not lower the welfare of one or more persons in society (Mishan 1982, 34).

The second criterion of whether accounting regulation produces higher efficiency is the potential Pareto criterion (other terms are the "Kaldor Compensation Principle" and "Kaldor-Hicks criterion"). That is, accounting regulation is efficient if it is possible for the winners from the regulation to compensate losers so as to leave nobody worse off and at least one person better off. The compensation of losers is hypothetical and assumed to be costless.

The potential Pareto improvement, like other efficiency criteria, "have been used to describe 'benchmark' characteristics of economies which are typically judged to be more or less desirable" (Ohlson and Buckman 1980). As such, efficiency criteria are just "rules of the game" and their selection implies individual value judgments. The choice of the Pareto criterion cannot be judged from an economic perspective (Espahbodi and Hendrickson 1986). For example, accepting the Pareto criterion as the overriding principle for evaluating accounting regulation implies the value judgment that the distributional effects of accounting regulation are not relevant for accounting policy-making. If the cost-benefit criterion is met, hypothetical costless transfers *could* make everyone better off. This implies that a regulation that meets the cost-benefit criterion can still have considerable negative effects on equity (Sunder 1988).

Cooper and Sherer (1984) and Williams (1987) point to several effects of using efficiency as the most important criterion to judge accounting regulation. First, a large number of studies intending to contribute to the evaluation of accounting regulation have focused on informational efficiency of the capital market. Informational efficiency clearly is not equivalent to resource efficiency in the allocation of societal resources. Second, because it is very difficult to assess the efficiency of a future accounting regulation, the efficiency requirement will frequently result in no government intervention, maintaining the status quo. Third, the focus on efficiency has reduced the attention on distributional effects of accounting regulation. Because accounting regulation has both efficiency effects and distributional effects, their separation is somewhat arbitrary for a policymaker (Williams 1987).

Revealing Preferences

A cost-benefit analysis tries to measure the value of all produced goods and services in society before and after a change in government policy, in this case a change in accounting regulation. It is assumed that an increase in the value of production means that the efficiency of society is higher (Verrecchia 1982). The increased value of the total production implies that winners of the regulation can compensate losers so as to leave nobody worse off and at least one person better off. A major problem in carrying out a cost-benefit analysis is the difficulty of establishing market prices to value the produced goods. Significant informational requirements are a disadvantage of cost-benefit analyses in general (Smith 1986). Because of market failures and imperfections, no market prices exist for many goods that are regulated by the government. Market prices are indispensable for revealing the preferences of consumers for various goods.

The problems involved in establishing preferences have received considerable attention in the accounting literature (see, e.g., Amershi et al. 1982; Foster 1980). Among the problems suggested are: (1) even if people are asked, they may not know their preferences; (2) the process of revealing preferences is costly for participants; voluntary participation in a preference revealing process may therefore result in unbalanced representation; and (3) the respondents may exhibit strategic behavior and not reveal their real preferences. In addition to these more technical problems, Morgan (1988) points to a more fundamental problem in establishing preferences. Specifically, whose preferences should be included in the evaluation of accounting regulation? The focus of accounting researchers on shareholders implies that shareholder preferences are important for the evaluation of accounting regulation whereas the preferences of other groups, like creditors or employees, are less important. The preferences that should be included or excluded is again a political choice.

Another problem when implementing a cost-benefit analysis is to decide which prices should be used to value the production before and after the change in government policy. The change in government policy will change the distribution and prices of goods. The choice between the prices of produced goods before and after the change in government policy is arbitrary (Mishan 1982, 205; Verrecchia 1982).

Because market prices are lacking, the cost-benefit studies discussed in the previous section only take a few cost and benefit categories into account. On the cost side, in general, only the direct administrative costs of accounting information are investigated. Indirect costs, such as competitive disadvantage effects for disclosing firms, are rarely considered. On the benefit side, in general only effects for stockholders are investigated. Possible benefits for other groups, such as debtholders, creditors, and the general public are usually not considered. Another effect of the lack of market prices is that costs and benefits are not measured in money terms. The studies rely on respondents' estimates, or do not quantify costs and benefits at all. The benefits of accounting regulation are especially difficult to quantify. Costs and benefits are difficult to compare if they are not quantified.

Distributional Effects

For cost-benefit analyses a distinction is made between regulatory effects on the efficiency of the allocation of society's resources and regulatory effects on the distribution of wealth among individuals in society. The division is made along these lines because desirability of efficiency effects can be assessed by cost-benefit analyses, while the desirability of distributional effects cannot (Beaver 1989, 193). That accounting regulation has redistributional effects was established early in the accounting literature (see, e.g., Demski 1973). Given the problems with interpersonal utility comparison, it is not possible to rank different distributional consequences in terms of social desirability.

In the accounting literature, attempts have been made to find solutions to the problem of the evaluation of the distributional effects of accounting regulation. One solution is based on the idea that equity can be justified on efficiency considerations. Other solutions are based on concepts from other fields of research like the fairness and justice literature. Both approaches to the problem of distributional effects are discussed below.

The first solution circumvents the impossibility of evaluating the social desirability of a particular wealth distribution by stating that a more equal distribution of wealth makes everybody better off. As a result, increasing equity can be defended as being Pareto optimal. Applying this to accounting regulation, Lev (1988) and Cooper and Keim (1983) conclude that all investors (informed and uninformed) will be better off if they have equal opportunities to obtain accounting information. Unequal information opportunities may result in the withdrawal of investors. A reduction of the number of investors might cause thin markets, higher transaction costs, lower liquidity of securities, and in general, decreased gains from trade. These adverse consequences of unequal information distribution are detrimental for all investors and an equal distribution of information opportunities may be Pareto optimal.

This approach to distributional effects can be criticized on the following grounds. First, it does not take into account the possible costs of accounting regulation for groups outside the capital market. Therefore, accounting regulation that establishes equal information opportunities might be Pareto optimal for the group of investors but not for society as a whole. Second, the detrimental effects of information asymmetry for capital markets are not clear. Whether capital market activity will decrease as a result of information asymmetry is an empirical question.

Other solutions to the problem of evaluating the distributional effects of accounting regulation are based on concepts from other fields of research. The results of the economic analysis of distributional consequences suggest that the evaluation of these effects is beyond the solutions within economics. Therefore, links with other disciplines, for example, philosophy, are proposed as alternative solutions (see, e.g., Porcano 1984; Gaa 1986; Williams 1987). Concepts from other disciplines can be imported to accounting research to tackle this problem.

Cooper and Sherer (1984) state that the current economic analyses in accounting are not satisfactory for establishing the social value of accounting. As an alternative they suggest a political economy approach. Applying this approach to social welfare problems entails: (1) a view of accounting regulation in the context of social conflicts, (2) recognition that all social welfare notions are political, (3) a focus on social indicators of welfare, and (4) the use of accounting numbers to measure indicators of social welfare. The essence of a political economy approach is that it encourages researchers to base their research and accounting policy suggestions on their personal political values.

Gaa (1986) uses concepts from the fairness and justice literature for evaluating distributional consequences of accounting regulation. A rational choice on the desirability of distributional consequences can be made behind a "veil of ignorance." The rational choice behind the "veil" is a hypothetical situation in which individuals do not know their own position (i.e., whether they are winners or losers). This abstraction makes it possible to construct a fair distributional principle that does not depend on the actual economic positions of individuals. According to Gaa (1986), the analysis can both explain and justify the distributional principle chosen by a regulator. Gaa's study can be criticized for the problems that are inherent in the "veil of ignorance" concept. The results of the analysis depend on the assumed risk preferences of the individuals behind the "veil." If these individuals are highly risk averse, a high degree of equity can be expected. If risk seeking individuals are assumed, a low degree of equity can be expected.

It can be concluded that the restriction of a cost-benefit analysis to efficiency effects clearly reduces its value as a decision making framework for accounting regulation. The actual determination of the social desirability of accounting regulation requires an analysis and evaluation of both efficiency effects and distributional effects.

SUMMARY, CONCLUSIONS, AND SUGGESTIONS FOR FURTHER RESEARCH

An unanswered demand for cost-benefit analyses more or less ended the debate on the social desirability of accounting regulation. Cost-benefit analyses have appeared to be an unsuccessful area of research, and it is not expected that substantive results will come from using this technique in future accounting regulation research.

So what is left for accounting researchers to contribute to accounting policy-making? If accounting regulation researchers maintain an economic perspective, with its assumption of the impossibility of interpersonal utility comparisons, one solution seems to be to go back to one of the earliest definitions of economic consequences of accounting regulation. Researchers can document the effects of accounting regulation on the decision making behavior of various parties (Zeff 1978). However, comparisons of these changes in decision making, in terms of social costs and social benefits, are difficult to make. This approach is termed "economic impact analysis" in the public policy literature (Smith 1986). It can be described as providing evidence on the effects of regulation on prices, output, employment and other economic variables. Compared with cost-benefits analyses, the information requirements are less. Of course, many accounting regulation studies conducted can be categorized as economic impact analyses (see, e.g., Chow 1983). However, they mainly focus on capital suppliers and managers and use stock prices to measure regulatory effects. The effects for other groups and other economic variables have received limited attention.

A disadvantage of economic impact analysis is that it does not have a clear criterion for using the information on economic effects for policy-making. The role of the researcher is explicitly restricted to providing evidence of specific economic effects of accounting regulation (see, e.g., Sunder 1988; Mishan 1981, 263). The overall evaluation of economic effects is up to accounting regulators and/ or other disciplines. Given the latter there is no necessary need for accounting regulation researchers to maintain an economic perspective. The use of concepts from other disciplines seems to be a promising approach to the problem of evaluating distributional effects. Justice theories and the political economy approach, briefly mentioned in the previous section, are examples of these other disciplines.

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TOWARD A GLOBAL REPORTING MODEL:

CULTURE AND DISCLOSURE IN SELECTED CAPITAL MARKETS

Robert J. Kirsch

ABSTRACT

The absence of internationally agreed upon securities regulations and financial reporting and disclosure standards has led to calls for international accounting harmonization. The International Accounting Standards Committee has undertaken a major effort to enhance harmonization by amending existing International Accounting Standards to reduce the number of acceptable accounting treatments. Care needs to be taken in international efforts to establish uniform accounting regulations and disclosure requirements to avoid superimposing alien structures and concepts on business entities in various cultural areas. What is appropriate for one culture is not necessarily proper for another. In the paper, the author attempts to employ a conceptual framework for analyzing various regulatory

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environments in two major cultural blocks, the Anglo-American and the Chinese-Asian. Major cultural differences exist in these blocks which may account for the vast differences in regulation and accounting disclosure found in them. Such differences have serious implications for international harmonization efforts.

INTRODUCTION

For the past several years there have been trends toward the internationalization of securities offerings and markets, and easing of capital movements across borders. These developments have taken place despite the absence of internationally agreed upon regulatory requirements and internationally harmonized accounting reporting and disclosure standards. The speed of internationalization of securities trading has out-stripped the pace of efforts at internationalization of rules to regulate securities trading and at harmonization of accounting standards.

Recently, there have been calls from several quarters for international organizations and national governments to advance the internationalization of securities offerings by easing restrictive disclosure requirements, and to reduce the differences among national accounting reporting and disclosure standards. Behind such calls is the notion that dropping the existing impediments to international trading in securities will result in an increased volume in such trading to the economic benefit of individual and institutional investors throughout the world.

Much of the pressure to harmonize international regulatory and accounting reporting and disclosure requirements seems to deemphasize the influence of a particular culture on national regulatory policies and procedures and on national accounting reporting and disclosure requirements. The underlying argument seems to be the idea that if all nations measure and report in the same manner, then the substance of the reports will be essentially similar. However, the world in which we live is complex with numerous national and cultural differences which have a profound influence on organizational structure and functioning.

The focus of this paper is on the implications of culture for the harmonization of regulatory reporting and disclosure requirements of listed companies, that is, those which are publically traded on the world's stock exchanges. It is such companies for which the harmonization of accounting disclosure is most pressing as they are most likely to be the ones to attract international investment capital. For nontraded, purely domestic companies it is unnecessary to harmonize financial reporting; for them, local standards are sufficient and, from a cultural perspective, make sense.

To understand the pitfalls inherent in and barriers to international harmonization of regulatory and accounting reporting and disclosure, it would be helpful to employ an analytical framework with which to analyze various national regulatory environments and their implications for organizational formation, structure, and development. Such a framework would be useful for situational analysis and global comparison. This paper presents such a conceptual framework and uses it to analyze regulatory disclosure environments in two quite different cultural blocks: the Anglo-American group of nations, which, among others, includes the United Kingdom, the United States, Canada, and Australia; and the Chinese-Asian group, which, among others, includes Singapore, Hong Kong, and Taiwan. The Anglo-American cultural group of countries is heir to a common Judeo-Christian culture with emphasis on individualism and adherence to abstract principles as motivators of behavior. The Chinese-Asian cultural group is heir to a common Confucian culture with its deemphasis of the individual and the prominence which it gives to the group, particularly the extended family, and the acceptance of one's place in the scheme of things. Examination of regulatory requirements in such different cultural blocks should serve to indicate some of the problems with and prospects for international harmonization efforts. As a common reference point, U.S. regulatory and disclosure requirements will be used for purposes of comparison with and between these two cultural blocks.

INTERNATIONALIZATION OF SECURITIES TRADING

Recent trends toward globalizing securities markets and easing of capital movements across borders are apparent in the value of institutional and individual investments in foreign securities and in the number of companies that list their securities in multiple markets.

For example, U.S. investments in foreign securities rose from $20.9 billion in 1970 ($53.87 billion in constant 1984 U.S. dollars as adjusted by the U.S. Consumer Price Index) to $156.8 billion in 1988 ($133.0 billion in 1984 dollars), a 750% increase over the 1970 amount (247% in real terms). Foreign investments in U.S. corporate stocks and bonds rose from $34.8 billion in 1970 ($89.7 billion in 1984 dollars) to $393.6 billion in 1988 ($332.7 billion in 1984 dollars), 1,131% of the 1970 amount (371% in real terms) (Scholl 1985; 1989). However, in 1990, foreign investors sold $15 billion more of U.S. stocks than they bought (*Wall StreetJournal* 1991). Nevertheless, the overall trend is in an upward direction.

Also, the number of companies actively listing their stocks in foreign markets has grown. In May 1984, *Euromoney* listed the names of 236 companies whose stocks are actively traded in foreign stock markets. In May 1986, it listed 472 companies, twice as many as were included in the 1984 list. In May 1989, it listed 470 companies for 1988, but the number for 1990 declined to 403, still 171% above the number listed in 1984.

Foreign sector equity turnover assumes a significant market share of total equity turnover on the world's top stock exchanges. The International Stock Exchange (ISE) of London, England, is far ahead of the competition in the trading of international equity securities (see Table 1). Such trading is also important to the New York, Toronto, Montreal, and Hong Kong exchanges.

So rapid has been the trend toward an integrated worldwide securities market that there is a danger that national regulatory agencies will be too slow to respond and, thus, will be overtaken by events. If regulatory agencies are too slow to facilitate trading in nondomestic securities, investors will trade in foreign markets which have a more favorable regulatory environment. There is some evidence that this has already begun to happen as London's International Stock Exchange (ISE) trades twice as many foreign equities as the New York Stock Exchange, 7 times more than Tokyo, 8-1/2 times more than all of Germany's 8 exchanges combined, and 33 times more than the Paris Bourse (*Euromoney* 1990b, 62). National and international pressures have mounted on standard setting and regulatory bodies to take steps to facilitate greater international harmonization of corporate financial information and relaxation of registration and disclosure requirements to encourage a higher volume of international securities trading. Some steps have

Table 1. Stock Exchanges Ranked by Foreign Equity Turnover (in millions of U.S. dollars)

	Foreign Sector Turnover (US$m)		*Total Equity Turnover (US$m)*		*Foreign Sector Market Share (%)*		*Foreign Sector Growth 1990/91*	*Total Equity Turnover (US$m)*
Rank Exchange(s)	*1991*	*1990*	*1991*	*1990*	*1991*	*1990*	(%)	*1983*
Anglo-American Exchanges								
1. London	240,965.2	262,063.6	553,922.0	543,392.5	43.5	48.2	−4.7	225,837.0
2. New York	87,973.9	80,600.0	1,520,164,0	1,325,332.4	5.8	6.1	−0.3	1,522,160.0
3. Toronto	534.7	273.8	58.597.7	54.776.3	0.9	0.5	0.4	140,630.0
4. Montreal	375.7	39.9	16,005.5	13,183.2	2.3	0.3	2.0	117,004.2
5. Australian	NA	NA	46,696.6	40,186.1	NA	NA	NA	59,619.8
6. American	NA	NA	40,919.3	37,715.0	NA	NA	NA	57,574.4
Japanese Exchanges								
1. Tokyo	3,809.3	13,587.0	882,932.3	1,287,694.2	0.4	1.1	−0.7	545,848.3
2. Osaka	8.9	NA	138,548.7	243,822.9	0.0	NA	NA	467,638.7
Overseas Chinese Exchanges								
1. Hong Kong	71.0	99.9	38,596.7	34,676.1	0.2	0.3	−0.1	NA
2. Taiwan	NA	NA	362,041.2	711,737.0	NA	NA	NA	NA
3. Singapore	NA	NA	18,718.8	21,069.6	NA	NA	NA	15,525.3

Note: NA = Not available

Source: Adapted from Federation Internationale des Bourses de Valeur (1983, 5; 1991, 26).

been taken toward achieving these objectives, while others have been proposed.

On November 15, 1988, the SEC issued a policy statement on regulation of international securities markets. The SEC noted that "[m]utually acceptable international accounting standards are a critical goal because they will reduce the unnecessary regulatory burdens resulting from current disparities between the various national accounting standards" (SEC 1988b, 9). It encouraged securities regulators and accounting professionals throughout the world to continue efforts to harmonize international accounting standards with the twin aims of increasing comparability and reducing costs.

The International Accounting Standards Committee (IASC) has taken the initiative to further harmonization of financial reporting. On January 1, 1989, the IASC published proposals to eliminate most of the alternative acceptable accounting treatments permitted under current international accounting standards (IASs). Exposure Draft 32 (ED32), *Comparability of Financial Statements*, specifies proposals to ensure that similar transactions and events are accounted for in the same manner, regardless in which country they are reported.

The IASC argued that its harmonization project should provide additional benefits to business enterprises which have their debt or equity securities traded on foreign markets.[1] Presently, many multinational corporations must present information that restates or reconciles their financial statements to conform with the accounting regulations of each country in which their securities are traded. Regulators from various countries have indicated a willingness to consider replacing such restated or reconciled financial information with a single reconciliation of net income and equity according to the IASC's required or preferred accounting treatments (ED32, para. 7).

The question of harmonization has two principal aspects: standard setting and regulation. Both are intimately intertwined with the national subculture for standard setting, reporting, and regulation. To adequately understand the problems and prospects for harmonization, a conceptual framework with which to examine the regulatory environment of specific nations is needed. The next section of this paper discusses such a framework. Subsequent sections of the paper will examine regulatory disclosure requirements in selected countries, both highly industrialized and industrializing.

CULTURE'S IMPACT ON NATIONAL MODES OF REGULATION

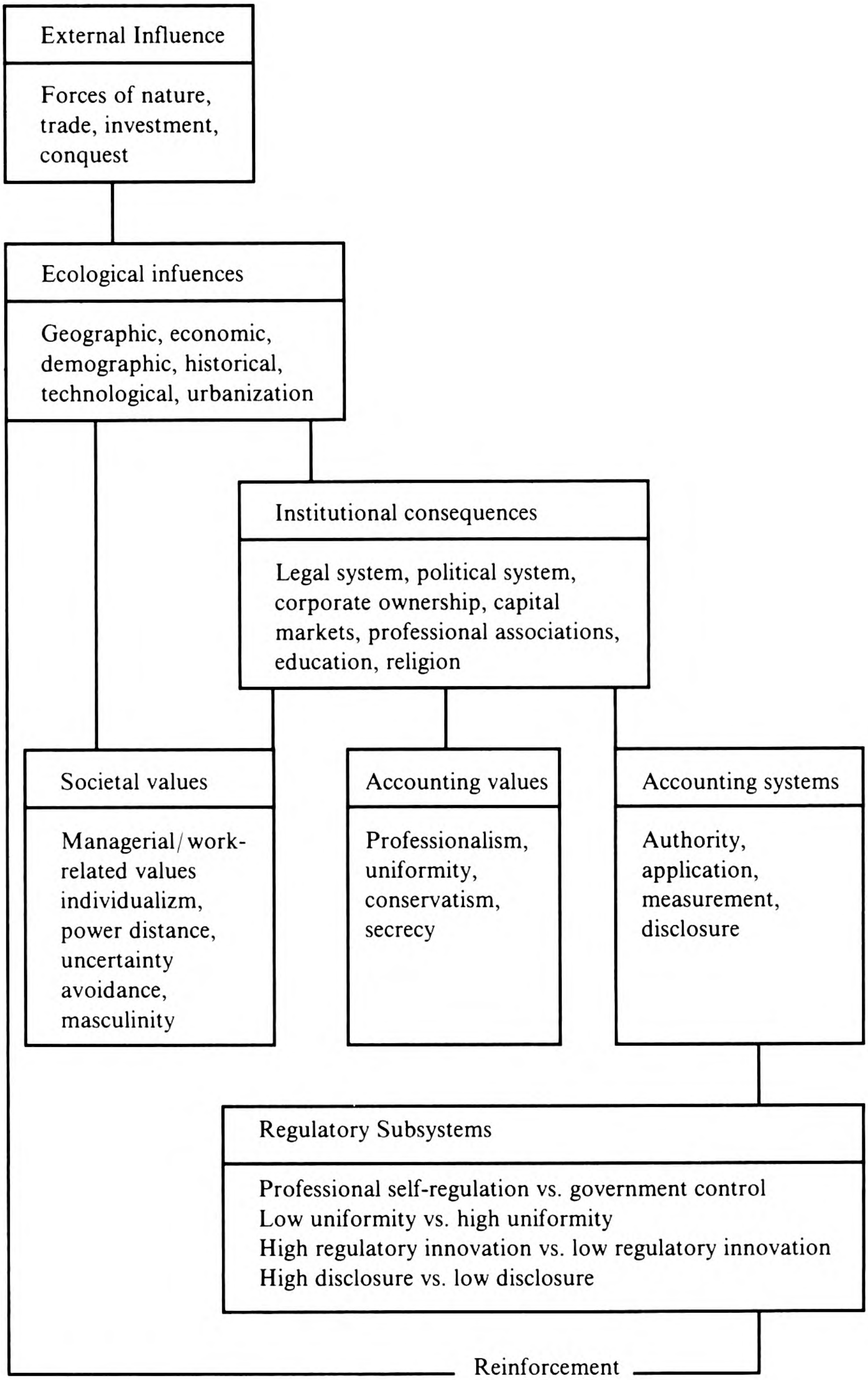
In *Culture's Consequences*, Hofstede (1980) explored the differences in thinking and social action between citizens of 40 modern nations. He argued that people in various nations carry "mental programs" which are fostered in the family in early childhood and strengthened in schools and other social organizations. These mental programs contain a component of national culture and are expressed in the different values that are found among peoples from different nations.

Hofstede sought to identify the specific elements of which culture is composed. He identified four principal dimensions along which dominant value systems in the 40 countries he studied could be ordered. He argued that these value systems affect human thinking, organizations, and institutions in predictable manners. By theoretical reasoning and statistical analysis, he identified the four main dimensions as Power Distance (PDI), Uncertainty Avoidance (UAI), Individualism (IDV), and Masculinity (MAS).[2]

Using factor analysis, Hofstede assigned scores to these 40 nations along these four dimensions; using cluster analysis, he grouped these countries into culture areas. Two of Hofstede's culture areas are of particular interest to the present study—the Anglo and less developed Asian clusters. In the Anglo area, Hofstede grouped Australia, Canada, Great Britain, Ireland, New Zealand, and the United States. In the less developed Asian area, he grouped Pakistan, Taiwan, Thailand, Hong Kong, India, the Philippines, and Singapore.

Hofstede characterized the Anglo area as having: low to medium power distance, low to medium uncertainty avoidance, high individualism, and high masculinity. The less developed Asian area he characterized as having: high power distance, low to medium uncertainty avoidance, low individualism, and medium masculinity. Thus, on three of the four cultural dimensions, Hofstede noted marked differences between the Anglo and less developed Asian areas.

In Hofstede's model, societal values are rooted in ecological influences which are modified by external factors such as international trade and investment, foreign conquest, and natural forces. Societal values themselves have institutional consequences that take the forms of the legal, political, capital market, corporate ownership systems, and the like. These institutions reinforce the ecological influences and social values of the nation (see Figure 1).


External Influence
Forces of nature, trade, investment, conquest
Ecological infuences
Geographic, economic, demographic, historical, technological, urbanization
Institutional consequences
Legal system, political system, corporate ownership, capital markets, professional associations, education, religion
Societal values
Managerial/work-related values individualizm, power distance, uncertainty avoidance, masculinity
Accounting values
Professionalism, uniformity, conservatism, secrecy
Accounting systems
Authority, application, measurement, disclosure
Regulatory Subsystems
Professional self-regulation vs. government control
Low uniformity vs. high uniformity
High regulatory innovation vs. low regulatory innovation
High disclosure vs. low disclosure
Reinforcement

Source: Adapted from Perera (1989).

Figure 1. Culture, Societal Values, and the Accounting Subculture

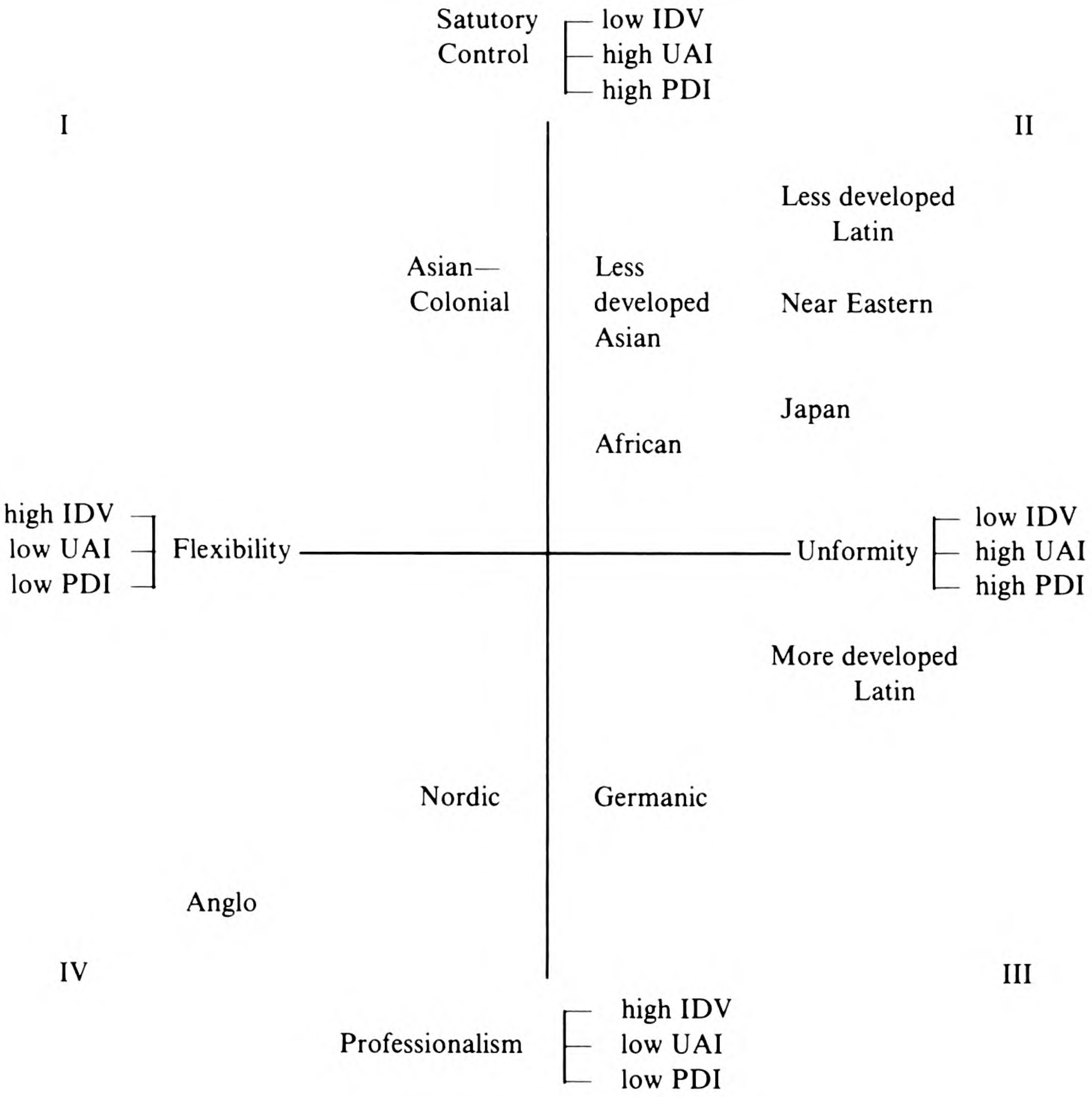
Gray (1988) proposed an extension of the Hofstede model to express societal values at the accounting subcultural level. As such, accountants' value systems or attitudes may be predicted to relate to and derive from societal values but with special reference to work-related values. Thus, "values" will impact on accounting systems.

Gray argued further that it should be possible to establish the relationship of Hofstede's four significant cultural value dimensions to accounting values. He offered the following value dimensions: (1) professionalism vs. statutory control, (2) uniformity vs. flexibility, (3) conservatism vs. optimism, and (4) secrecy vs. transparency.[3] A link between societal values and accounting systems could be established and the influence of culture thereupon assessed.

The professionalism and uniformity dimensions, concerned with regulation and the extent of enforcement or conformity, appear the most relevant to the professional or statutory authority for accounting systems and their enforcement. Gray combined them and classified culture areas. According to Gray's classification, the Anglo culture area, on the authority and enforcement axes, is characterized by high flexibility and high professionalism. Gray split Hofstede's less developed Asian group into the Asian-Colonial subgroup, consisting of Hong Kong and Singapore, and the less developed Asian subgroup, in which he included Taiwan. These two subgroups tended toward greater statutory control; but Taiwan was seen as tending more toward uniformity while Hong Kong and Singapore were seen as leaning more toward flexibility (see Figure 2).

The conservatism and secrecy dimensions, Gray argued, are the most relevant accounting values to the measurement practices used and the extent of information disclosed. He combined them and hypothesized the measurement and disclosure classification of culture areas. Here the Asian-Colonial subgroup related more closely with the Anglo group. The Anglo group was classified as having greater optimism and transparency, however, than the Asian-Colonial. Taiwan, among the less developed Asian subgroup, was classified as having greater secrecy and conservatism (see Figure 3).

Perera (1989) has pointed out that accounting values are likely to influence accounting practice in the areas of authority, application, measurement, and disclosure. Expanding on Gray's accounting values, Perera suggests the following: (1) the higher the degree of professionalism, the higher the degree of professional self-regulation and the lower the need for government intervention; (2) the more

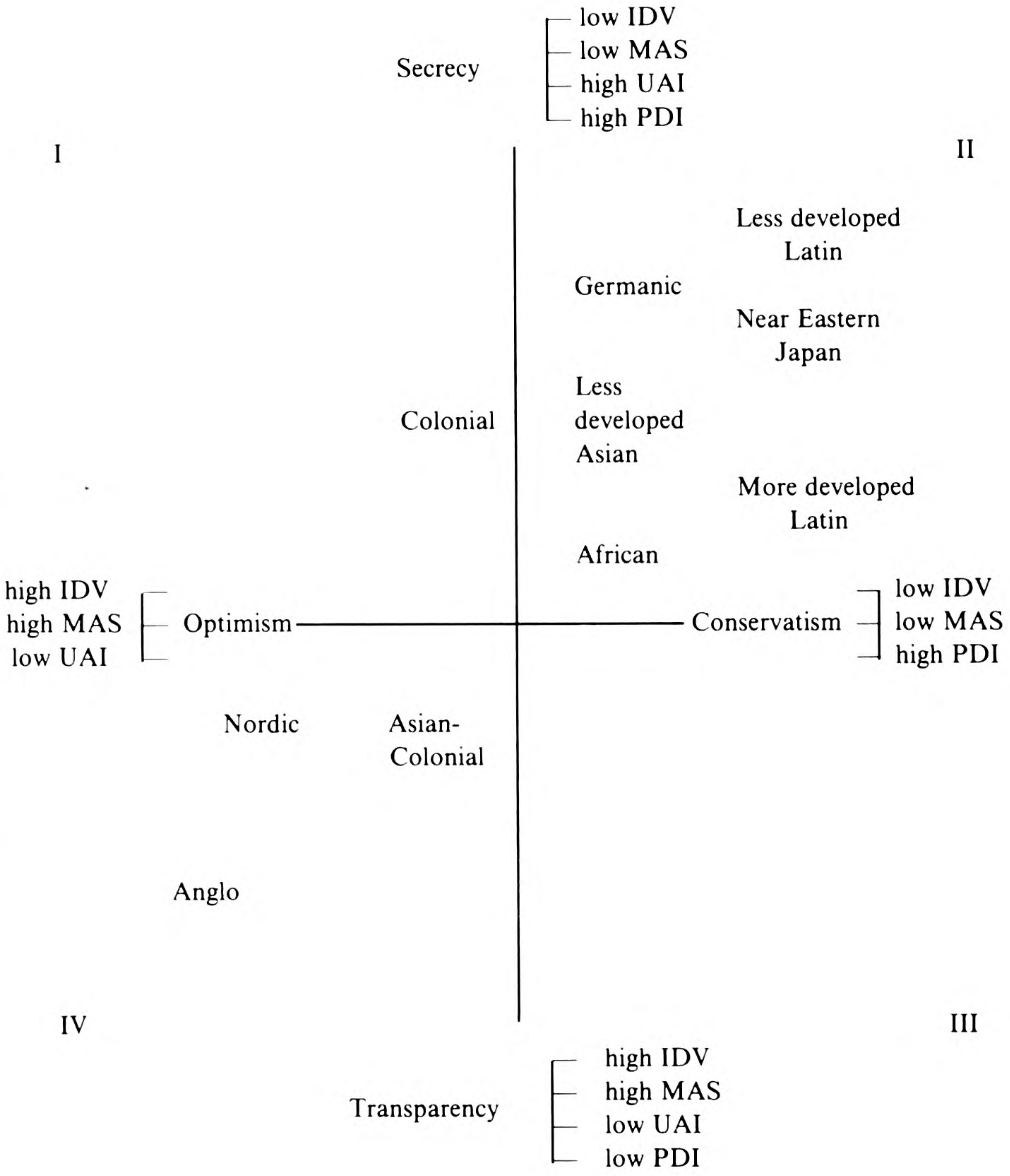

Satutory
Control
low IDV
high UAI
high PDI
I
II
Less developed
Latin
Asian—
Colonial
Less
developed
Asian
Near Eastern
Japan
African
high IDV
low UAI
low PDI
Flexibility
Unformity
low IDV
high UAI
high PDI
More developed
Latin
Nordic
Germanic
Anglo
IV
III
Professionalism
high IDV
low UAI
low PDI

Key: IDV = Individualism
UAI = Uncertainty Avoidance
PDI = Power Distance

Source: Adapted from Gray (1988).

Figure 2. Accounting Systems: Authority and Enforcement

uniformity, the lower the extent of professional judgment and the stronger the force applied to accounting rules and procedures (i.e., the greater the role of governmental authority in accounting rule-making and procedures definition); (3) the higher the degree of conservatism, the stronger the ties with traditional measurement practices (i.e., the less likely accounting innovation will occur); and (4) the higher the degree of secrecy, the lower the extent of disclosure


Secrecy
low IDV
low MAS
high UAI
high PDI
I
II
Less developed Latin
Germanic
Near Eastern Japan
Less developed Asian
Colonial
More developed Latin
African
high IDV
high MAS
low UAI
Optimism
Conservatism
low IDV
low MAS
high PDI
Nordic
Asian-Colonial
Anglo
IV
III
Transparency
high IDV
high MAS
low UAI
low PDI

Key: IDV = Individualism
MAS = Masculinity
UAI = Uncertainty Avoidance
PDI = Power Distance

Source: Adapted from Gray (1988).

Figure 3. Accounting Systems: Measurement and Disclosure

of information. Perera notes further that any particular aspect of accounting practice may be influenced by more than one accounting value. For example, the extent of disclosure may be influenced not only by the degree of secrecy but also by the levels of conservatism, uniformity, and professionalism found in a particular accounting subculture. Thus, the amount of disclosure will differ between countries based on differences in national value orientations of financial report preparers.

Within individual national accounting systems exist regulatory subsystems which possess their own subcultural characteristics. Extending the work of Hofstede, Gray, and Perera, it is possible to develop hypotheses about regulatory subcultures that are based on societal values, accounting values, and accounting systems. On the authority dimension, one can differentiate between nations in which regulation and disclosure are largely determined through professional self-regulation, and nations in which the government assumes the dominant role in establishing rules for regulation and disclosure. In a subculture of self-regulation, disclosure will be largely determined by independent regulatory bodies; whereas, in a subculture of government control of regulation and disclosure, independent, professional bodies will be little developed. In a subculture of self-regulation, the tendency will be to emphasize professional judgment rather than to adhere to strict rules established by government authorities; in a subculture of government control, there will be a tendency of adherence to rules and deemphasis of professional judgment. Self-regulated accounting subcultures are likely to lead to innovation and expansion of regulatory and disclosure requirements through proliferation of standards for reporting and disclosure. This, in turn, would result in the deemphasis of secrecy and the disclosure of large amounts of financial information. Government controlled accounting subcultures, on the other hand, are likely to be more conservative, with slow progress in the development of new regulatory and disclosure requirements, and a high degree of secrecy (see Figure 1). Societal change over time may result in greater or lesser professionalism, uniformity, regulatory innovation, and level of disclosure in individual nations.

Cultures and the subcultures within them are dynamic, they respond to external and internal stimuli. Harrison and McKinnon (1986) used change analysis to determine the essential properties of a corporate reporting regulation system. They argued that the form of systems change is visible in the response events to internal and external stimuli. Collective and individual responses of the system's structural elements are circumscribed by the interactions between the system and its neighboring systems. Thus, national culture conditions the change responses of the national accounting regulatory subsystems which must respond to change stimuli from within the regulatory environment itself and from without, from within the nation and from without. Culture is thus dynamic and changeable.

To argue that development progresses from nascent industrial to advanced industrial states is not to suggest that it occurs in uniform or universally applicable stages. "It is not that modernity 'emerges' from tradition as leaves emerge from the buds of a plant, but that it spreads from place to place" (Weinstein and McIntyre 1986, 69). In its progression, it interacts with and challenges ancient traditions and cultures. As a result those ancient traditions and cultures adapt. "Cultures make their choices according to their ethos and idiom and determine how best they can adapt and absorb innovations" (Dube 1988, 508). Individual states progress at different paces over time and with respect to each other. Traditions and cultures are intervening forces that have considerable power to influence both the pace and direction of development.

In the comparison of regulatory disclosure requirements in selected countries which follows, an attempt will be made to confirm the location of each country on the theoretical framework suggested above while maintaining an awareness throughout of the impact of national culture and the dynamic character of development.

REGULATION AND CULTURE

From a theoretical standpoint, it is arguable that international disclosure and measurement standards be in complete harmony. Practically, however, it has been difficult to agree on a set of harmonized standards. Some commentators argue that, in order to maintain fair competition, foreign issuers should disclose information on the same basis as domestic issuers. However, such individuals fail to recognize that this may not be readily achieved. Measuring and disclosing economic activities is a process influenced heavily by political, social, and economic factors (Gambling 1974; Jaggi 1979). Business activities are greatly impacted by the cultural environment(s) in which they are conducted. Thus, when measuring and reporting the results of business activities, attempts to impose foreign standards and norms may distort the information content.[4]

The United Kingdom, through its imperial past and its commonwealth of nations, and by its example, has had a great influence on the accounting practices of many nations. The common accounting heritage of present and former commonwealth nations includes company laws that require the preparation of financial statements based on sound accounting records. Historically, these company laws did specify what information was to be disclosed in the financial reports but not what form it was to take. Actual statements of accounting standards were the province of professional accounting associations, such as the Institute of Chartered Accountants in England and Wales (ICAEW). The U.K. approach emphasized stewardship in financial reporting, a well-defined role for the independent auditor, and "true and fair" disclosure (Evans et al. 1985, 29-30).

Of the countries whose regulatory disclosure requirements are discussed in this study, four are present or former members of the Commonwealth of Nations. Two are predominantly of European extraction—Canada and Australia; two are primarily of Asian extraction—Singapore and Hong Kong. In all of these countries, some form of company laws is to be found. Both Canada and Australia are federal systems. Singapore has a unitary system and Hong Kong remains a British Crown Colony until it reverts to mainland China in 1997 according to the terms of a treaty registered with the United Nations. Both Singapore and Hong Kong have a very strong ethnic Chinese population as the dominant group.

As Wojthkowski and Mealin (1987) have observed, Chinese social behavior is rooted in Confucianism and fundamentally demonstrates a preoccupation with social order. In social relations, the relative positions of involved parties are defined and hierarchial patterns are culturally set. The actions of the parties involved are bound by rules of correct behavior that specify rights and responsibilities for each. Society's smooth functioning depends on individuals' willingness to accept their places within the social hierarchies found in families, friendships, and between the government and citizens of the state. Thus, there exists a complicated network of obligations and loyalties that bind individuals together within social hierarchies. The Confucian tradition has infused an element of homogenous Chinese cultural experience to mainland Chinese as well as the overseas Chinese cultures in Singapore, Hong Kong, and Taiwan. Various external changes and pressures, such as the Colonial and Marxist experiences, have not fundamentally altered Chinese social behavior. The networks, with their intertwining obligations, endure. In such cultural areas, one might expect to find different corporate forms and regulatory environments than in societies with primarily Western traditions of individualism with legally mandated taboos against networks and cultural insistence on reliance upon absolute abstract standards to resolve value conflicts. Thus, in Singapore and Hong Kong, with their former and/or current experiences under British dominance, and in Taiwan, until 1945 under Japanese control and more recently with strong U.S. contacts, one may expect to find a greater family influence on business enterprise and less restrictive regulatory environments than in Australia, Canada, the United Kingdom, or the United States.

CHINESE-ASIAN VS. ANGLO-AMERICAN CORPORATE GOVERNANCE

In the Anglo-American conception of the corporation, organizational horizontal divisions for marketing, production, purchasing, finance, personnel, distribution, and so forth are hierarchically vertically oriented with the Chief Executive Officer (CEO) at the top of the organizational pyramid. The CEO reports to the stockholders who own the company. In the Chinese family business, each of these functions is divided and subdivided among numerous legally independent firms each performing but a small part of the total productive effort which normally is done within one Anglo-American company (Tam 1990).

The Chinese family business is the dominant form used by the overseas Chinese in Hong Kong, Singapore, and Taiwan. The typical Chinese family business tends to function in one specialty field and not to develop as a conglomerate. While there are exceptions, such firms tend to become more and more unstable as patrimonial central coordination is diluted. In the typical case, the firm develops extensive networks to assure inputs and markets. Thus, a factory may utilize the services of another independent company for decades to distribute its goods, rather than develop its own marketing function. "Vertical integration is not normally handled within the enterprise but rather by the building of trust bonds between enterprises" (Redding and Whitley 1990, 92).

Despite their family capitalism, many successful overseas Chinese enterprises have gone public, listed on stock exchanges, and sold stock to numerous individual and institutional investors. The Chinese run family business typically offers only a minority stake in a public company. Control is maintained within the family by direct investment in the equity by individual family members and/or by other family companies; by cross-holdings and/or cross-directorships with companies associated with the family group; and by transactions with related parties that create an element of control. Thus, in the overseas Chinese public company, great care is taken to maintain control in the hands of the owner-manager and for succeeding generations, even though the company has gone public. To the Chinese there is no division between family and business interests. Corporate boundaries are unclear both internally and externally. Due to fission within, as talented nonfamily members who have plateaued leave the company to establish their own similar firms, and due to shifting external alliances, as the business adjusts to changing market conditions, the Chinese family business, despite its outward adoption of Western practices and organizational forms, remains a distinctly different entity. This has serious implications for stewardship and accountability. Tricker (1990, 209-10) gives some indication of the different meanings which attach to the Chinese business mind set, despite organization as joint-stock companies:

> 1. the concept of members' rights, exercised in a members' meeting, presupposes an egalitarian, democratic meeting of members: in a centrally controlled company, dominated by the family head, such a perception is irrelevant.
> 2. similarly, in a public company, if both the managers and minority public shareholders coincide in viewing minority shareholdings as permission to participate in the company to share in the family fortunes, concepts of stewardship for the benefit of the members are inappropriate.
> 3. where secrecy about business matters is the norm, disclosure and reporting for accountability are likely to be kept to the absolute minimum demanded by legislation or Stock Exchange rules.

Whether the desire to preserve the family domination of the enterprise is inherent in the Chinese conception of family and business, or representative of a stage through which Chinese-owned companies are passing in their evolution is unclear. However, the present existence of such distinctions is likely to contribute to greatly different accounting subcultures with attendant implications for regulation, reporting, and disclosure. These are explored in the next section of the paper.

COMPARISON OF REGULATORY DISCLOSURE REQUIREMENTS IN SELECTED COUNTRIES

Measurement and disclosure standards vary from country to country; however, from a legal perspective, many of these differences may be of form rather than substance. This observation is made with the full realization that form may conceal and / or distort culturally significant differences, such as Lowe discovered in Japan (see note 4), with actual differences being greater than apparent. Nevertheless, examination of such standards in the United States, the United Kingdom, Canada, and a number of the Pacific Rim countries, including Australia, Singapore, Hong Kong, and Taiwan should prove instructive.

Table 2 presents a comparison of selected disclosure requirements of the United States, the United Kingdom, Canada, and Australia. These jurisdictions agree on many disclosure issues, but vary on others. Typically, the differences relate to direction, level of detail, and location of the information disclosed. For example, the United States requires audited income statements for a 3-year period while Canada requires them for a 5-year period and the United Kingdom and Australia require them only for the current and prior year. The United States, United Kingdom, Canada, and Australia all require detailed segmental reporting of industry segment revenues (external and intersegment), operating profit or loss, carrying value of identifiable assets, and the like. The United States, the United Kingdom, Australia, and Canada mandate disclosure of two years of dividend information.

Table 3 presents a comparison of selected disclosure requirements of the United States, Singapore, Hong Kong, and Taiwan. While the disclosure requirements of these three Asian Pacific Rim countries are not as extensive as those of the United States, there are, nevertheless, a number of areas of agreement. For example, in the area of dividend disclosure, the United States, Hong Kong, and Taiwan require 2 years of comparative information, while Singapore's 5-year requirements are more stringent. In addition, the United States requires an audited 3-year Statement of Changes in

Table 2. Regulatory Disclosure Requirements of the United States, the United Kingdom, Canada, and Australia

U.S. General Requirements under S-K or S-X	*United Kingdom*	*Canada*	*Australia*
Reconciliation with U.S. GAAP	Comply with U.K. GAAP	Reconcile with Canadian GAAP	Comply with ASRB standards
Foreign currency translation required	Required	Disclosure must be in either Canadian or U.S. dollars	Financial statements and disclosures in Australian dollars
Financial information about industry segments required, including disclosure of revenue (distinguish between external sales and intersegment sales and transfers), operating profit or loss, carrying value of identifiable assets and amount of period capital expenditures, and so on	Comparable to United States with minimum differences	Identify industry segment, describe products/service, disclose revenue (distinguish between external customer and intersegment); segment operating profit or loss, carrying value of identifiable assets, and amount of period capital expenditures, and so on	Identify industry segment, discribe products/services, disclose segment revenue (distinguish between external customer and other segments), operating profit or loss identifiable assets, basis of intersegment pricing
Financial information about foreign and domestic operations and export sales	Comparable to U.S. requirements	Less stringent requirements than United States	Identify geographical segments (show countries included in each)
Disclosure of location and general character of principal plants, mines, and other important properties	Similar to U.S. requirements	Similar to U.S. requirements	Not specifically required
Mining, oil, and gas operations: Full costing or successful efforts in addition to reserve recognition accounting supplemental disclosure	Similar to U.S. requirements	Similar to U.S. requirements	Successful efforts without reserve recognition accounting disclosure
Dividends: require disclosure of the frequency and amount of dividends paid for 2 years	Directors' report states amounts, but not frequency of dividends paid	Comparable to U.S. general requirements	Amount of dividend paid or proposed with comparatives for prior year

Capital stock: disclosure or voting rights, conversation, redemption, liquidation rights, and so on	Similar to U.S. requirements	Similar to U.S. requirements	Similar to U.S. requirements
Debt securities: disclosure of terms, maturity, interest rate conversation, redemption, and so on	Similar but not as extensive	Similar to U.S. requirements	Similar but not as extensive
Selected financial data: disclosure of 5 years of financial data including operating revenues, income from continuing operations, income per share, total assets, long term obligations, and so on	Similar but not as detailed for 2 years	Not specifically required, usually disclosed in Managements' Discussion and Analysis	Not required
Supplementary information such as quarterly financial information, effects of changing prices, and so on	Not specifically required	Last quarter information is required only	Not specifically required
Managements' Discussion and Analysis required	Directors' Report required	Not specifically required	Not specifically required
Disclosure of disagreement with accountants on accounting and financial disclosure required	Required	Not specifically required	Directors must disclose rationale for noncompliance with approved accounting standard
Audited consolidated Balance Sheet for last 2 years	Same but for current and prior year only	Same as U.S. requirement	Same but for current and prior year only
Unaudited interim Balance Sheet	Similar to U.S. requirements	Similar to U.S. requirements	No unaudited interim Balance Sheet required

(continued)

Table 2. (Continued)

U.S. General Requirements under S-K or S-X	*United Kingdom*	*Canada*	*Australia*
Audited Income Statements and Statements of Change in Financial Position (SCFP) for 3 years*	Audited income statement required. Previously, SCFP required for 2 years; Cash Flow Statements mandatory on or after March 23, 1992	Audited Income Statement and SCFP for 15 years	Audited Income Statement and SCFP but for current and prior year only
Audited Statements of Changes in Stockholders' Equity for the past 3 years	Not specifically required	Similar to U.S. requirements	Not specifically required

Note: * In the United States, for fiscal years ending after July 15, 1989, the U.S. Financial Accounting Standards Board, in SFAS No. 95, *Statment of Cash Flows,* requires all U.S. corporations to issue a cash flow statement in place of the Statement of Change in Financial Position (SCFP).

Sources: The Australian information was compiled with the help of Ernst and Young, New South Wales, Australia. Also the Price Waterhouse Series of Information Guides, *Doing Business in*..., were consulted, as was Davies et al. (1992).

Stockholders Equity; Taiwan requires a similar statement but for only 2 years; Singapore requires 5 years of disclosure; and Hong Kong has no specific requirement. Capital stock and debt securities disclosures are similar for all four countries. All four countries require disclosure of 5 years worth of selected financial data; however, Hong Kong's and Taiwan's requirements are not as detailed as those of the United States and Singapore. All four countries have requirements for audited consolidated balance sheets for at least 2 years; Singapore requires them for abridged prospectuses only. Audited income statements are also required for 2 years in Hong Kong and Taiwan, 3 years in the United States, and 5 years in Singapore.

The three Asian countries, Singapore, Hong Kong and Taiwan, have less stringent disclosure requirements than the four European extraction countries, the United Kingdom, the United States, Canada, and Australia. The stock markets in these Asian countries are not as developed as those of the United Kingdom, United States, Canada, and Australia, nor are their trading volumes as large. In fact, none of them make the *Euromoney* (1990b) top stock exchange list.

Table 1 gives an indication of the size of these three countries' stock markets in comparison to that of Japan. After Japan, the third largest stock market ranked by foreign equity turnover, the Asian stock markets decrease rapidly in size and become unknown territory for most foreign investors. Taiwan's is the largest Asian stock market after Japan's, but its 1991 total equity turnover of $362 billion was less than 36% of Japan's. The 1991 total equity turnover of Hong Kong (U.S. $39 billion) and Singapore (U.S. $19 billion) were each less than 6% of Japan's. While small compared to Japan's giant stock market, the overseas Chinese stock markets are likely to grow in significance as these three countries continue to expand economically.

Taiwan has not been part of the British empire, but Singapore and Hong Kong have experienced recent membership in the British Empire; Hong Kong will remain a British Crown Colony until 1997. Thus, there are certain similarities among their regulatory environments, and certain differences. Singapore and Taiwan have political/social environments wherein the governments tend to intervene heavily in securities regulation and trading. For example, in Singapore, the governmental body charged with overseeing the Singapore Stock Exchange is the Monetary Authority of Singapore (MAS). As part of the effort to reform the trading of securities in

Table 3. Regulatory Requirements of the United State, Singapore, Hong Kong, and Taiwan

U.S. General Requirements under S-K or S-X	*Singapore*	*Hong Kong*	*Taiwan*
Reconciliation with U.S. GAAP	Comply with local statements of Accounting Standards which follow IASC. If not, nature of significant deviation is disclosed	Comply with IASC	Should comply with Republic of China GAAP
Foreign currency translation required	Disclosure must be in Singapore dollars	Not required	Disclosure must be in local currency
Financial information about industry segments required, including disclosure of revenue (distinguish between external sales and intersegment sales and transfers), operating profit or loss, carrying value of identifiable assets and amount of period capital expenditures, and so on	Recommended to be disclosed in note to accounts	Less stringent than U.S. requirements	Comparable to the United States
Financial information about foreign and domestic operations and export sales	Comparable to the U.S. requirements	Less stringent than U.S. requirements	Less stringent than U.S. requirements
Disclosure of location and general character of principal plants, mines and other important properties	Similar to U.S. requirements	Less stringent than U.S. requirements	Less stringent than U.S. requirements
Mining, Oil, and Gas operations: Full costing or successful efforts in addition to reserve recognition supplemental disclosure	Not required	Not required	Not required

Dividends: require disclosure of the frequency and amount of dividends paid for 2 years	Require disclosure of the frequency and amount so dividends paid for 5 years	Amount paid and proposed disclosed with comparatives for previous year	Amount paid and proposed with comparatives for previous year
Capital stock: disclosure of voting rights, conversion, redemption liquidation rights and so on	Similar to the U.S. requirements	Similar to the U.S. requirements	Similar to the U.S. requirements
Dept securities: disclosure of terms, maturity, interest rate conversion, redemption, and so on	Similar to the U.S. requirements	Similar to the U.S. requirements	Similar to the U.S. requirements
Selected financial data: disclosure of 5 years of financial information including operating revenues income from continuing operations, income per share, total assets, long term obligations, and so on	Similar to the U.S. requirements	Comparative table of results, assets and liabilities for the last 5 years	5 years comparative financial data required, but not as detailed as the United States
Supplementary information such as quarterly financial information, effects of changing prices, and so on	Not specifically required	Not specifically required	Not required
Managements' Discussion and Analysis required	Required	Not specifically required	Not required
Disclosure of disagreement with accountants on accounting and financial disclosure required	Not specifically required	Not specifically required	Not specifically required
Audited consolidated Balance Sheet for last 2 years	Required for abridged prospectus	Audited consolidated balance sheet for the current year together with comparatives for the previous year	Same as United States
Unaudited interim Balance Sheet	Not required	Not specifically required	Not specifically required

(*continued*)

Table 3. (Continued)

U.S. General Requirements under S-K or S-X	*Singapore*	*Hong Kong*	*Taiwan*
Audited Income Statements and Statements of Change in Financial Position (SCFP) for 3 years*	Audited income statement for 5 years, Statement of Change in Financial Position not required	Audited income statement and Statement of Change in Financial Position for current year with last year for comparision	Audited Income Statement and Statement of Cash Flows required only for 2 years
Audited Statements of Changes in Stockholders' Equity for the past 3 years	Disclosure of all securities sold or issued for past 5 years	Not specifically required	Similar to the U.S. requirements but only for 2 years

Note: * In the United States, for fiscal years ending after July 15, 1989, the U.S. Financial Accounting Standards Board, in SFAS No. 95, *Statement of Cash Flows,* requires all U.S. corporations to issue a cash flow statement in place of the Statement of Change in Financial Position.

Sources: Adapted from Table 1. The information on Singapore, Hong Kong, and Taiwan was compiled with the help of the offices of Coopers and Lybrand and their affiliates in those countries. Also the Price Waterhouse Series of Information Guides, *Doing Business in*..., were consulted.

Singapore following the Pan-El "forward contracts" trading scandal of 1985, which led to closing the Stock Exchange of Singapore (SES) and Malaysian Kuala Lumpur Stock Exchange (KLSE) for three full trading days, from December 2 to December 5, 1985, the Singapore government transferred administration of the 1985 Securities Industry Act to the MAS. In November 1986, the MAS installed a new committee at the SES. Instead of consisting entirely of brokers as in the past, the new committee is composed of four elected brokers and five nominees—four bankers and a lawyer. One of the five nominees is the committee's executive chairman and an MAS governor. Thus, brokers, like bankers, in Singapore are very much subject to MAS rule. In Taiwan, in 1958 the government decided to establish a formal securities market; it sent teams to the United States and Japan to study securities development. Then, the Taiwan government established its own Securities and Exchange Commission (TSEC) in 1960 to regulate securities transactions. The Taiwan Stock Exchange (TSE) was founded in 1961. Since then the TSEC maintains a firm hold over the TSE. By contrast, the Hong Kong stock exchange has until fairly recently enjoyed the reputation of being largely an unfettered environment for securities trading. In September 1986, ughter laws on corporate disclosure and compliance with listing laws were introduced (Rowley 1987, 101-2, 138-42, 173-74).

Historically, all three of these Chinese dominated countries have experienced the influence of local "syndicates," which have manipulated their local stock markets, and they have known instances of insider trading. In Chinese society, insider trading has not had traditionally the negative connotation it has had in the West. In fact, in some Asian countries insider trading is accepted as part of the culture of making money. Whether company directors are making money from trading on the inside matters little to small investors on the outside, provided they can also make something. With the rising influence of foreign brokers and fund managers in the Hong Kong stock markets, there has been a decline in the manipulative power of the local "syndicates." Today, the power to move the market appears to lie with two or three big players (Rowley 1987, 147).

The globalization of securities trading and the desire of Western investors to invest capital in the emerging Asian stock markets is likely to increase pressure on them to tighten up their securities regulations and disclosures, and to enforce more vigorously their laws against insider trading and market manipulation. Such pressures are likely to continue to meet local cultural resistance.

In Chinese culture, the long-standing tradition of family owned and controlled businesses is a reason Rowley cites for the relatively few companies which offer their securities for sale to investors in Singapore, Taiwan, and Hong Kong. Although there are a number of companies which would seem to qualify from the standpoint of size, their owners apparently are hesitant to go public, at least in part due to their reluctance to comply with these countries' comparatively mild disclosure requirements.

The structures of many Chinese company groups differ significantly from the typical integrated Anglo-American company. As such, if Chinese family dominated company activities are disclosed, how accurate a picture emerges if the activities and financial positions of "related" companies are not disclosed? If consolidated financial statements are presented along Western lines, how representative are they of the company's usual manner of functioning and natural groupings?

In sum, there are significant cultural and organizational differences between the Chinese-Asian and Western business entities and their resultant securities trading environments. These differences cannot be ignored by regulators nor international securities traders. Their impact on and significance to successful harmonization of securities regulation and disclosure practices cannot be underestimated.

MODES OF REGULATORY ACCOUNTING DISCLOSURE IN VARIOUS STATES

The theoretical framework developed above provides a basis for locating the states discussed in this paper on the appropriate regulatory and disclosure axes. Accounting regulation in the United States, as it relates to the corporate reporting of larger companies, is governed principally by the Securities and Exchange Commission. Generally, the SEC has taken the position that detailed accounting standards should be promulgated by a more "independent" quasi-governmental body organized by the U.S. accounting profession. The present such body is the Financial Accounting Standards Board. The SEC has the power, which it has occasionally exercised, to overrule he FASB if it disagrees with what the private standard-setting body s proposing to do. Tthe U.S. Congress can overrule the SEC on ıccounting regulations when necessary. There is usually a close elationship between the SEC and the FASB and the accounting profession both lobbies and provides expertise to the FASB.

Canada has eleven corporate law jurisdictions, with varying equirements; an entity may be subject to requirements in more than ne jurisdiction (Coopers & Lybrand 1989, 26-27). Since the 1970s, he Accounting Research Committee (ARC) of the Canadian nstitute of Chartered Accountants (CICA) and its successor, the Accounting Standards Committee, established in 1973, and estructured in 1991 as the Accounting Standards Board, have eceived support from the Canadian federal and provincial governments and from Canadian industry. Its accounting reporting ınd disclosure recommendations are published in the CICA Handbook. The provisions of the 1975 Canadian Business Corporations Act require that financial statements and the audit eport be prepared in conformance with the ARC's recommendations contained in the CICA Handbook. In addition, several provincial securities administrators require adherence to the Handbook (Evans et al. 1985, 30-32). The close cultural and economic ties between the United States and Canada have fostered in the two countries a tendency toward similar financial accounting principles and practices. The recently ratified North American Free Trade Agreement (NAFTA) is likely to encourage even closer ties as cross-border access to professionals is eased, and mutually acceptable professional standards and licensing and certification criteria develop (*World Accounting Report* 1992/1993).

U.K. professional accountancy bodies have not been established by the government (although it may have been influential in their development) and the professional accountancy bodies are independent of it, at least nominally. Accounting standards are set by the Accounting Standards Board (ASB), successor to the Accounting Standards Committee (ASC), whose membership overwhelmingly is composed of representatives of the six major U.K. Institutes of Chartered Accountants. Historically, ASC rulings have not had the force of law and reporting companies not infrequently ignored them. When U.K. corporate financial reports were heavily publically criticized in the late 1960s, the ICAEW responded by forming what ultimately became the Accounting Standards

Committee. ASC membership was large (21 at its dissolution), unpaid, part-time, drawn largely from the accountancy profession. In 1988, following the recommendations of the Report of the Dearing Committee, the Accounting Standards Board replaced the ASC. The ASB, with a full-time paid chairman and technical director, and seven part-time paid members, has the power to issue accounting standards on its own authority (Parker 1991a). The standards proposed by the ASB are supported by the Stock Exchange and receive favorable government comment generally. Applicable accounting standards have legal backing in the United Kingdom presently and are monitored by the Financial Reporting Review Panel. Within the United Kingdom, there is an informal structural relationship between the state and the accounting profession, but considerable governmental pressure. U.K. membership in the European Community has resulted in greater hierarchical governmental involvement in accounting reporting and disclosure. There have been significant changes in the U.K. Companies Acts. The 1981 Companies Act and the 1989 Act introduced the Fourth and Seventh European Community directives which specify standardized formats and detailed accounting rules to be followed. Thus, U.K. standard setters and accountants find their freedom of action increasingly constrained by law (Davies et al. 1992).

To a significant extent, Australia reflects the impact of British traditions and practices. The Companies Acts of the States and Commonwealth territories comprise the "Uniform" Act of 1961, which, with subsequent amendments, governs Australian business affairs. Until 1978, the Australian Accounting Research Foundation (AARF), sponsored by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants, recommended accounting and auditing standards (Choi and Mueller 1984, 77-78). Events in Australia in 1978 and subsequently have led to significant changes in the Australian regulatory environment. In 1978, there was a formal agreement between the Australian federal government and the states whose purpose was to achieve uniformity in company law and its administration. Two central bodies were established: a Ministerial Council for Companies and Securities and a National Companies and Securities Commission (NCSC). The Ministerial Council, made up of the Attorney Generals of the states and the commonwealth, was a policy-making body which recommended to the federal and state governments any matters which required legislation. The Ministerial Council established the Accounting Standards Review Board (ASRB). The ASRB approved accounting standards according to which Australian companies must prepare accounts and give a "true and fair" view. There was tension between the ASRB which had legal authority and the AARF which had professional expertise and persuasive power. The AARF formulated, through appropriate committees, accounting and auditing standards (AASs). If the ASRB considered them appropriate it approved them as applicable approved accounting standards. By early 1990, 24 AASs had been issued and most had been incorporated into ASRBs (Parker 1991b). The disproportionately high number of Australian corporate failures in the 1980s, and doubts about the accountancy profession's ability to regulate itself, forced the Australian Accountancy profession into a reluctant marriage with the government on standard setting. The Australian Securities Commission (ASC) was established by the Securities Commission Act of 1989 as a new national regulatory authority responsible solely to the federal minister; it replaced the NCSC. The ASC Act strengthened inspection and investigation powers of the ASC, compared to those of the NCSC, and provided it with greater financial resources. The new Corporation Law of 1990 altered fundamentally the position of the ASRB, which it renamed the Australian Accounting Standards Board (AASB). The AASB, a federal statutory board, was given the power to make accounting standards for corporate financial reports (Miller 1991).

From the preceding discussion, the four Anglo-American English speaking countries would be located in quadrant IV of the Authority and Enforcement axes (Figure 2) and quadrant IV of the Measurement and Disclosure axes (Figure 3). However, there have been significant European Community developments in the past decade which have had major impact on the regulatory and disclosure environments of the United Kingdom. Adherence to the EC Fourth and Seventh Directives is shifting the United Kingdom more in the direction of quadrant III as more emphasis is placed on uniformity and statutory control. Likewise, Australia has moved in the direction of greater statutory control. On the Measurement and Disclosure axes (Figure 3) there are trends in all the Anglo-American countries for greater disclosure (i.e., transparency). The issue to be addressed next is where do the Chinese-Asian countries, Singapore, Hong Kong, and Taiwan fall within the Authority and Enforcement, and Measurement and Disclosure axes.

While Singapore shares a common experience with Hong Kong as beneficiary of the British Colonial rule, its present day securities regulatory environment bears a closer affinity to that of Taiwan than that of Hong Kong. In both nations, the role of the government in regulation is paramount and the professional accounting bodies have comparatively little input into regulation and accounting reporting and disclosure policies. In Hong Kong, on the other hand, until recently the government, like the government of the United Kingdom, has tended to rely on voluntary professional bodies to establish and police these functions.

In Singapore, the regulatory authorities in the stock market are the Singapore Stock Exchange and the government. The main statutory regulations which affect securities trading are the Companies Act, Chapter 185 and Companies Regulations administered by the Registrar of Companies, and the Securities Industry Act, administered by the Monetary Authority of Singapore (Spicer and Oppenheim 1988, 164-65). Requirements regarding the form and content of annual financial statements are found in the Companies Act. These annual reports are normally accepted by the SES for public release. The SES may request additional disclosures and explanations of any material variation in earnings or assets of a listed corporation, between one financial year and another, if such variation is not adequately explained in the annual report (Price Waterhouse 1984, 37). In recent years, financial reporting in Singapore has tended to diverge from U.K. financial reporting. Singapore has chosen constituent features of its own law from countries such as Australia and Malaysia, from the IASC, and from its analysis of its own requirements, while the United Kingdom itself is subject to the Fourth and Seventh Directives of the European Community. Such divergence is likely to continue (Briston and Liang 1990).

In Taiwan, legal requirements are the most influential force in determining accounting standards and procedures. This influence is demonstrated in the many Taiwanese laws related to accounting, such as the 1964 Commercial Accounting Law, the Company Law, the CPA Law, the regulations of the ministry of Finance, and the regulations of the Taiwan Securities and Exchange Commission (TSEC). The Commercial Accounting Law requires business entities to keep proper accounting records and mandates the use of accrual basis accounting in the preparation of financial statements. The

Ministry of Finance issues regulations which require enterprises in Taiwan to submit audited financial statements to tax authorities. The basic financial statements are an income statement, balance sheet, and statement of cash flows. The TSEC requires companies whose stocks are listed on the Taiwan stock exchange to have semi-annual audits of their financial statements. The Ministry of Finance and the Ministry of Economic Affairs regulate auditors' independence, reporting and disclosure requirements, and audit procedures. The accounting profession itself has only recently become actively involved in establishing accounting standards and procedures (Al Hashim and Arpan 1988, 40-42).

In both Singapore and Taiwan strong elements of traditional Chinese values and modes of behavior persist. There is a strong sense of community. On the one hand, many companies prefer to remain private, closely held corporations and thereby minimize the impact of the government in business affairs. On the other hand, publicly traded companies are subject to regulations which are largely government determined.

Hong Kong's regulatory authority is the Office of the Commission for Securities and Commodities Trading which is the executive body of the Securities Commission, a statutory body which determines Hong Kong securities industry policies. There are few restrictions on trading except the prohibition against going short and there are presently no prohibitions against repatriation of income for foreign-owned organizations (Spicer and Oppenheim 1988, 67-68). The Companies Ordinance specifies the form and content of annual financial statements and stipulates that they be "true and fair." The financial statements should also be prepared in accordance with the Hong Kong Society of Accountants Statements of Standard Accounting Practice. The stock exchange also requires statements showing the separate contributions of widely differing operations and a geographical analysis of trading operations for companies operating outside Hong Kong (Price Waterhouse 1984, 21). Reports of companies incorporated in Hong Kong must be audited by auditors licensed by the Hong Kong Society of Accountants. The auditors are guided by Hong Kong Society of Accountants statements of standard practice (Coopers & Lybrand 1989, 70-71). Recently, the Hong Kong Society of accountants announced the initiation of its practice review program which is primarily educational and aimed at monitoring and improving professional auditing standards (*World Accounting Report* 1992). Thus, in Hong Kong, as in the United Kingdom, professional accountancy bodies have been the dominant influence over regulatory, reporting, and disclosure policies. In Hong Kong, as in Singapore and Taiwan, strong traditional elements persist with their interlocking communal networks.

Based on the discussion above, it is clear that there are changes afoot in the three overseas Chinese countries—Hong Kong, Singapore, and Taiwan. There appears to be a convergence between Taiwan and Singapore on the Authority and Enforcement axes (Figure 2) and on the Measurement and Disclosure axes (Figure 3). Hong Kong also appears to be moving in the direction of greater statutory control and uniformity and more disclosure (i.e., transparency). While it is risky to predict the impact of the Crown Colony's reversion to the Peoples Republic of China, given that country's authoritarian system, greater government control, and uniformity are quite likely.

SUMMARY AND CONCLUSION

Efforts to internationally harmonize securities regulations and accounting reporting and disclosure standards are worthwhile and may yield productive fruits for investors and regulators as well. For this to happen, however, the international accounting and investing communities must be cognizant of the various national environmental factors which are likely to impinge on the outcomes.

As discussed in this study, various cultural areas exist in today's world; two such areas were examined—the Anglo-American and Chinese-Asian. Our investigation noted that regulatory policies and practices are influenced by political history and cultural traditions. These forces contribute to organizational structures and modes of behavior, both institutional and individual. For example, Canada, Australia, Singapore, and Hong Kong have all been part of the British Empire. All have some form of Companies Act, as does the United Kingdom. Yet, only Hong Kong has not significantly altered its regulatory environment. (It may be inclined or forced to do so when it ceases to be a British Crown Colony and reverts to the Communist Chinese Mainland in 1997.) Australia is moving away from a professionalism orientation to more governmental influence and control. Canada has approached the U.S. mode of professionalism/flexibility. Singapore has gravitated toward greater statutory control. Taiwan, never part of the British Empire, but up until World War II under Japanese domination, has modeled its regulatory environment in some measure on a mixture of Japanese and U.S. influences; like Singapore it has trended toward greater statutory control. The United Kingdom, subject to European Community influence, seems to be moving away from its professionalism mode toward greater governmental influence over regulation, reporting, and disclosure.

Thus, the regulatory environments in the nations studied are dynamic, not static. They change over time in response to local and international pressures and developments. As nations industrialize and permit/encourage foreign nationals to invest in their local securities markets, to list their securities on them and to hold memberships on them, there are pressures for more stringent securities regulatory requirements and accounting reporting and disclosure standards. As these forces exert themselves, national regulatory and accounting professional bodies are placed under a critical microscope. Regulators may feel the need to tighten up and to reduce abuses, such as insider trading, and accounting professionals may feel compelled to play a more significant role in standard setting and application. As a nation industrializes further and becomes tied more intimately to the international economic arena, it is likely to encounter international pressures to upgrade its regulatory disclosure requirements. The direction it takes will be influenced by the system operating within the nation. Nations with strong constitutional traditions are likely to continue to avoid the extremes; those with strong dictatorial or near-dictatorial heads of state are more likely to swing in the direction of statutory control and uniformity.

The harmonization movement not only confronts different regulatory environments, it also is exposed to different corporate structures and modes of organization and control. Thus, accounting standards based on a Western model for consolidation may not be appropriate for non-Western environments. Culturally specific methods of reporting consolidated results appear to be needed so that the substance of a particular consolidated organization is captured, rather than being forced into an inappropriate form. Thus, perhaps it would be advisable to recognize different culturally influenced types of corporate governance by adding a category of "dominated company" for entities like the Chinese family business discussed in this paper (Tricker 1991). This would expand the current typology of public and private companies and result in more meaningful financial reports.

Finally, it needs to be noted that different levels of regulation and disclosure exist in various nations. The regulatory requirements of the United States, for example, are often regarded as very onerous. It is claimed that such requirements discourage foreign corporations from listing on U.S. stock markets. The U.S. Securities and Exchange Commission justifies its rigorous requirements on its mandate to protect investor interests; it therefore seeks to minimize investor risk. The United Kingdom, on the other hand, has less detailed regulatory, reporting, and disclosure requirements. The ASC and ASB in the United Kingdom have taken quite different approaches from the FASB to accounting standard setting. The U.K. bodies have allowed a high degree of flexibility, thereby requiring considerable judgment in the application of standards. On the other hand, this looseness, or lack of detailed rules, has resulted in like transactions being accounted for in dissimilar ways producing materially different effects. Conversely, the U.S. FASB has generated a mountain of highly detailed, legalistic standards which threaten to obscure the concept of fair presentation (Davies et al. 1992). With such differences in perception of the proper rules of disclosure, international harmonization is a long way off.[5]

This study is subject to the limitation that it looked at only two cultural blocks. Many such blocks exist in the contemporary world and are worthy of investigation. Furthermore, empirical examination was not made; rather an extrinsic observational study was undertaken. While differences were noted, it was not possible to precisely measure their significance, statistically speaking.

Suggestions for future research include examining other major cultural environments' impact on business organizations and regulatory disclosure and accounting subcultures. It would be interesting and helpful to derive a greater understanding of the cultural influences on organizational business forms in emerging nations and their resulting behavioral characteristics. Such an understanding should prove beneficial to foreign investors if and when those business entities go public.

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NOTES

1. Although the international community understands the importance of international harmonization of accounting standards, no consensus has yet emerged on the ways to achieve such harmony. Wright (1989) suggests several approaches.

> 1. Comparability through full disclosure; this would permit the most sophisticated users to process the information but would be of little benefit to the less sophisticated users;
> 2. Reconciliation of domestic financial statements to some other basis. If IASs were to be accepted as a common benchmark for reconciliations, in theory, that would enable everyone to understand everyone else's financial statements, provided they understood the international standards, not an easy task for many users. Reconciliations were subjected to criticism as at best unwieldy, as overseas registrants with the SEC who reconcile to U.S. GAAP can testify. At worst, reconciliations perpetuate national differences;
> 3. Dual standards for domestic and foreign registrants. London's International Stock Exchange supports this approach by allowing overseas companies to comply with IASs to obtain a listing. However, traditionally Americans have regarded this as inequitable since the restrictive and detailed SEC rules would disadvantage U.S. companies compared to foreign companies reporting under looser IASs; and
> 4. Encouragement of the IASC's comparability project and agreement to a reduction of the optional treatments available in current IASs. As the IASC has no enforcement powers, this definition presupposes voluntary national compliance by various nations with different regulatory environments.

2. These dimensions were well defined by Hofstede (1984, 83-85) as follows.

> Individualism versus Collectivism
>
> Individualism stands for a preference for a loosely knit social framework in society wherein individuals are supposed to take care of themselves and their immediate families only. Its opposite, Collectivism, stands for a preference for a tightly knit social framework in which individuals can expect their relatives, clan, or other in-group to look after them, in exchange for unquestioning loyalty (it will be clear that the word "collectivism" is not used

here to describe any particular political system). The fundamental issue addressed by the dimension is the degree on interdependence a society maintains among individuals. It relates to people's self-concept: "I" or "we".

Large versus Small Power Distance

Power Distance is the extent to which the members of a society accept that power in institutions and organizations is distributed unequally. This affects the behavior of the less powerful as well as of the more powerful members of society. People in Large Power Distance societies accept a hierarchical order in which everybody has a place which needs no further justification. People in Small Power Distance societies strive for power equalization and demand justification for power inequalities. The fundamental issue addressed by this dimension is how a society handles inequalities among people when they occur. This has obvious consequence for the way people build their institutions and organizations.

Strong versus Weak Uncertainty Avoidance

Uncertainty Avoidance is the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity. This feeling leads them to beliefs promising certainty and to maintaining institutions protecting conformity. Strong Uncertainty Avoidance societies maintain rigid codes of belief and behavior and are intolerant towards deviant persons and ideas. Weak Uncertainty Avoidance societies maintain a more relaxed atmosphere in which practice counts more than principles and deviance is more easily tolerated. The fundamental issue addressed by this dimension is how a society reacts on the fact that time only runs one way and that the future is unknown: whether it tries to control the future or to let it happen. Like Power Distance, Uncertainty Avoidance has consequences for the way people build their institutions and organizations.

Masculinity versus Femininity

Masculinity stands for a preference in society for achievement, heroism, assertiveness, and material success. Its opposite, Femininity, stands for a preference for relationships, modesty, caring for the weak, and the quality of life. The fundamental issue addressed by this dimension is the way in which a society allocates social (as opposed to biological) roles to the sexes.

3. Gray defined his "accounting" values as follows:

Professionalism versus Statutory Control—a preference for the exercise of individual professional judgment and the maintenance of professional self-regulation as opposed to compliance with prescriptive legal requirements and statutory control.

Uniformity versus Flexibility—a preference for the enforcement of uniform accounting practices between companies and for the consistent use of such

> practices over time as opposed to flexibility in accordance with the perceived circumstances of individual companies.
>
> Conservatism versus Optimism—a preference for a cautious approach to measurement so as to cope with the uncertainty of future events as opposed to a more optimistic, laissez-faire, risk-taking approach.
>
> Secrecy versus Transparency—a preference for confidentiality and the restriction of disclosure of information about the business only to those who are closely involved with its management and financing as opposed to a more transparent, open and publicly accountable approach.

4. For example, Japan's Ministry of Finance, in October 1976, released Ordinance No. 30 which provided that all Japanese corporations subject to the Japanese Securities Law prepare consolidated financial statements for accounting periods commencing on or after April 1, 1977. These statements, prepared in accordance with Ordinance No. 28, were to be consolidated and to employ the equity method of accounting for investment in a manner nearly identical with U.S. GAAP. The Japanese recognize that consolidation accounting procedures, which use a 20-50% stock ownership provision similar to U.S. practice, often require them to prepare financial reports for unnatural corporate groups. This tends to group Japanese companies in a manner contrary to their usual functioning which, in turn, tends to distort the complex natural groups within Japanese corporations and portray them from an alien perspective. While the opportunities to manipulate accounting information between groups have been diminished and Japanese corporate reporting is better received by foreign users, this has been achieved "at the expense of creating reporting misfits" (Lowe 1990, 1-9). Such phenomena may be found in other countries as harmonization efforts achieve targeted objectives in the years ahead.

5. For a recent, optimistic view of the rapidity with which the international harmonization of accounting standards is likely to occur, see Wyatt and Yospe (1993). "U.S. business should recognize the acceptance of IASs (International Accounting Standards) is closer to reality than ever before." The authors issue a clarion call to American business to pay attention to IASC harmonization efforts, and to participate in them in order to influence them.

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CONSOLIDATION POLICIES AND PROCEDURES DISCUSSION MEMORANDUM:

AN EXAMINATION OF THE POTENTIAL IMPACT ON REPORTING QUALITY

Robert E. Hoskin and Andrew J. Rosman

ABSTRACT

This paper examines issues presented by the FASB in its discussion memorandum (DM) on consolidation policy and procedures (FASB 1991). The purpose of this examination is to provide the FASB and its constituents with information that could be used in deliberating the DM, consistent with calls for conducting ex ante research. Two major issues, when to consolidate and how to consolidate, are considered. Our analysis is guided by the criteria set by the board for deciding whether to add a project to its agenda (pervasiveness, alternative solutions, technical feasibility, and practical consequences).

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Based on a review of the literature and empirical data analysis, we reach two conclusions. First, the board's concern over whether to change the criteria for when to consolidate from majority ownership to economic control does not appear to be pervasive. Nonetheless, the board still may be intent on changing the rules, if only to become more compatible with international standards. If the FASB chooses to move toward economic control, we urge that it learns from history. Like *SFAS 94*, the change from majority ownership to economic control is likely to increase the number of companies that are included in consolidation, which, by definition, results in a loss of information. When *SFAS 94* was implemented, no changes were made to provide users of financial statements with enhanced disaggregated disclosure, although disclosures made prior to *SFAS 94* were continued. We recommend that the board not proceed with another standard that results in increased aggregation (i.e., consolidation of more companies) without also providing at the same time more useful disaggregated disclosure. Second, the issue of how to consolidate, which is a choice from among three competing theories (parent company, economic unit [which itself has two forms], and proportionate consolidation), also is not pervasive. Furthermore, our empirical analysis shows that changing practice from the most commonly used method (parent company) would not dramatically alter current reporting. Thus, we recommend that the Board not proceed further on this issue.

In 1991, the FASB issued a discussion memorandum (DM) on consolidation policy and procedures (FASB 1991) as a part of its overall project on consolidations. Two major issues were addressed in the DM: criteria for determining which entities to include in consolidation and the conceptual merit of several theories that underlie how to prepare consolidated financial statements. This paper is written as a response to these two issues and is based on ex ante research. This type of research has been called for by the board (see Beresford 1993) and relies on "thoughtful analysis and logical argumentation" (Beresford 1993) and reliable empirical data, when available. Ex ante research is the only approach available for examining the DM because the alternative reporting practices described by the FASB have not yet been implemented.

This paper investigates the potential changes in financial reports under the alternatives offered in the DM. In so doing, this paper asks two fundamental questions: whether users are better served by the alternative methods than they are by current reporting requirements, and if they are not better off, why require change?

In their classic article on accounting policy setting, May and Sundem (1976, 758) argue forcefully that academic research should address these fundamental questions. Specifically, they state that a "potentially profitable avenue of accounting research is investigating the degree to which actual accounting time series may be expected to differ under various accounting alternatives." In the overall scheme of standard setting they go on to say:

> since predictions of the effects of alternatives on accounting outputs is the first-substantive step in predicting consequences, it has special implications for the efficiency of the *applied policy-making* process. That is, considerable savings potentially may be realized if the prediction process stops at this point in those cases where the alternatives being considered show no potentially significant differences in accounting outputs (May and Sundem 1976, 758).

In our analysis of the issue of when to consolidate, we develop an argument that efforts to increase the likelihood that entities will be included in consolidation will change accounting outputs, and that this change will result in a loss of information for users such as analysts. While some may find the consolidated information useful, we argue that the user community would be well served by the FASB developing standards on reporting disaggregated information in tandem with standards on consolidation. Such a move would be consistent with recent recommendations made by the AICPA's special committee on financial reporting.

With regard to the issue of how to consolidate, we show that potential alternatives to current practice do not affect accounting outputs. Thus, consistent with the perspective developed by May and Sundem, we recommend that the FASB should not proceed with this part of the DM.

The structure of the examination followed in this paper is to consider the two issues in the DM in terms of the agenda criteria followed by that the FASB. We believe that this approach has broad appeal in that it may be applied to examine the merits of any FASB standard as it is developed. Before we address the two issues in the DM, the next two sections describe the consolidations project and the FASB's agenda criteria.

OVERVIEW OF CONSOLIDATIONS PROJECT AND DM

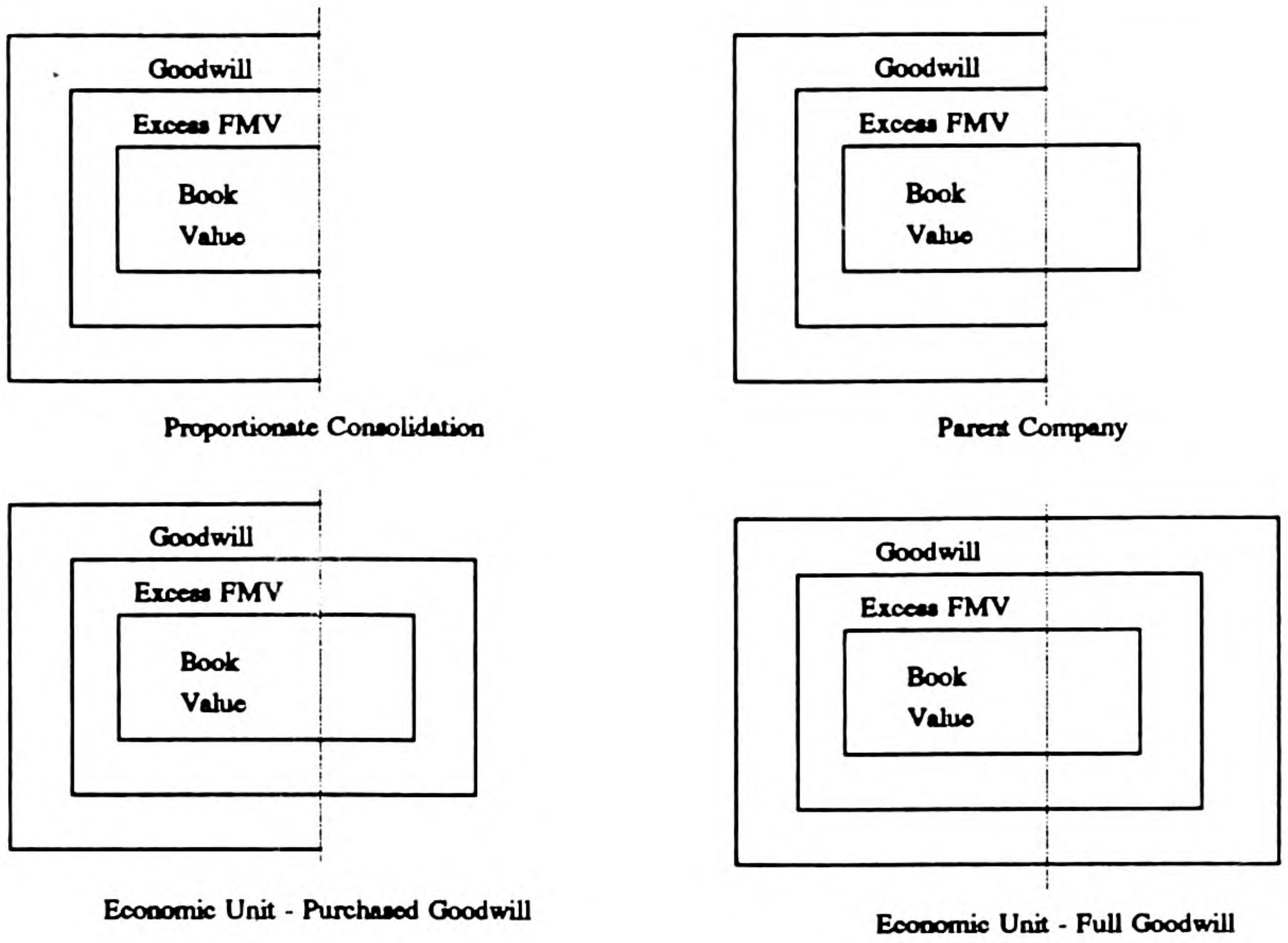
The project on consolidations and related matters has been organized in the following phases, of which the DM only addresses phase (b):

a. reconsideration of the "nonhomogeneity" exception (this phase was completed with the issuance of FASB Statement No. 94, *Consolidation of All Majority-owned Subsidiaries*),
b. consideration of specific financial accounting and reporting issues,
c. accounting for entities that do not qualify for consolidation, including joint ventures,
d. determining when, if ever, a "new basis of accounting" is appropriate (the subject of a separate DM),
e. disclosure of disaggregated information in financial statements, and
f. consideration of all of the above related to not-for-profit entities.

The two major areas of concern covered by the DM are when and how to consolidate. The issue of when to consolidate is driven in current practice by a limited concept of control that generally is evidenced by majority ownership. That is, consolidation is required if a company owns over 50% of the outstanding voting shares of another company. The principal alternative to current practice offered in the DM is to broaden the concept of control from legal control to economic control. For example, control may be evidenced by contracts or conditions other than majority ownership.

The DM identifies two reasons to reconsider using majority ownership to determine when to consolidate. First, there is an increased interest internationally to move away from majority ownership toward an economic control concept. Second, *ARB 51* is vague with respect to the ability of companies to consolidate less-than-majority-owned investees in which control is evident. The implication of broadening the definition of control is that some entities that are currently accounted for under the equity method may be included in consolidation.

The second issue of how to consolidate is presented as a choice from among four concepts of consolidation: the economic unit-full goodwill, the economic unit-purchased goodwill, the parent company concept, and the proportionate consolidation concept. The four concepts are summarized in Figure 1. Each concept would represent a 100%, single transaction acquisition in exactly the same way because no noncontrolling interest would be involved. Differences arise, however, in an acquisition that is less than 100% and in a step-acquisition. The implication of changing from the dominant method in current practice (parent company) to either of the more extreme concepts (proportionate consolidation or either variation of the



The four concepts of consolidation discussed in the FASB's DM are illustrated above. The areas to the left of the dotted line in each diagram represent the parent company's share of book value, excess fair market value, and goodwill of the purchased subsidiary. The areas to the right of the dotted line represent the amounts attributed to noncontrolling interest (NCI). Each of the concepts is briefly described as follows:

Proportionate Consolidation: NCI is not recognized. The amounts recorded on the consolidated statements reflect only the parent company's share of the financial results of the subsidiary.

Parent Company Concept: NCI is recognized to the extent of its ownership in the book value of the net assets of the subsidiary. NCI's share of excess fair market value and goodwill is not recognized in the consolidated statements.

Economic Unit - Purchased Goodwill: NCI is recognized for its share of book value and excess fair market value of the net assets of the subsidiary. Note that the NCI's interest in excess fair market value is implicitly determined based on the purchase price for the parent's share of the net assets. The NCI's share of goodwill is not recognized in the consolidated statements.

Economic Unit - Full Goodwill: NCI is recognized for its share of book value, excess fair market value, and goodwill. Note that NCI's share of goodwill and excess fair market value are implicitly determined based on the purchase price for the parent's share of the net assets.

Figure 1. Summary of Four Consolidation Concepts

economic unit concept) is to change the amount reported for noncontrolling interest as well as the composition of all other assets, liabilities, revenues, and expenses included in consolidation.

AGENDA CRITERIA

We evaluate the potential for the issues covered in the DM to influence decision making by using as benchmarks for comparison the criteria established by the board for deciding whether to add projects to its agenda. These criteria are (FASB 1992):

1. *Pervasiveness of the problem:* the extent to which an issue is troublesome to users, preparers, auditors, or others; the extent to which there is diversity of practice; and the likely duration of the problem (i.e., is it transitory, or will it persist);
2. *Alternative solutions:* the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability, and comparability are likely to be developed;
3. *Technical feasibility:* the extent to which a technically sound solution can be developed, or whether the project under consideration should await completion of other projects; and
4. *Practical consequences:* the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act (e.g., the SEC or Congress).

The discussion in the following two sections of this paper is organized on two levels. First, we present separate discussions for each of the two major issues covered in the DM (i.e., when and how to consolidate). Second, within each discussion, we provide analysis categorized according to the four agenda criteria used by the FASB.

DM ISSUE 1: WHEN TO CONSOLIDATE

Accounting practitioners and academics have argued for years over the most appropriate manner in which to report the results of entities that are under some form of common control. In fact, a monograph on consolidated financial statements articulated many of the alternatives discussed in the DM more than 40 years ago (Childs 1949). In the United States, the debate has resulted in a fairly clear standard that requires consolidation of majority-owned subsidiaries. The few exceptions that existed to this standard were eliminated with the passage of *SFAS 94*. The purpose of the analysis in this section is to consider whether the alternatives proposed in the DM are likely to impact practice, and if so, to try to assess the likely policy implications for the FASB.

Pervasiveness

With the exception of joint ventures (which are excluded from this DM), the issue of whether economic control or majority ownership should guide the decision of when to consolidate has not created much debate among practitioners. Of the six AICPA Issues Papers that created much of the concern raised in the overall project on consolidation and related matters, only the one on joint venture accounting directly addresses the issue of economic control. Although this clearly is not a scientific survey of practice, recommendations of the AICPA to the board are reasonable surrogates of practitioner sentiment. It would, therefore, appear that the issue of when to consolidate is not pervasive.

Another factor that is being considered by the board that is related to the issue of pervasiveness is that using economic control as the criterion for deciding when to consolidate, rather than applying the criterion of majority ownership, has drawn much attention in other countries. Australia, for example, has passed Australian Accounting Standard 24, *Consolidated Financial Statements*, that establishes an economic control criterion. The international impetus to make changes in this area may be the only pervasive reason for considering it in the DM. However, it is questionable whether the intent of the pervasiveness criterion is met by a goal of harmonizing U.S. and international standards.

Alternative Solutions and Technical Feasibility

Even if the issue of when to consolidate was pervasive, there is some question as to whether consolidating more entities than would be the case in current practice, as would probably happen under a concept of economic control, would meet the second criterion of improving financial reporting. Indeed, we believe that some recent research indicates that the quality of financial reporting may have declined with the passage of the first phase of the consolidations project (*SFAS 94*) which required more subsidiaries to be consolidated than in prior periods.

There is a presumption in U.S. accounting pronouncements (*ARB 51* and *SFAS 94*) that consolidated statements are more useful to users than separate financial statements. This was the main argument, in fact, in the passage of *SFAS 94*. This presumption is not backed by research indicating that users prefer or need this type of consolidated data. In fact, some research has indicated that users would prefer disaggregated data for certain purposes (e.g., Rosman 1992; Previts et al. 1993). Bankers, in particular, may have more interest in separate, rather than consolidated statements, particularly if their lending agreements are predicated on the results of the borrowing entity and not the consolidated entity. For example, lenders to a subsidiary may only be interested in consolidated financial statements if there is a guarantee of debt by the parent or some other form of maintenance agreement. However, even in this instance, there is a need to have disaggregated data to be used to assess the probability that the borrowing entity will default causing the parent to incur the liability. Stock analysts also may have a need for more disaggregated data. Previts et al. (1993, 9), in a study on the information needs of sell-side financial analysts, indicate that "analysts disaggregate company performance in a finer set of operating units (segments) than specified by GAAP."

One additional piece of casual empiricism also suggests that users other than lenders and analysts might prefer disaggregated data. The preparers of the Compustat database have included data for approximately 30 companies (those with significant finance or insurance subsidiaries) on a pre- and post-*SFAS 94* basis at the request of database users.[1]

While it is difficult to argue that disaggregated data are more valuable for all purposes than consolidated data, there would seem to be sufficient evidence that disaggregated data are useful to readers of the annual report. To consider a standard that would aggregate more companies than under current standards, without simultaneously considering the needs for disaggregated information seems inappropriate. The issue of disaggregation should at least be concurrently considered with the issue of when to consolidate. However, substantial progress on the issue of disaggregation has yet to be made, even though *SFAS 94* was issued in October 1987. Although the board recently issued a research report on reporting disaggregated information (Pacter 1993), and issued a discussion document (FASB 1993), progress on disaggregation lags behind progress on consolidation issues.

The issue of reporting quality subsequent to the passage of *SFAS 94* has also been studied in terms of users' assessments of liquidity (Gosman and Meyer 1992). Comparing pre- and post-*SFAS 94* disclosures of current assets and liabilities, the authors found significant differences and, in some cases, noted that the classification of assets and liabilities into current and noncurrent categories completely disappeared from balance sheets in the post-*SFAS 94* period.

Finally, two issues regarding the disclosure requirements of *SFAS 94* raise concern about whether financial reporting is improved by this standard. First, many companies that were significantly impacted by *SFAS 94* include disclosures previously required by *APB 18* in the main body of their financial statements (e.g., General Electric Company), rather than as supplemental information as required by *SFAS 94*. While this treatment is consistent with the board's desire for companies to "experiment" with disclosures (*SFAS 94*, par. 12), it is apparent that some believe information would be lost if they narrowly complied with the requirements of *SFAS 94*. Second, former board member Victor Brown dissented to *SFAS 94* because companies that become part of the consolidated reporting entity subsequent to *SFAS 94* would not have to provide supplemental disclosures of disaggregated operations required by *APB 18*. This would limit the ability of financial statement users to compare companies that are essentially similar. Thus, returning to the board's first criterion, providing more disaggregated data in the post-*SFAS 94* period may be more of a pervasive problem for practice than determining when to consolidate, particularly because the latter will result in more aggregation of data than that which already exists. Such a dilemma may also indicate that the technical feasibility of the new standard (the third criterion for placement on the agenda) is doubtful without jointly considering the need for, and the form of, disaggregated data.[2]

Of all the user groups, the one with the most interest in information about the consolidated (economic) entity may be investors. Because they have a beneficial interest in the economic entity, investors may be better served by consolidated statement information. Nonetheless, research has shown that disaggregated information also is useful to investors as evidenced by the reports that analysts generate for investors.[3] For example, consider that fact that the ratio of total liabilities to total assets using consolidated data from the 1991 annual report of General Electric is approximately 85%. This amount of leverage would be viewed as high for a manufacturing firm and low for a financial institution. Because GE is a combination of both, the overall ratio is not of much use. Using the disaggregated data provided in the GE report, the manufacturing subsidiary's ratio is 55% and the financial services subsidiary's ratio is 92%. These ratios would seem to be well within the normal range, given the nature of the two types of business.

The issue of economic control versus ownership as the criterion for deciding when to consolidate, as discussed in the DM, seems to be too simplistically portrayed as an "either-or" choice. In many situations, however, the decision of when to consolidate is not so clear cut and may at times be a function of economic control or ownership, depending on the circumstances. Consider, for instance, the following two extremes: economic control with no ownership and no economic control and complete ownership. With respect to the first extreme, it is difficult to understand the relevance of consolidated statements. The owners of the parent company would have no ownership stake in the entity that it controls. Unless there are significant intercompany transactions between the entities, the parent company's stockholders cannot benefit from their control over the entity. Even if they can benefit, it will be through the transactions of the parent company with the controlled entity, and not through the success or failure of the entity itself. Details of these intercompany transactions may be better conveyed through disclosure in the footnotes of the financial statements to indicate the benefits that the parent company enjoys due to its control of the entity. Further, it is important to consider the interpretation of consolidated results. For example, is it meaningful to show all of the net assets of the controlled entity in the parent company's consolidated statements if the parent must also show an equivalent amount of equity attributable to noncontrolling interests? As a related issue, suppose a pension fund controls a large block of stock of a particular company, but not a controlling interest. If the rest of the ownership is spread very thinly, the pension fund can exercise significant control over the company. If the pension fund became proactive in exercising its control (as many of them have started to do) should the pension fund consolidate the financial results of the company?

In the Australian standard, *AAS 24*, the issue of control without ownership is discussed. The standard indicates that this situation would be rare in the private sector but might exist in the public sector where an equity interest is not possible, but where power may be granted by legislative or executive authority. It also alludes to the fact that control must be accompanied by economic benefits. In paragraph 28 of the standard it states:

> The capacity of one entity to dominate decision-making, in relation to the financial and operating policies of another entity, is insufficient in itself to ensure the existence of control as defined in this Standard. The parent entity needs to be able to dominate decision-making so as to enable that other entity to operate with it as part of an economic entity for the achievement of its objectives. *This would require the controlling entity, through its capacity to dominate decision-making, to be able to enjoy, in substance, the majority of the benefits of the other entity and to be exposed to the majority of the risks of that entity.* This will have the effect of excluding from the definitions of parent entity and subsidiary, relationships which do not extend beyond, for instance, that of a lender and borrower, or a liquidator and the entity being liquidated. Similarly a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for purposes of this Standard (emphasis added).

In the private sector, the ability to enjoy the benefits of the other entity are obviously tied to the degree of ownership. Therefore, even if control is the central criterion, we believe that ownership cannot be ignored.

The other extreme of no control and complete ownership provides another benchmark on which to judge the usefulness of consolidated statements. For the owners of the parent company, information concerning the results of the operation of the subsidiary would still be important to the performance of their investment. Losses or gains by the entity would have an economic effect on the owners' wealth. It might make sense under such circumstances to highlight the results of these noncontrolled entities much as is currently done with discontinued operations. Without this type of disclosure, analysts and others would be unable to assess the quality of these earnings and their implication for future results.

Practical Consequences

Of the four criteria, the issue of practical consequences is the most difficult to address. Whether a standard that incorporates a criterion of economic control rather than ownership would be acceptable would have to await the reaction of various user groups. The passage of such a criterion in other countries does suggest that there is a possibility that it would be acceptable in the United States as well. As to whether not addressing the issue would cause others to act, because the issue of when to consolidate was not directly proposed in the AICPA Issues Papers that helped to motivate the consolidations project, changing the criterion does not seem to be high on a list of priorities of the AICPA or SEC.

DM ISSUE 2: HOW TO CONSOLIDATE

Similar to the issue of when to consolidate, alternatives to current practice that address how to consolidate have been around for a number of years. It is the position of this paper that the decision to move from current practice to some alternative must be the result of clear evidence that decision makers will be better off after the change. Put simply, if users such as analysts know how to use information as currently reported, why incur the costs of learning a new method if the information provided is not substantially different from current practice or lacks relevance and/or reliability?

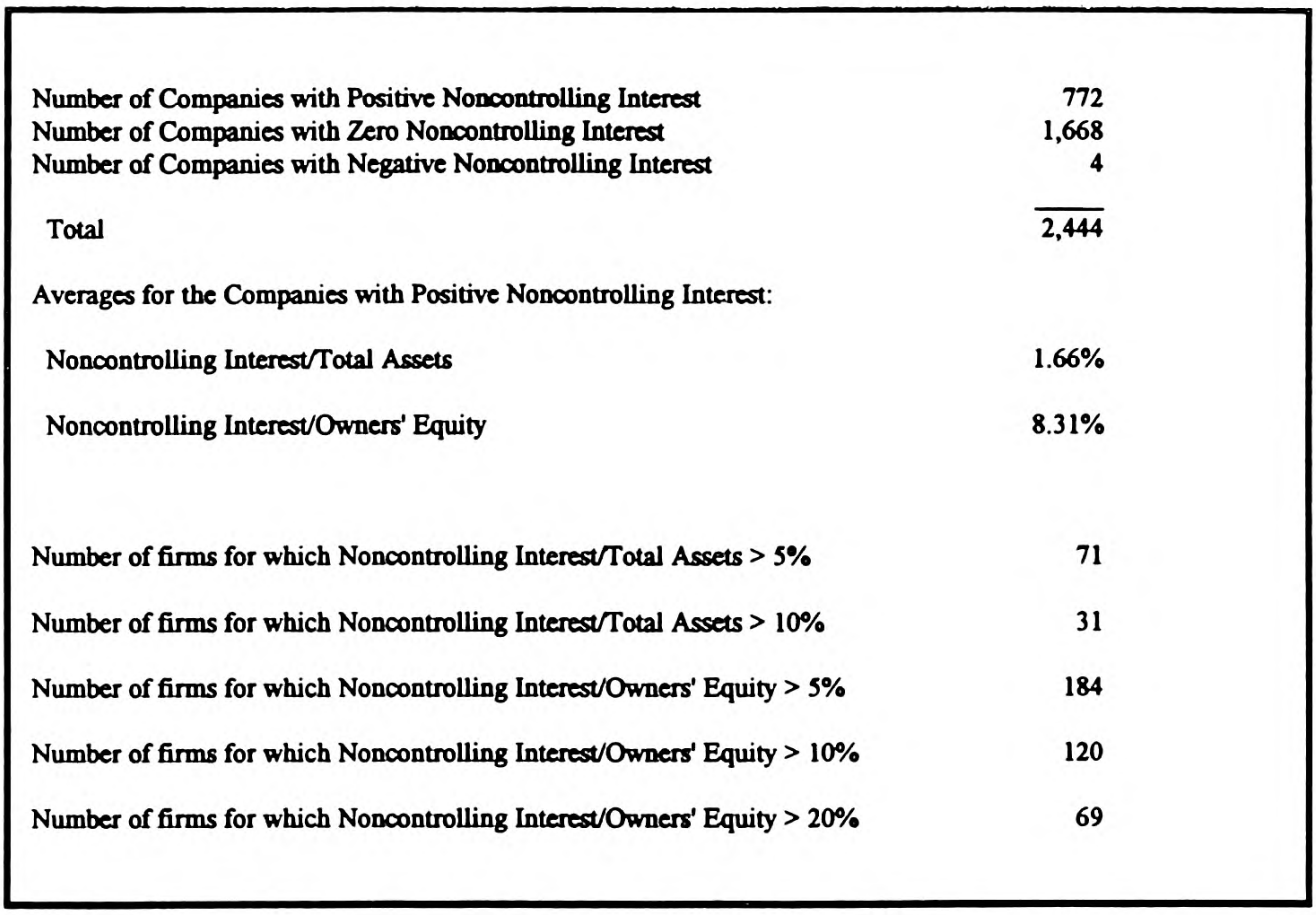
Pervasiveness

Current practice does not appear to be fundamentally divided on the issue of how to consolidate. Most advanced accounting textbooks indicate that the parent company concept dominates practice. The results of a study by Price Waterhouse (1990), excerpted in the DM, indicate that the basis of the calculation of noncontrolling interest in the United States is generally the historical basis of the investee. Although there has been some discussion in the academic literature of the underlying concepts, this has not translated into much diversity in practice. However, even if there were considerable controversy in practice regarding the method to be used, pervasiveness must also be evaluated in terms of how many companies would be affected and what the size of the effect would be. To examine these issues, we collected data from the 1989 Compustat tape[4] on the size of the noncontrolling interest account and compared it with other account balances from the balance sheet (Figure 2).

According to Figure 2, only about 30% of the companies on Compustat report any noncontrolling interest. The average size of the noncontrolling interest for those companies that report positive noncontrolling interest is less than 2% of total assets and less than 9% of owners' equity. The number of firms for which noncontrolling interest is greater than 10% of total assets and 10% of owners' equity is 1.2% and 4.9% of the total sample, respectively.

If noncontrolling interest was a material item on the balance sheets of American firms, it would be pertinent to ask whether the different consolidation concepts would produce significant differences in the interpretation of consolidated financial statements. In this section we investigate this question. There are two concerns for how to do this. The first is to determine what measures to use. Different users have different needs and it would be impractical to attempt to analyze all of the various measures used. The four consolidation methods have little effect on the income statement of the firm, in fact, the bottom line income is exactly the same under the four methods. Therefore, we decided to concentrate on the balance sheet effects of consolidation. On the balance sheet the major effects are that total assets and total liabilities are different under the various methods. A summary measure that captures both of these effects is the debt/equity ratio.[5] We also analyzed the return on assets ratio to relate the income statement to the balance sheet changes.

The second concern we had in analyzing the financial statement effects was how to define the concept of significance. We had the same dilemma that auditors face in trying to assess materiality. We were in a less enviable position than auditors in that we were trying to address significance for various user groups. In some respects we made a nondecision: we provide sensitivity analysis of the results so the reader can decide whether the effects are significant or not. We do, however, use 5% as a benchmark and feel that changes this small or smaller would not have a significant effect on the analysis of the financial statements.



Number of Companies with Positive Noncontrolling Interest	772
Number of Companies with Zero Noncontrolling Interest	1,668
Number of Companies with Negative Noncontrolling Interest	4
Total	2,444
Averages for the Companies with Positive Noncontrolling Interest:	
Noncontrolling Interest/Total Assets	1.66%
Noncontrolling Interest/Owners' Equity	8.31%
Number of firms for which Noncontrolling Interest/Total Assets > 5%	71
Number of firms for which Noncontrolling Interest/Total Assets > 10%	31
Number of firms for which Noncontrolling Interest/Owners' Equity > 5%	184
Number of firms for which Noncontrolling Interest/Owners' Equity > 10%	120
Number of firms for which Noncontrolling Interest/Owners' Equity > 20%	69

Figure 2. Descriptive Statistics Regarding Noncontrolling Interest from Company Data on Compustat (1989)

It would be difficult to make an assessment of the effects of alternative consolidation methods based on the actual company data found in Compustat because no information is provided about the details of the transactions that result in noncontrolling interest. In order to investigate the potential financial statement and ratio effects of the various proposed consolidation concepts we decided to simulate the consolidations process. The key input parameters were the leverage ratio[6] of the parent and subsidiary, the percentage ownership, the size of the subsidiary relative to the parent, and the size of both the excess fair market value and the goodwill component of the acquisition of the subsidiary.

While numerous ratios could be produced from the simulation, we chose to use the leverage ratio as discussed above. The various consolidation concepts change the value of the assets and the corresponding amounts in equity (noncontrolling interest). Debt is, for the most part, held constant. Therefore, the leverage ratio changes proportionately as more equity is added. Our analysis initially set the input parameters to approximate the average firm observed in lata we analyzed from the Compustat tapes. Figure 3, Panel A shows he input parameters that were used to simulate a typical onsolidation situation. We initially set the leverage ratio for the arent company and the subsidiary at 70% to approximate the verage leverage ratio observed for the 772 firms from Compustat vith positive noncontrolling interests (actual average was 67%). The urchase percentage was initially set at 75% so that a significant mount of noncontrolling interest would be present and consolidaion would be required. The amount of excess fair market value and oodwill were each initially set at 100% of the book value, implying price/book ratio of 3 to 1. Obviously, the larger the ratio the more hance there will be to observe an effect. This assumption is tested elow and data are provided concerning typical price/book ratios n recent transactions. The size of the subsidiary and the inputs were hen adjusted incrementally until the ratios of noncontrolling nterest/total assets and noncontrolling interest/owners' equity losely matched the average ratios found in the Compustat data Figure 2). The simulated values of these two ratios (based on the ssumed inputs) are given at the bottom of Panel A in Figure 3.

The leverage ratio was then computed based on the parent ompany method (the method most commonly used in practice), the conomic unit-full goodwill method, and the proportionate onsolidation method. The economic unit-full goodwill method is xpected to have a negative deviation from the parent company nethod because the former adds the extra fair market value and the mplied goodwill for the noncontrolling interest to the denominator f the leverage ratio. In contrast, the proportionate consolidation nethod is expected to have a positive deviation from the parent ompany method, as long as the subsidiary has positive equity (i.e., oth the numerator and denominator are larger using the parent ompany method, and the difference between numerators is less than he difference between denominators).

As can be seen in Panel B of Figure 3, the switch to the economic nit-full goodwill method would change the ratio −2.5%. A similar witch to the proportionate consolidation method would change the atio 0.9%. To test the sensitivity of the change in the leverage ratio o the assumed price/book ratio, a data table was constructed in vhich the percentage of fair market value to book and goodwill to ook was varied from 25% to 400%. This data table appears in Figure . The entries in the data table are the percentage change in the

Panel A		
Parent Information		
Total Assets (without investment)	$1,000	
Leverage (with investment)	77.00%	
ROE (without investment)	15.00%	
Purchase Percentage	74.00%	
Subsidiary Information		
Total Assets (as a % of Parent's total assets)	25.00%	
Leverage	65.00%	
ROE	15.00%	
Total excess FMV as a % of book value	100.00%	
Total Implied goodwill as a % of book value	100.00%	
Amortization Period of Excess FMV (in years)	5	
Amortization Period of Goodwill (in years)	40	
MI/OE (Parent Company)	8.4%	
MI/TA (Parent Company)	1.7%	
Panel B		
		% Change Relative to Parent Company
Leverage (Parent Company)	78.3%	
Leverage (Economic Unit-Full Goodwill)	76.3%	-2.5%
Leverage (Proportionate Consolidation)	79.0%	+0.9%

Figure 3. Simulated Consolidation Results and Effects on Ratios Based on Average Characteristics of Firms on Compustat

leverage ratio for the corresponding parameters of goodwill and fair market value. The cell in the lower right hand corner of the top table indicates that if the FMV/book and goodwill/book were both 400% (this would indicate a price to book ratio of 9 to 1) the difference in the leverage ratio between the parent company and economic unit-full goodwill methods would be −7.8%. The corresponding cell in the lower table indicates a 0.7% difference in the leverage ratio between the parent company and proportionate consolidation methods (i.e., proportionate consolidation leverage minus parent company leverage). Note that there almost is no variation in the difference in the leverage ratio across the cells in the lower table.[7]

A price to book ratio of 9 to 1 seems somewhat extreme. To assess which portion of the table in Figure 4 is likely to apply to typical transactions, we estimated a "typical" price/book value by multiplying two ratios. The first ratio, which came from data presented in *Mergers and Acquisitions* (1990, 1991), was the price

Economic Unit-Full Goodwill

Percentage Change in Leverage Ratio

		GW as a % of Book Value							
		25%	50%	75%	100%	150%	200%	300%	400%
	25%	-0.7%	-1.0%	-1.4%	-1.7%	-2.4%	-3.0%	-4.2%	-5.2%
	50%	-1.0%	-1.3%	-1.7%	-2.0%	-2.6%	-3.3%	-4.4%	-5.4%
	75%	-1.3%	-1.6%	-1.9%	-2.3%	-2.9%	-3.5%	-4.6%	-5.6%
FMV as a % of Book Value	100%	-1.6%	-1.9%	-2.2%	-2.5%	-3.1%	-3.7%	-4.8%	-5.8%
	150%	-2.1%	-2.4%	-2.7%	-3.0%	-3.6%	-4.2%	-5.2%	-6.2%
	200%	-2.6%	-2.9%	-3.2%	-3.5%	-4.1%	-4.6%	-5.6%	-6.5%
	300%	-3.6%	-3.9%	-4.2%	-4.4%	-4.9%	-5.4%	-6.4%	-7.2%
	400%	-4.5%	-4.8%	-5.0%	-5.3%	-5.7%	-6.2%	-7.1%	-7.8%

Proportionate Consolidation

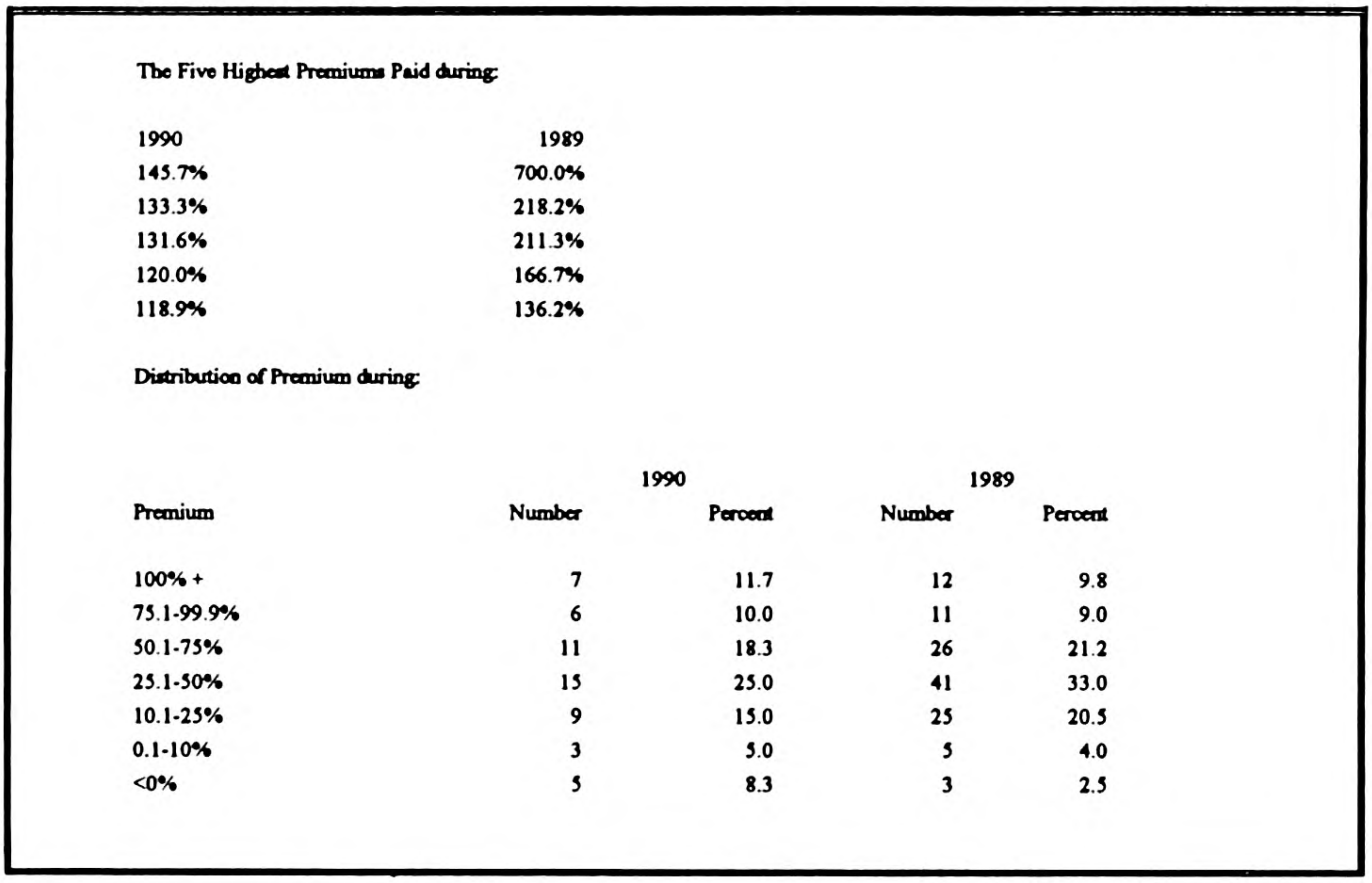
Percentage Change in Leverage Ratio

		GW as a % of Book Value							
		25%	50%	75%	100%	150%	200%	300%	400%
	25%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.7%
	50%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.7%
	75%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.7%
FMV as a % of Book Value	100%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.7%
	150%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.7%
	200%	0.9%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.7%
	300%	0.9%	0.9%	0.9%	0.8%	0.8%	0.8%	0.8%	0.7%
	400%	0.9%	0.9%	0.8%	0.8%	0.8%	0.8%	0.8%	0.7%

Figure 4. Percentage Changes in Leverage Due to Changes in Goodwill and Fair Market Value Average Case Scenario

of securities at the time of acquisition divided by the price of securities one month prior to the announcement of the tender offer. The data collected were on the highest five premiums paid during the year and the distribution of premiums on all of the transactions surveyed. The data for 1989 and 1990 appear in Figure 5. The second ratio was the average year-end stock price to book value for all firms on Compustat. In 1989 the average ratio was 2.6. Noting that the median premium reported (from Figure 5) in 1989 was in the range of 25.1-50% (indicating a 1.5 value for ratio one), the median price/book for the transactions in 1989 could be approximated as 3.9 (1.5 for ratio one multiplied by 2.6 for ratio two) or a 4 to 1 price to book.

Returning to Figure 4, the typical transaction (highlighted by the boxed-in area) would produce less than a 4% change in the leverage ratio. In fact, 90% of the transactions in 1989 would have price/book ratios less than 5 to 1 (those in the less than 100% premium rows in Figure 5). Therefore, these transactions would result in less than



The Five Highest Premiums Paid during:

1990	1989
145.7%	700.0%
133.3%	218.2%
131.6%	211.3%
120.0%	166.7%
118.9%	136.2%

Distribution of Premium during:

	1990		1989	
Premium	Number	Percent	Number	Percent
100% +	7	11.7	12	9.8
75.1-99.9%	6	10.0	11	9.0
50.1-75%	11	18.3	26	21.2
25.1-50%	15	25.0	41	33.0
10.1-25%	9	15.0	25	20.5
0.1-10%	3	5.0	5	4.0
<0%	5	8.3	3	2.5

Source: *Mergers and Acquisitions* (1990, 1991)

Figure 5. Data on Purchase Premiums from Tender Offers in 1989 and 1990

a 5% change in the leverage ratio. Except for the rare, extremely high price/book ratios, the change in the leverage ratio is not material. Therefore, the typical firm with noncontrolling interest will not be materially (assuming that 5% is our cutoff for materiality) affected by the choice of consolidation method.

While the typical firm would seem to be little affected by the choice of consolidation method, the remaining question is how would a firm that has a significant amount of noncontrolling interest be affected by the change in methods? To investigate this question, we examined the most extreme case in our sample from Compustat. The firm that had the largest ratio of noncontrolling interest to assets was Chris-Craft Industries with a ratio of 36%. It also had the next to the highest ratio of noncontrolling interest to owners' equity at 311% (Empire of America FSB had the highest at 489%). To investigate this worst case scenario, we adjusted the input parameters of the simulation to produce ratios similar to those for Chris-Craft. The assumptions necessary to produce the required ratios are shown in Figure 6 (311%

NCI/OE and 36% NCI/TA). Although these assumptions may seem extreme, they produce results that are very close to the actual results reported by Chris-Craft. Note that we were forced to assume that the subsidiary was very large compared to the parent company, that the leverage ratio of the subsidiary was relatively small compared to that of the parent, and that the price/book ratio was relatively small (1.3 to 1). Note also that we set the percentage of ownership as small as possible (51%) and yet high enough that it would still require consolidation.[8]

Panel B of Figure 6 shows the change in the leverage ratio that accompanies the change in consolidation method, assuming the 1.3 to 1 price/book ratio. You can see that it is much more dramatic than the average case shown in Figure 3. Given that this is the most extreme case from the Compustat data, this would represent a worst-case scenario. Given the small price/book assumption required to produce the extreme ratios, the question remains about how sensitive

Panel A		
Parent Information		
Total Assets (Without Investment)	$1,000	
Leverage (with investment)	85.00%	
ROE (without investment)	15.00%	
Purchase Percentage	51.00%	
Subsidiary Information		
Total Assets (as a % of Parent's total	2800.00%	
Leverage	16.00%	
ROE	15.00%	
Total excess FMV as a % of book value	15.00%	
Total Implied goodwill as a % of book value	15.00%	
Amortization Period of Excess FMV (in years)	5	
Amortization Period of Goodwill (in years)	40	
MI/OE (Parent Company)	311.3%	
MI/TA (Parent Company)	36.3%	
Panel B		
		% Change Relative to Parent Company
Leverage (Parent Company)	52.1%	-
Leverage (Economic Unit-Full Goodwill)	48.0%	-7.7%
Leverage (Proportionate Consolidation)	79.5%	+52.6%

Figure 6. Simulated Consolidation Results and Effects on Ratios Based on Worst Case Scenario

the leverage ratio is when larger price/book ratios are present. Figure 7 shows the sensitivity of the change in the leverage ratio to alternative assumptions concerning the price/book ratio. Note that in the normal price to book range (the boxed-in area in the figure) the changes are much larger than were observed for the average case in Figure 4, with the largest change being over 30%.

It is clear from the simulation that in rare, extreme cases, such as certain holding companies, consolidated financial statements could be significantly affected by the selection of consolidation method. The leverage ratio would clearly be affected if the economic unit-full goodwill method were to be applied, particularly if there was a high price to book ratio in the transaction and the subsidiary was significantly under-leveraged compared to the parent.[9]

Alternative Solutions and Technical Feasibility

As indicated in the DM, there are four alternative solutions to the presentation of noncontrolling interest, including the most commonly used presentation method in current practice (parent company). The analysis above does indicate that the magnitude of the differences between the other three methods and current practice would be very small in the vast majority of firms. The only scenario in which the alternative methods would make a significant difference would be if the percentage of ownership in the subsidiary is close to 50% and the size and leverage characteristics of the parent and subsidiary are drastically different from each other. The data in this paper indicate that these situations are rare in practice.

Practical Consequences

As with the issue of when to consolidate, assessing whether there will be practical consequences of how to consolidate is difficult to address. Whether one of the concepts other than the parent company concept would be accepted by preparers and users is impossible to know. However, currently there does not appear to be a large group, either preparers or users, that advocates a change in current practice. With no impetus for change, it is unlikely that there would be much support for change, particularly without clear indication that consolidated statements would be materially different and practice improved.

Economic Unit-Full Goodwill

Percentage Change in Leverage Ratio

		GW as a % of Book Value							
		25%	50%	75%	100%	150%	200%	300%	400%
	25%	-11.7%	-16.0%	-19.4%	-22.2%	-26.4%	-29.5%	-33.7%	-36.4%
	50%	-15.3%	-18.9%	-21.7%	-24.1%	-27.8%	-30.6%	-34.4%	-36.8%
	75%	-18.3%	-21.3%	-23.7%	-25.8%	-29.0%	-31.5%	-34.9%	-37.3%
FMV as	100%	-20.8%	-23.3%	-25.4%	-27.2%	-30.1%	-32.3%	-35.5%	-37.6%
a % of	150%	-24.7%	-26.6%	-28.3%	-29.7%	-32.0%	-33.8%	-36.5%	-38.3%
Book	200%	-27.7%	-29.2%	-30.5%	-31.6%	-33.5%	-35.0%	-37.3%	-39.0%
Value	300%	-31.9%	-32.9%	-33.7%	-34.5%	-35.8%	-37.0%	-38.7%	-40.0%
	400%	-34.7%	-35.4%	-36.0%	-36.6%	-37.6%	-38.4%	-39.8%	-40.8%

Proportionate Consolidation

Percentage Change in Leverage Ratio

		GW as a % of Book Value							
		25%	50%	75%	100%	150%	200%	300%	400%
	25%	48.6%	43.8%	39.8%	36.5%	31.3%	27.4%	21.9%	18.3%
	50%	44.9%	40.8%	37.3%	34.4%	29.7%	26.2%	1.1%	17.7%
	75%	41.7%	38.1%	35.0%	32.4%	28.3%	25.0%	20.4%	17.2%
FMV as	100%	38.9%	35.7%	33.0%	30.7%	26.9%	24.0%	19.7%	16.7%
a % of	150%	34.3%	31.8%	29.6%	27.7%	24.6%	22.1%	18.4%	15.7%
Book	200%	30.6%	28.6%	26.8%	25.3%	22.6%	20.5%	17.3%	14.9%
Value	300%	25.1%	23.7%	22.5%	21.4%	19.5%	17.9%	15.4%	13.5%
	400%	21.3%	20.3%	19.4%	18.6%	17.1%	15.9%	13.9%	12.3%

Figure 7. Percentage Changes in Leverage Due to Changes in Goodwill and Fair Market Value Worst Case Scenario

SUMMARY

The purpose of this paper has been to examine issues under consideration by the FASB in its consolidations project to facilitate deliberation by both the board and its constituents. The policy implications of this examination are important for the FASB as it develops standards that maintain and/or enhance reporting quality. We have examined whether the two primary issues in the DM on consolidations policy and procedures are pervasive and whether proposed alternative solutions would improve the quality of financial reports. We conclude that the issue of when to consolidate does not seem to be pervasive and that deciding whether to replace majority ownership with economic control as the criterion for when to consolidate should be done simultaneously with deliberations on the issues of disaggregation and accounting for joint ventures, both of which pose more pervasive problems for practice. At a minimum, the vigor and timetable followed by the board in efforts to broaden the scope of the consolidated entity should be matched by similar efforts for disaggregating that entity.

Based on an examination of practitioner and academic literature and data analysis concerning noncontrolling interest, we conclude that the issue of how to consolidate is also not pervasive and would not materially change the interpretation of financial statements for most companies. The exception to this is the difference in leverage reported under proportionate consolidation and parent company theories in the rare and extreme case of a holding company that has a large noncontrolling interest. Unlike the first issue where there may be benefits to some users from additional consolidation (with commensurate levels of disaggregation), we conclude that there are no obvious benefits to financial statement users from a change in practice regarding the method of how to consolidate.

NOTES

1. Per a phone conversation with representatives of Compustat.

2. The FASB issued several discussion documents in 1993 on disaggregated disclosure. Nonetheless, we are concerned that the board's examination of the need to provide disaggregated disclosure follows *SFAS 94* by six years, even though previously unconsolidated subsidiaries now are part of the consolidated reporting entity. Furthermore, progress on revising disaggregated disclosures lags behind work on projects that may result in more aggregated information (i.e., *Consolidations Policy and Procedures* Discussion Memorandum).

3. The importance of disaggregated information for decision making is evident in academic research as well as in studies by practitioners. For instance, three out of the four major recommendations made by a special committee on financial reporting of the AICPA, referred to as the "Jenkins" committee, identify the need for disaggregated information that extends well beyond current financial reporting requirements (Berton 1993).

4. The Compustat tape used contains data on firms whose stock trades on either the New York or the American Stock Exchange. The total number of companies on the tape is over 2,400.

5. While not all users would necessarily use the debt/equity ratio, almost all users would be concerned about the effects of the changes in assets and liabilities and the effects on liquidity and risk that are representated by this ratio. The ratio is used as a surrogate for these concerns.

6. The leverage ratio is defined in the simulation as total liabilities divided by total assets.

7. We also examined the effect of the alternative theories on return on assets and found the results of the sensitivity analysis to be very similar to the results that are reported for the debt/equity ratio.

8. Chris-Craft is a holding company that has two subsidiaries, BHC Communications and Chris-Craft Industrial Products. The industrial products subsidiary is relatively small but the communications subsidiary is very large. The total assets of BHC Communications are 18.5 times the assets of the parent and the industrial products subsidiary combined. The leverage ratio of BHC Communications is also very low (21%). The parent company combined with the industrial products subsidiary (no data were available to separate the parent from this subsidiary) showed a much higher leverage ratio (52%). These facts confirmed the reasonableness of the assumed parameters in the simulation.

9. Another way to define leverage is the ratio of total liabilities to total liabilities plus owners' equity of the controlling interest. This representation of leverage might be more meaningful to management than the ratio used throughout this paper (i.e., total liabilities/total assets), because the former ignores noncontrolling interest. Using this ratio in both the average and worst-case scenarios (Figures 4 and 7, respectively), there would be no difference between the parent company and entity theories. Although parent company and proportionate consolidation would produce different leverage ratios, these differences are of similar magnitude (but different direction) in the average case scenario, and much less dramatic in the worst case scenario than when leverage was defined as total liabilities to total assets (−2.3% to .3% rather than 48.6% to 24.6% as reported in Figure 7). Thus, using the ratio of total liabilities to owners' equity of the controlling interest rather than total liabilities to total assets strengthens the findings reported in the body of the paper that there would be little impact on the analysis of leverage if a method other than parent company were adopted.

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COMMENTARY ON "CONSOLIDATION POLICIES AND PROCEDURES DISCUSSION MEMORANDUM: AN EXAMINATION OF THE POTENTIAL IMPACT ON REPORTING QUALITY"

Paul Pacter

At one time or other we have all wanted to yell "Look out the window, it's pouring cats and dogs" at the television weather forecaster who just predicted a 10% chance of rain. I have a somewhat similar reaction to a paper whose basic premise is that the FASB is wasting its time reexamining the existing rules for consolidated financial statements because any changes that the FASB might make probably will not have much of an impact and, if anything, will be harmful rather than helpful to financial statement users. Maybe the existing consolidation standards have not created a downpour of problems, but there certainly are scattered showers.

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To show the insignificance of potential changes to consolidation standards, the authors calculate that leverage ratios would change by around 5% for most companies, 8% for some, and 30% worst case. Are those percentages insignificant? Beyond that, the percentages would be much higher under economic unit-full goodwill approach (sometimes called the entity theory), though they were not calculated. The full goodwill approach is one of four possibilities under consideration by the FASB and, incidentally, is the method favored by the Financial Accounting Policy Committee of the Association for Investment Management and Research (formerly the Financial Analysts Federation) and the Financial Accounting Standards Committee of the American Accounting Association. It seems reasonable that this is an issue that the FASB should examine at least once in 35 years (the current consolidation standards were adopted in 1959).

The authors also try to demonstrate the insignificance of potential changes to consolidation standards by citing limited discussion of consolidation questions in AICPA Issues Papers: "Although this clearly is not a scientific survey of practice," they say, "recommendations of the AICPA to the Board are reasonable surrogates of practitioner sentiment. It would therefore appear that the issue of when to consolidate is not pervasive."

In fact, numerous issues of when to consolidate have created major debates in practice and at the SEC. Examples follow.

1. Many companies have created special purpose entities to do an end run around existing consolidation rules by keeping certain assets or liabilities out of consolidated financial statements.
2. Pyramid corporate ownership has raised questions of when to consolidate. A owns 60% of B, which owns 60% of C, which owns 60% of D. A's residual interest in D is just a few percentage points. Is consolidation of D with A appropriate? There is disparate practice and lack of standards.
3. Is consolidation appropriate when one entity has the unilateral power to take control of another (for instance, if it were to exercise a right or option to obtain a majority voting interest) though it has not yet exercised that right or option? That is an unresolved "when to consolidate" issue.

4. Temporary control is another unresolved "when" issue. Is intent to dispose sufficient grounds to exclude a subsidiary from consolidation? Must there be a legal obligation to dispose, for instance, to resolve a restraint of trade problem? Does the exemption for temporary control apply only when a subsidiary is first acquired or does it have to be reevaluated each reporting period?
5. How is control assessed when there are two classes of stock, one with a majority of voting rights and the other with a majority of residual interest (entitlement to sharing of profits and assets)?
6. Is consolidation appropriate if an investor owns a majority of voting rights with a capped cash return?
7. Is consolidation appropriate if an investor exercises control through ownership of a large minority interest, perhaps coupled with other contractual rights? How large is large?
8. Is consolidation appropriate if an investor exercises control solely through a management contract with minimal or no ownership?

Accounting for subsequent increases and decreases in a parent's interest in a subsidiary is another broad area rich with unsettled consolidation questions. For instance, is there a gain in consolidation when a subsidiary issues more common stock? These and similar practice problems point up shortcomings in consolidation standards that were adopted nearly 35 years ago in a very different business environment.

Are the authors correct in contending that users will be worse off with revised consolidation policies and procedures due to "a loss of information for users such as analysts"? The accounting alternatives to consolidation are equity method or cost method. Either way, the investee shows up as one line on the balance sheet and one line on the income statement. Consolidation replaces that one line with a spreading of investee amounts among all the lines in the financial statements on grounds that the investor's management controls the investee assets, liabilities, and operations. Is this the loss of information the authors fear—trading one line for spreading? Or is it the loss of supplemental disclosure of separate financial data for the unconsolidated investees that they fear will hurt analysts? Supplemental disclosures can accompany consolidated financial statements just as they can accompany the equity or cost methods.

Moreover, the flip side should not be ignored—that consolidation can add important information, for example, by putting "off-balance-sheet" financing onto the balance sheet or by enhancing the ability to compute an appropriate return on assets.

What do the financial analysts themselves say about consolidation? They want it continued. In a 1993 position paper titled *Financial Reporting in the 1990s and Beyond*, the AIMR said, "We support the requirement that consolidated financial statements be the basis for general purpose financial reporting." AIMR acknowledged that consolidation results in less data compared to presenting the separate statements of the parent and each subsidiary. To solve that problem, they therefore recommend additional disclosures and in certain cases consolidating statements, but not rejection of consolidated statements.

Moreover, financial analysts concur that present consolidation procedures need a fresh look. The AIMR 1993 position paper used the following example:

> An even more difficult situation arises when Firm B acquires less than total ownership of Firm A. Under current practice, only the proportionate share of Firm A's assets and liabilities owned by Firm B are revalued, but all of Firm A's assets and liabilities—partially revalued and partially not—are consolidated with those of Firm B, none of whose assets and liabilities are revalued. What a melange! The result is a combination of historic and current values that only a mystic could sort out with precision.

The AIMR recommended numerous changes to current consolidation procedures in its 1992 letter of comment on the FASB's consolidations DM, further evidence that the user community feels that it is timely to reconsider consolidations.

In arguing against possible expansion of consolidation, the authors note that "bankers in particular may have more interest in separate, rather than consolidated statements, particularly if their lending agreements are predicated on the results of the borrowing entity and not the consolidated entity." By definition, the management of a parent company controls the subsidiary to which the bank has loaned money, including an ability to shift assets and profits among components of the consolidated group. Why should the banker ignore the consolidated statements? Observing that bankers need the separate statements does not demonstrate the authors' premise that users do not want consolidation.

The authors "argue that the user community would be well served by the FASB developing standards on reporting disaggregated information in tandem with standards on consolidation.... To consider a standard that would aggregate more companies than under current standards, without simultaneously considering the needs for disaggregated information, seems inappropriate. The issue of disaggregation should at least be concurrently considered with the issue of when to consolidate."

These statements ignore that the FASB is, in fact, doing exactly what the authors recommend. Considering the two issues in tandem was the FASB's plan from the outset.

The authors dismiss the international impetus for the project too lightly:

> The international impetus to make changes in this area may be the only pervasive reason for considering it in the DM. However, it is questionable whether the intent of the pervasiveness criterion is met by a goal of harmonizing U.S. and international standards.

Canada, Australia, New Zealand, the United Kingdom, the International Accounting Standards Committee, and the European Community have all recently adopted control, rather than majority ownership, as the primary condition for consolidation, along with numerous other changes to their consolidation procedures. Other countries are beginning to follow suit. That a similar change here in the United States could be pervasive is suggested when one considers that over 40% of the 11,000 public companies in the United States have at least one subsidiary and that over 1,100 listed companies (NYSE, ASE, and NASDAQ) report some minority interest in their balance sheets or income statements.

The authors also cite *SFAS 94* (which required consolidation of nonhomogeneous subsidiaries) as further evidence that expanded consolidation would be harmful to financial statement users: "We believe that some recent research indicates that the quality of financial reporting may have declined with the passage of the first phase of the consolidations project (SFAS 94) which required more subsidiaries to be consolidated than in prior periods."

AIMR (analysts) concluded that *SFAS 94* has had both good and bad effects:

> [Statement 94] has the good effect of presenting an overall report on complex economic entities and brings onto the consolidated balance sheet a large amount of debt that previously had not appeared. Its cost has been the loss of much detailed information about subsidiary operations quite different in character from those of the parent company.

The research report on disaggregated disclosures that I wrote for the FASB included an analysis of ten published studies of the impact of *SFAS 94*. While these showed that *SFAS 94* caused significant changes in reporting, it is unclear that they support the authors' conclusion that "the quality of financial reporting may have declined" as a result of *SFAS 94*.

Finally, as author of the DM, I must respectfully take issue with the following observation in the article:

> The issue of economic control versus ownership as the criterion for deciding when to consolidate, as discussed in the DM, seems to be too simplistically portrayed as an "either-or" choice. In many situations, however, the decision of when to consolidate is not so clear cut and may at times by a function of economic control or ownership, depending on the circumstances.

The DM does not portray an either-or choice. There is an entire chapter on different definitions of control, attributes of ownership, and other judgmental matters. The DM includes an appendix of 10 "gray area" cases. Further, a number of variations of the four major consolidation models are illustrated.

THE ACCOUNTING THOUGHT OF NEWMAN T. HALVORSON (1908-1992)

Robert Bloom, Marilynn Collins, and Jayne Fuglister

ABSTRACT

Halvorson exercised considerable influence in accounting standard setting. This paper deals with his philosophy of accounting and examines his views on the pronouncements he played a role in formulating or disapproving. While he stressed the importance of verifiability in financial reports, he observed the need for flexible accounting standards to allow accountants and auditors professional judgment in their application.

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INTRODUCTION

As a partner in Ernst & Ernst's national office in Cleveland, Ohio throughout most of the 1950s, 1960s, and early 1970s, and as a member of the AICPA Committee on Accounting Procedure (1956-1959), the Committee on Auditing Procedure (1963-1965), and the Accounting Principles Board (APB, 1966-1973), Newman T. Halvorson exercised considerable influence over the development of accounting policy. Halvorson was a loyal pragmatist, who espoused his firm's views in the accounting and auditing standard-setting processes.[1] Where possible, he preferred accounting standards based on verifiable measurements. Where verifiable measurements were not possible and estimates had to be made, he preferred flexible standards that enabled management and the auditor to exercise judgment.

This paper analyzes the policy directions of Halvorson while he was a member of the APB. To our knowledge, this is the first paper articulating Halvorson's accounting ideas. The paper focuses on his philosophy of accounting and financial reporting and examines his views on a wide variety of pronouncements that he had a hand in shaping or disapproving. The materials used to prepare this paper are: (1) opinions of the APB, including dissents and qualified assents of the committee members; (2) notes from a 1987 interview conducted with Halvorson; and (3) a 1990 telephone interview with Phillip Defliese, who served as a chairman of the APB while Halvorson was a member.[2]

In the next section, Halvorson's environment is examined. The third section covers the development of concepts of independence. In the fourth and fifth sections, Halvorson's concepts of verifiability, flexibility, and standards overload are discussed. The sixth section addresses Halvorson's views on accounting versus disclosure standards. The seventh section summarizes Halvorson's legacy and is followed by a conclusion. Table 1 recounts Halvorson's qualified assents and dissents to APB opinions and links his views to preferences for standards that are verifiable, but flexible.

HALVORSON'S ENVIRONMENT

Embarking on his accounting career in 1930, Halvorson experienced firsthand the significant changes in accounting and auditing set in

Table 1. Halvorson's Qualified Assents and Dissents to Particular APB Opinions

	Verifiability				
	No Retroactive Restatements	*No Subjective Data*	*Flexibility*	*No Standards Overload*	*Other*
APB *Opinion No. 9: Reporting the Results of Operations* (1966)					
He gave a qualified assent because:					
● He is against the mandatory exclusion of prior period adjustments from the income statement, which militates against flexibility.			X		
● Prior period adjustments in retained earnings would be confusing. Halvorson is against retroactive adjustments because they cast a cloud on the credibility of previously issued financial statements. They should be permitted in an all-inclusive income statement.	X				
● He is against the mandatory determination of arbitrary "income before extraordinary items" because that practice militates against flexibility.			X		
APB *Opinion No. 11: Accounting for Income Taxes* (1967a)					
He gave a qualified assent because:					
● No retroactive application of the opinion to prior periods as permitted for comparability should be allowed. Accounting should be prospective only—a recurring theme of Halvorson's.	X				
APB *Opinion No. 12: Omnibus Opinion* (1967b)					
He gave a qualified assent because:					
● He is against retroactive applications (paragraph 14 of the opinion)	X				
APB *Opinion No. 14: Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* (1969a)					
He gave a qualified assent because:					
● He is against retroactive application.	X				
● In his view, there are various circumstances where the conversion feature should be accounted for as part of the proceeds. He favors flexibility in financial reporting.			X		

(continued)

Table 1. (Continued)

	Verifiability				
	No Retroactive Restatements	*No Subjective Data*	*Flexibility*	*No Standards Overload*	*Other*
APB *Opinion No. 15: Earnings Per Share* (1969b)					
He dissented because:					
● The subject in his judgment is not appropriate for an accounting principle, but is suitable for financial analysis.				X	
● Determination of common stock equivalents is very subjective.		X			
● The reporting of earnings per share should be voluntary.			X		
APB *Opinion No. 18: Equity Method for Investments in Common Stock* (1971a)					
He dissented because:					
● Significant influence should be affirmatively demonstrated, but not presumed based on an arbitrary 20% rule.			X		
● Correspondence of the equity method and accrual accounting is not supported by this opinion.					Not Consistent
● If the equity method is GAAP, it should be applied by parent companies regardless of who the user of the financial statements may be. (The opinion calls for the application of the equity method only for financial statements geared to stockholders).					Not Consistent
APB *Opinion No. 19: Reporting Changes in Financial Position* (1971b)					
He dissented because:					
● APB is going beyond its province in requiring this statement.				X	
● A statement of changes in financial position, of necessity, is implicit in financial reporting, and thus there is no need for an implicit opinion.				X	

APB *Opinion No. 20: Accounting Changes* (1971c)				
He dissented because:				
● Newly adopted principles should be applied only prospectively, not using a cumulative effect approach in the income statement or a retroactive approach in retained earnings.	X			
● Restatement of previously issued information will adversely affect credibility.	X			
● Pro forma data cannot properly report on what might have been—a recurring motif that Halvorson addresses.	X			
APB *Opinion No. 23: Accounting for Income Taxes–Special Areas* (1972b)				
He gave a qualified assent in part because:				
● There is a stifling of alternative developments in accounting by prohibiting accrual of taxes in particular circumstances.				Economic consequences
APB *Opinion No. 25: Accounting for Stock Issued in Employees* (1972c)				
He dissented because:				
● The APB was acting prematurely on a subject being explored in an accounting research study then in progress.			X	
● The abuses that the opinion seeks to correct are blown out of proportion, in light of their immaterial accounting effects.			X	
APB *Opinion No. 28: Interim Financial Reporting* (1973a)				
He dissented because:				
● The opinion encourages normalization or smoothing of income. Favoring the reporting of events as they are, he opposes smoothing as being contrary to economic reality.		X		Smoothing
● The opinion ignores consistency, which he favors, by condoning GAAP for interim reporting that is inconsistent with annual reporting GAAP.				Not consistent
● The opinion should have addressed the problem of measuring income during fractions of annual or other cycles.				Incomplete

(continued)

Table 1. (Continued)

	Verifiability				
	No Retroactive Restatements	*No Subjective Data*	*Flexibility*	*No Standards Overload*	*Other*
- Minimum disclosures are presribed without an understandable frame of reference.					Not understandable
APB *Opinion No. 31: Disclosure of Lease Commitments by Lessees* (1973b) Halvorson dissented because: - The disclosure requirements are implicit in APB *Opinion No. 5: Reporting of Leases in Financial Statements of Lessee* (1964). APB *Opinion No. 31* introduces rigidity into the reporting process because the disclosure requirements are all too specific rather than general.			X	X	

motion by the 1929 stock market crash with its revelations of the pitfalls and weaknesses in financial reporting. Prior to the Stock Market Crash and the Great Depression, the balance sheet was the primary financial report. Income statements were not required. Many companies appeared to have strong financial positions because asset write-ups were allowed. Several companies went bankrupt because they lacked the significant earnings necessary to generate long-run cash flows. Misinterpretations of the value of companies were made from reliance on the balance sheet alone. As a result of this experience, the income statement replaced the balance sheet as the principal financial statement. In the 1920s, there were no generally accepted accounting principles. Financial reporting was a free-for-all in the sense that different accounting methods could be used for similar economic events. Out of the chaos of the 1920s, the Securities Acts of 1933 and 1934 were enacted by Congress. The 1933 Act regulates financial reporting and disclosure, and the 1934 Act created the Securities and Exchange Commission (SEC) to implement the 1933 Act. While the SEC has never formally delegated its authority to regulate financial reporting to the accounting profession, it has generally allowed the profession to establish accounting standards, but has often prodded standard-setting bodies to develop standards on specific issues. Occasionally, the SEC has formulated its own standards when it was dissatisfied with the actions taken or not taken by the standard setters. In 1938, the Committee on Accounting Procedure (CAP) was created by the American Institute of Accountants. The main objective of CAP was to formulate generally accepted accounting principles and in so doing to reduce the latitude management had in selecting alternative principles or methods of applying such principles in financial reports.

Almost two decades after CAP was created, Halvorson became a member of CAP and served from 1956 to its end in 1959. CAP was a reactive rather than a proactive standard-setting body, making little headway in reducing alternative accounting principles. CAP was never able to develop a conceptual framework, which was one of its original objectives. Furthermore, CAP pronouncements were not mandatory and therefore they were not universally followed.

CAP was dissolved in 1959 amid much dissatisfaction, and replaced by the Accounting Principles Board (APB), which served as the principal standard-setting body until 1973. Halvorson joined the APB in 1966 and served until it was dissolved. Like CAP, the

APB was a committee of the American Institute. Additionally, the APB consisted of some 20 members, all of whom served part-time on the board and were CPAs. However, unlike CAP, the APB members did not have to be in public practice; some were management accountants, others government accountants, and a few others academics. The APB was not able to develop a prescriptive conceptual framework, even though the board did develop a descriptive framework (APB *Opinion No. 4* 1970). Neither was the APB successful in narrowing alternative measurements of similar events. The APB was widely criticized by many constituents who were dissatisfied with particular opinions that it issued.

From the 1920s to the late 1960s, uniformity versus flexibility had been a key issue for standard setters. Their mission was to reduce alternative measurements of similar events. Credibility of the accounting profession was a related issue because flexibility and diversity in practice casts a cloud on the credibility of financial reporting. Although these problems persist today, they are mentioned here because they are key factors in understanding Halvorson's environment.

CONCEPTS OF INDEPENDENCE

Independence was another key issue in Halvorson's day. One dimension of independence addresses the relationship between auditors and standard setters. Unlike membership in the Financial Accounting Standards Board (FASB), complete independence from one's audit firm was not a prerequisite to membership on the APB. Independence between audit firms and standard setters was not a major issue until the 1950s when many financial executives criticized the Committee on Accounting Procedure, claiming that the public was not involved to a significant extent in the standard-setting process. A similar criticism was levelled later against the APB. In response, the APB introduced public hearings in 1971; but by that time the Wheat Committee had already been formed, and the 1972 Wheat Committee report recommended that an independent Financial Accounting Foundation (FAF) be established to appoint members of the FASB and to raise funds for its operations. The purpose of the FAF was to enable FASB standard setters to be more independent by requiring them to sever all ties with previous employers.

Another dimension of independence addresses the relationship between the auditor and the client. Halvorson's contemporaries had differences of opinion concerning the desirable level of independence between the auditor/accountant and the client. Accountants at one extreme thought they should be independent of the client firm and that there should be only one way to account for a particular type of transaction. Accountants at the other extreme thought they should work toward the success of the client, so there should be wide areas of flexibility to accommodate the unique needs and circumstances of each firm (Blough 1964).

Halvorson supported flexibility in making accounting estimates. Flexibility allows accountants and auditors to exercise a significant degree of judgment in deciding what should be included in financial reports and how accruals should be made. He was against standards "overload" partially because it limited flexibility.

HALVORSON'S PHILOSOPHY ON VERIFIABILITY

Halvorson developed, and held tenaciously throughout his career, the conviction that accounting data should not be subjective—but verifiable, and only reflect what actually occurs, not what might have been. He rarely deviated from that conviction, and he dissented from opinions that did (e.g., APB *Opinion No. 28* 1973a; APB *Opinion No. 31* 1973b; CAP, *ARB 50* 1958). Thus, he maintained that accounting primarily should be historical.[3]

Verifiability is a measurement attribute advantageous to auditors and clients. According to FASB *Statement of Financial Accounting Concepts No. 2* (1980, par. 84):

> Verification implies consensus. Verifiability can be measured by looking at the dispersion of a number of independent measurements of some particular phenomenon. The more closely the measurements are likely to be clustered together, the greater the verifiability of the number used as a measure of the phenomenon.

If measurements are verifiable, the auditor can defend them, and legal liability is minimized.

Consistent with his preference for verifiability, Halvorson also objected to retroactive restatement, or "what if" accounting, as he termed it. He argued that retroactive application in accounting has legal implications for auditors who previously furnished unqualified opinions on financial statements which were subsequently changed. Again, he was apprehensive about the vulnerability of auditors to lawsuits. In APB *Opinion No. 20* (1971c), Halvorson's objections to restatement are described.

> He believes that restatement ("actual" or pro forma) of information previously published in good faith will endanger the credibility of financial reporting and that availability of the cumulative-adjustment device will minimize the disciplinary effect that accounting has on the issuers of financial statements.

To APB *Opinion No. 11* (1967a) and APB *Opinion No. 12* (1967b) he qualified his assents because these opinions permit retroactive application. Other opinions to which he objected because they called for retroactive restatement are APB *Opinion No. 9* (1966) and APB *Opinion No. 14* (1969a). So Halvorson was fairly consistent in his rejection of retroactive restatements, which have long been regarded as a threat to the credibility, and therefore, legal liability of the profession.

HALVORSON'S PHILOSOPHY ON FLEXIBILITY AND STANDARDS OVERLOAD

Flexibility

There has been a long-standing controversy between uniformity and flexibility. On this subject, the American Institute of Accountants' *Accounting Research Bulletin No. 1* (1939) can be cited:

> *Uniformity* has usually connoted similar treatment of the same item occurring in many cases, in which sense it runs the risk of concealing important differences among cases. Another sense of the word would require that different authorities working independently on the same case should reach the same conclusions. Although uniformity is a worthwhile goal, it should not be pursued to the exclusion of other benefits. Changes of emphasis and objective as well as changes in conditions under which business operates had led, and doubtless will continue to lead, to the adoption of new accounting procedures. Consequently diversity [flexibility] of practice may continue as new practices are adopted before old ones are completely discarded.

Later in 1965, a year before Halvorson joined the APB, Grady (1965, 33) stated:

> There is a minority view which urges uniformity in accounting as the panacea for all accounting and reporting deficiencies. The following pertinent factors indicate the unreality of such suggestions or expectations:
>
> Judgment and estimates play a substantial role in accounting on an accrual basis, which is the only useful basis for presenting statements of financial position and results of operations for complex business entities. It is axiomatic that when there is diffusion in decision-making, a necessity to the free enterprise system, there is bound to be diversity in the accounting results.

Consistent with the majority in his time, Halvorson preferred more flexible standards where accruals or estimates had to be made. For example, to APB *Opinion No. 18* (1971a), he dissented because he believed significant influence should be demonstrated affirmatively, and he did not approve of such a rigidly uniform rule in which such influence is merely presumed based on a 20% test. Halvorson viewed users of financial reports as largely naive and unsophisticated, those who are overwhelmed by the vast array of data conveyed in the reports. In one article (Halvorson 1968a, 554), he refers to "the lack of sophistication of the typical reader of a published annual report." He emphasizes the importance of professional judgment and flexibility in financial reporting—in his word, "professionalism," at least on the part of accountants and auditors. As we discussed in our interview with him, it is this emphasis on professional judgment that ironically prevails in British and Canadian financial reporting with far fewer codified accounting and auditing standards than in the United States. Moreover, such standards are looser and easier to read than American standards.

Halvorson maintained that accountants should use their discretion in applying the standards or guidelines; after all, they are professionals. His dissent to APB *Opinion No. 31* (1973b) was based on its introduction of "a rigidity into the reporting process that goes beyond what is appropriate in a pronouncement of accounting principles." Likewise, he qualified his assent to APB *Opinion No. 9* (1966) because it was too uniform and rigid:

> in respect of the mandatory exclusion of prior period adjustments from the current statement of income...and to the mandatory determination of an arbitrary "income before extraordinary items" within the determination of net income.

In APB *Opinion No. 14* (1969a), his dissent identified a situation in which alternatives are necessary. He dissented

> because he believes that, as a matter of principle, there are circumstances under which an issuer should be permitted, or even required, to account for a part of the proceeds of convertible debt as being attributable to the conversion feature.

Standards Overload

Accounting, said Halvorson, "used to be so much more fun," when there were fewer rules to follow (i.e., when management had far more latitude to pick and choose among alternative accounting methods). He was against standards "overload" partially because it limited judgment. Critical of the legalistic way American standards are worded, he observed that the letter of such standards is often in conflict with their spirit, or at least that their phraseology leaves much to be desired. Halvorson dissented in part to APB *Opinion No. 18* (1971a) because the discussion is inconsistent and the opinion does not support "the asserted correspondence of the equity method with conventional accrual accounting."

Hankering for flexible guidelines as opposed to detailed, cookbook regulations, he opposed rule-book accounting; the fewer the rules in general, the better in his judgment. He was bothered by the problem of standards overload. He objected to publication of opinions when the requirements were implicit in other opinions or in the reporting process. As an example, in APB *Opinion No. 25* (1972c) his dissent was described as follows.

> Mr. Halvorson believes that the Board acted prematurely on a subject that presumably is being explored more comprehensively in an accounting research study now in progress and that the alleged abuses in accounting for stock compensation which the Opinion seeks to correct have been emphasized out of proportion to their real significance because of the abiding human concern and curiosity about executive compensation, which is a very different thing from the usually relatively immaterial accounting effect of the alleged abuses on results of operations and financial position.

His dissents to APB *Opinion No. 19* (1971b) and APB *Opinion No. 15* (1969) also demonstrate his objection to requirements implicit elsewhere. He dissented because he believed the APB was going beyond its province. For example, in his view the requirement of a Statement of Changes in Financial Position (SOCFP) was not supported by the opinion, and because a SOCFP is, of necessity, implicit in financial reporting explicit opinion is not needed. To APB *Opinion No. 31* (1973b) he dissented "because in substance it does no more than specify the disclosure requirements which are already implicit in ... APB *Opinion No. 5*."

HALVORSON'S PHILOSOPHY ON ACCOUNTING VERSUS DISCLOSURE STANDARDS

Halvorson distinguishes between accounting standards per se and disclosure standards. He claims that all too many accounting standards should be viewed, instead, as reporting or disclosure standards. This is one of his key themes:

> I think there is a distinction between disclosure, which is a reporting and auditing problem, and principles, which are an accounting problem (Halvorson 1968b, 83).

This view may be the reason that Halvorson did not dissent nor qualify an assent to APB *Opinion No. 22* (1972a), which failed to establish an accounting standard per se and to eliminate alternative accounting practices. However, APB *Opinion No. 22* served to increase disclosures, leaving interpretation to the users of statements.

HALVORSON'S LEGACY

Halvorson's views on judgment and flexibility have been echoed by subsequent professionals involved in the standard-setting process. Flegm (1984, 103), in summarizing the trend toward absolute rules and standards overload, observes:

> Thus, as we have seen, the standards-setters since the CAP, through the APB and the FASB, have steadily marched toward the elimination of judgment and the mandating of a single method even when no clear abuse of alternative methods could be established.

Flegm (1984, 102-3) gives reasons for that trend:

> It is also obvious that, outright fraud aside, some managements will press for the most liberal interpretation of an accounting concept and, in the absence of a specific rule, the independent public accountants (and managerial accountants) will hold a more conservative position.
>
> Since experience shows that some managements will abuse the general concepts and that many auditors will not take exception without some specific authority that can be cited, some rule-making is necessary.

Halvorson's recognition of the standards overload problem and his criticisms of mandatory standards have been recognized by the AICPA, the FASB, and various accounting writers. In 1983, for example, an article in the *Journal of Accountancy* ("Standard's overload relief requires top priority" 1983) reported:

> The final report of the American Institute of CPAs special committee on accounting standards overload, to be published this month, recommends that "a concerted and concentrated effort" to relieve the burden of such an overload "must now be given the highest priority." ...The report suggests that the FASB reconsider rules now recognized as burdensome on small companies. Simplify existing standards when possible and make simplicity a goal in future standards. Consider providing differential measurement alternatives in accordance with generally accepted accounting principles when simplicity and flexibility aren't feasible.

Kirk (1983, 76), chairman of the FASB in 1983, identified standards overload as one of five key issues in the board's attempt to provide timely guidance to the accounting profession. Mosso (1983, 128), who was a member of the FASB in 1983, asserted:

> Simplified standards... are the only other way to lessen the standards burden without tinkering with a uniform GAAP measurement system. Standards should be clear and concise, without complex formulas, without cookbook rules. Everyone agrees on that—large CPA firms and small; public companies and private; users of financial statements and preparers; even standard setters.

Mosso did not think simplification alone would solve the standards overload problem. He also cited more alternatives, differential GAAP, and allowed departures from GAAP (1983, 132-34).

Acutely aware of the problem of standards overload, the FASB created the Emerging Issues Task Force to provide timely guidance.

Wishon's (1986, 102-4) analysis of the impact of the task force on standard setting reveals the reality of Halvorson's concerns.

> The task force was intended to provide more timely guidance without exacerbating concerns about standards overload. However, now that the task force has become a de facto standard setter, its additions to the accounting literature inherently add to overload concerns.
>
> Another general concern about task force activities stems from a long-debated question: What is the ideal degree of specificity of accounting standards? Some believe that standards should be broad and general, leaving detailed questions to the judgment of its auditors. Others believe that standards should be detailed and specific, both to address increasingly complex transactions and to curb the tendency for practice to grow in varied directions.

Halvorson did concede that in our contemporary business environment, more standards if not rules are needed than used to be the case in earlier, simpler times and circumstances. He did not, for example, dissent nor qualify an assent to APB *Opinion No. 16* (1970b), even though the standard sets up complex criteria as though there were different cash flow circumstances reflected in pooling versus purchasing.[4] To avoid retroactive application, Halvorson was willing to sacrifice comparability as illustrated in his qualified assent to APB *Opinion No. 11* (1967a). Carey (1970, chs. 4, 5, 6) describes the arguments between those who advocated uniformity (primarily corporate management, and those who advocated comparability, primarily academics, the SEC, and analysts) during the years that the Committee on Accounting Procedure operated and the APB was created. Halvorson's sympathies were with comparability, because it allows dissimilar accounting practices if they are justified by real differences in circumstances. As an example, in his dissent to APB *Opinion No. 18* (1971a), he said that "if the equity method is to be a generally accepted accounting principle, it should apply to parent-company financial statements regardless of the purpose of their issuance," so they would be comparable and consistent.

Halvorson implicitly assumed a pragmatic approach to standard setting. Well aware of the significance of research in the standard-setting process, he appeared, however, to view research as "too philosophical" to apply to setting practical accounting standards. Nevertheless, he recognized the importance of considering the "economic consequences" of accounting in the standard-setting process because accounting information, whether rightly or wrongly, does impact decision making. As an example, in APB *Opinion No. 23* (1972b) his qualified assent was described this way:

> Mr. Halvorson assents to the publication of this Opinion but believes that a company should be permitted to accrue taxes on differences between taxable income and pretax accounting income in any circumstances where management judgment so dictates and that the prohibition thereof ... will stifle what could be a desirable development in accounting.

Halvorson's philosophy of accounting and financial reporting is clearly reflected in his qualified assents to, and dissents from, accounting pronouncements issued by the APB. APB members by and large, and including Halvorson, represented the views of their firms and clients (Defliese 1990). Halvorson set forth his dissents and qualified assents to APB opinions well in advance of the drafting of the final opinions, so his views were known to the other board members in a timely fashion and this may well have caused them to reconsider their own positions on the issues under consideration (Defliese 1990). In contrast to the decision-making process of the FASB, the APB had an extensive "debugging" process in drafts of proposed opinions. There were no secrets as to how each member stood on each opinion. Many compromises were made by the board members in formulating each opinion (Defliese 1990).

CONCLUDING COMMENTS

Newman T. Halvorson was an active participant in accounting standard setting, judging from the summary in Table 1 of all of his dissents from, and qualified assents to, APB pronouncements. A pragmatist, his policy prescription was for verifiability of transaction-based events, but for flexibility in enabling accountants to exercise judgment when estimates have to be made. To the extent that Halvorson preferred flexible standards, he was at odds with one goal of the APB, which was to reduce alternative accounting policies. He also preferred fewer and looser accounting standards. In contrast, the FASB has established many tight, detailed rule book-oriented standards, allowing accountants less judgment in application in practice.

Halvorson's dissents to APB opinions reflect the weaknesses inherent in accounting standards as they are written and the perennial nature of accounting issues and controversies. Some of his dissents may well have served as the basis for revisions of the principles in question. In any case, the dissents provide food for thought on what accounting principles ought to be. As examples, dissents and qualified assents should indicate to readers the areas that will prove troublesome in the future because a standard overlooks possible circumstances calling for different treatment, because a standard is so detailed that it creates the climate for "form over substance" in its application, or because a standard applies to such a narrow topic that it fails to address similar problems that might be alleviated had a broader scope been taken. These are examples of a possible role for a dissenter and reasons for publishing dissents and qualified assents. Where the number of dissents and qualified assents was greater than one-third of the total members on the APB, the board reconsidered the proposed opinion; thus, Halvorson's dissents and qualified assents did play a significant role in the compromises inherent in the APB's standard-setting process (Defliese 1990). It is unrealistic to expect the standard-setting bodies on most accounting issues to go directly from "what is" to "what should be." There are just too many political and economic consequences to deal with in standard setting, so that standards in the final analysis turn out to be very much matters of compromise between ideas of opposing constitutents.

Some would say Halvorson was a crusty, old-fashioned reactionary. But, in this period of standards overload, Halvorson's perspective might be more appreciated, and that is why we decided to air his frank views in this paper. Although Halvorson desired flexibility with disclosure in financial reporting, the trend today is more toward uniformity with disclosure as in, for example, FASB *Statement No. 13* (1976) and FASB *Statement No. 87* (1985).

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NOTES

1. Halvorson, who was remarkably candid and ever eager to downplay his important role in accounting, asserted that the APB originally included most of the

managing partners of the "Big-Eight" firms, but the managing partners eventually decided that it was inappropriate for them to serve on the APB. Instead, they delegated this task to their top technical partners, including Halvorson. In this manner, according to Halvorson, the managing partners were able to delegate and avoid personal responsibility for any unfavorable pronouncements that might be issued by the APB.

2. The authors were unable to read the minutes of the APB because the minutes are not available.

3. In the course of our interview with Halvorson (1987), it was apparent that his views were firmly fixed on reality. He displayed almost no sense of imagination, no interest in "what might be," and no concern for fantasy. He did not believe that historical cost is misleading in financial reports. To the contrary, he argued that historical cost has a degree of reliability that the disclosure of current value lacks.

4. From Ernst & Ernst's involvement with the Westec case, Halvorson was undoubtedly aware of the abuses perpetrated under the all too flexible *Accounting Research Bulletin No. 48* (CAP 1957), which had been adopted unanimously by the Committee on Accounting Procedure while he was a member. Briloff (1972, 84-85) describes the way in which such loose accounting standards on business combinations were misused by Westec and Ernst & Ernst.

> [T]he corporation completed its year with inadequate earnings; and its management was sent scurrying for new corporate acquisitions—it mattered little where they were located or what businesses they were involved in, just so long as they had earnings during the conglomerate's already-closed fiscal year. In the meantime the conglomerate's statements were held in abeyance, frequently for an inordinate period of time.
>
> Then, after the dragnet was successfully completed and the managerial option to pool duly noted by the auditors, the earnings of the newly acquired companies were merged into those of their new parent. The result sought and achieved was ... that once again management's prophecy of increased year-to-year earnings had been fulfilled.

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AGENCY COST EXPLANATIONS FOR THE DEMAND FOR DIFFERENTIATED MONITORING ACTIVITY

Michael T. Dugan and Cindy D. Edmonds

ABSTRACT

Researchers investigating hypothesized relationships between agency costs and differentiated monitoring activities (e.g., presence of an audit committee) have reported conflicting findings (e.g., Francis and Wilson 1988). This paper examines evidence that studies using post-1970 data may have been affected by nonagency regulatory and legal influence factors. These potentially confounding variables may have contributed to the inconsistent findings reported in these studies. Pre-1971 data were gathered from COMPUSTAT tapes, Disclosure Incorporated's proxy statements, and surveys in an effort to minimize the effects of regulatory and legal influence. The final sample consisted of financial data from the 1970 fiscal years of 284 New York Stock

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Exchange firms. Four agency cost proxies were found to be associated with the voluntary operation of an audit committee of the board of directors. These proxies included (1) level of manager ownership, (2) presence of an accounting-based incentive compensation plan, (3) financial leverage, and (4) firm size. Two other variables, entrenchment and diffusion, were not found to be significant. Entrenchment theory suggests that the risk and reward structures associated with some levels of manager ownership are insufficient to encourage optimal performance. Diffusion refers to the motive for opportunistic activity that arises when ownership becomes so widely dispersed that it reduces the likelihood of management displacement. A review of recent research indicates that these two variables are rarely found to be significant even when other agency proxies in the same model are significant. Accordingly, the findings as a whole call to question the validity of these two variables as agency cost proxies. When the impact of entrenchment and diffusion is placed in such a perspective, the data provides strong support for the theory that the level of monitoring activity is affected by agency costs. To the extent that the findings of this study provide conclusive evidence of agency theory explanations for differentiated monitoring activity, future research should investigate the cost-benefit relationships associated with existing requirements for audit committees in order to improve accounting policy research.

INTRODUCTION

Since the dawning of capitalism, debates have raged over the appropriate mix between free markets and regulation. The employment of an audit committee of the board of directors has been no exception to the differences of opinion expressed by free market advocates and those favoring regulated intervention. Advocacy for mandated audit committees can be traced to the early 1940s when the Securities and Exchange Commission (SEC), the American Institute of Certified Public Accountants (AICPA), and the New York Stock Exchange (NYSE) encouraged the formation of audit committees in response to their investigations of the McKesson & Robins fraud case[1] (Birkett 1986). The response to these early recommendations for the establishment of audit committees was minimal (Mautz and Neumann 1970). Regulatory requirements were never forthcoming; and the formation of audit committees was left to the motivations of free market forces until the late 1960s.

In an effort to bolster audit independence, the AICPA issued a statement on July 20, 1967 recommending that publicly owned corporations "appoint committees composed of outside directors ... to nominate the independent auditors of the corporations' financial statements and to discuss the auditors' work with them." The SEC concurred with the AICPA's recommendation and began an advocacy campaign of its own. Manuel F. Cohen, then chairman of the SEC, stated that "corporate directors would be well advised to develop procedures of their own for institutional criticism of important corporate decisions, perhaps through internal review committees that are independent of on-line corporate decision-making."

While the rhetoric was enthusiastic, acceptance of the concept was not immediately forthcoming. Mautz and Neumann (1970) noted that the intuitive appeal of the concept coupled with endorsements by regulators failed to produce widespread implementation. Indeed, only 32% of the respondents to Mautz and Neumann's 1970 survey indicated that their companies had audit committees. However, as regulatory pressures persisted, the number of companies adopting audit committees gradually increased. In a 1977 follow-up survey by Mautz and Neumann, approximately 87% of the respondents indicated that their companies had established audit committees of the board of directors. Advocacy turned to regulation on June 30, 1978 when the New York Stock Exchange included the adoption of an audit committee as one of its listing requirements. The National Association of Securities Dealers Automated Quotation (NASDAQ) adopted a similar requirement effective July 1986.

The National Commission on Fraudulent Financial Reporting, commonly known as the Treadway Commission, recommended that the SEC require all public companies to adopt an audit committee of the board of directors. In May 1988, the SEC's five Commissioners decided against the recommended requirement. However, the vote against was narrow, and the Commission agreed to continue to encourage the adoption of audit committees (Vise 1988). The American Stock Exchange included a rule in its Company Guide that required its registrants to have a functioning audit committee of the board of directors by November 15, 1992. Accordingly, all three major stock exchanges in the United States currently require their registrants to include an audit committee in their corporate structures.

A call for similar requirements has been echoed in some other countries (*Canadian Chartered Accountant* 1968). However, regulatory requirements for audit committees in countries other than the United States are virtually nonexistent (Bradbury 1990). Accordingly, foreign subsidiaries of U.S. companies may operate without audit committees. Also, closely held corporations (i.e., those whose stock is not sold on one of the three major stock exchanges), partnerships, and proprietorships in the United States are not required to form audit committees. As a result, the issue of whether to require audit committees of the board of directors remains unresolved in the minds of many accounting professionals and policymakers both inside and outside the United States.

This paper examines pre-1971 data in an effort to identify the free market forces (i.e., agency cost factors) that motivated some firms to differentiate their monitoring activities through the voluntary adoption of audit committees in an environment that was relatively free from regulatory influence. The paper is organized in the following manner. The arguments associated with mandated audit committees are presented in the next section. This section is followed by a discussion of earlier research including the hypotheses tested and the conflicting findings that were reported. The paper suggests that earlier research may have produced contrary results because the data used were biased. A research design that avoids the suspected bias is outlined, and the results of a study that employed that design are presented. The paper concludes with a discussion of the relevance of these findings to the question of whether agency theory provides an explanation for the demand for differentiated monitoring activity in an unregulated environment. Given that free market forces affect monitoring activity and that regulation has been imposed on such free market forces, the paper provides suggestions for future research.

ARGUMENTS FOR AND AGAINST MANDATED AUDIT COMMITTEES

Those in favor of regulation believe that market forces provide inappropriate allocation queues upon which to base audit committee selection decisions. They reference the savings and loan debacle, junk bond fiasco, and corporate abuse where individuals profit at the expense of shareholders. They argue that regulation is necessary to protect the public interest (Paxton 1991). They believe that mandated audit committees would act to reduce such abuse. Because unscrupulous managers cannot be expected to initiate safeguards against their own abusive behavior, regulators must protect the public by requiring companies to form audit committees. In summary, most regulatory advocates agree with Bull's (1992) conclusion that markets probably never perfectly reflect the "right" set of enduring values. Almost all markets, including those for the voluntary establishment of audit committees, are open to criticism.

Free market advocates counter with charges that regulation results in inefficiencies and can lead to an inequitable distribution of costs. One time SEC Chairman, David Ruder, voiced concerns expressed by some of the SEC commissioners that a requirement for all public companies to form audit committees would place too great a burden on small companies (Vise 1988). Because the costs and benefits of operating an audit committee vary across firms, the cost of regulation may be unfairly distributed across firms (Bradbury 1990). Alternatively, some firms may respond to the cost of required monitoring expenditures by reducing expenditures that are currently being made for nonregulated monitoring options. For example, a company faced with the increased cost of establishing a required audit committee may seek to compensate through the cost savings that can be attained by switching to a smaller, less expensive external auditing firm or by reducing the size and scope of its own internal audit function. In addition, free market advocates note that some companies may comply with regulation by establishing audit committees but then render their committees ineffective by refusing to provide the necessary resources for the committee to function appropriately. Finally, free market advocates encourage regulators to consider the fact that the process of mandating audit committees eliminates one potential mechanism that companies have to signal differentiation in audit quality among themselves. If all firms are required to have an audit committee, particular firms are not able to distinguish themselves through the operation of an audit committee.

EARLIER RESEARCH

The first step in assessing the validity of the arguments for and against mandated audit committees is to identify the free market forces that motivate the selection of audit committees. In other words, the adequacy of free market forces cannot be addressed before their existence is established. Toward this end, researchers have investigated agency theory explanations for differentiated monitoring activity. In general, agency theory suggests that investors protect themselves from unwarranted wealth transfers to their agents by discounting the price paid for equity or debt instruments (i.e., reducing the value of the firm) or through reductions in management compensation. Agents attempt to reduce these costs by submitting to monitoring activities that minimize the likelihood of the unwarranted wealth transfers (Jensen and Meckling 1976; Fama 1980; Smith and Warner 1979). The body of research surrounding agency theory explanations for differentiated monitoring activity can be divided into three categories based on the type of monitoring activity investigated. The three specific areas studied include: (1) the presence of an external auditor; (2) the size or brand name of the external auditor; and (3) presence of an audit committee of the board of directors.

Chow (1982) investigated the association between agency costs and the employment of an external auditor as a monitoring mechanism. He used data from the year 1926 to investigate whether agency costs were associated with the voluntary engagement of external auditors. In the absence of a requirement to employ external auditors, Chow hypothesized that differences in agency costs would explain why some firms chose to engage such auditors and others did not. Several researchers have analyzed the association between agency costs and the size or brand name of the external auditor (Palmrose 1984, 1986; Johnson and Lys 1986; Francis and Wilson 1988). These researchers used samples of firms required to have an external audit. They tested the hypotheses that firms with higher agency costs are motivated to enhance monitoring as proxied by the size or brand name of the external auditor. Recent studies have used a more broadly based monitoring mechanism. Specifically, three studies have tested agency theory explanations for the presence of an audit committee of the board of directors (Eichenseher and Shields 1985; Pincus et al. 1989; Bradbury 1990). Because an audit committee impacts both external and internal audit services, it appears to be a richer proxy for differentiated monitoring activity.

Further research is merited because the results of earlier studies are conflicting and may have been affected by research design concerns. The hypotheses tested, the conflicting results, and the potential explanation for the conflicting results are discussed in the following sections.

DEVELOPMENT OF HYPOTHESES

As indicated above, auditor presence, auditor choice, and audit committee presence have been used as proxies for differentiated monitoring activities. Researchers also have used different proxies to represent agency costs. While some of the proxies differ, many of the hypothesized relationships between monitoring activity and agency costs were consistent across studies. Six frequently employed hypotheses are discussed below.

Manager Ownership

Jensen and Meckling (1976) suggest that managers' motives for opportunistic behavior vary with the level of their ownership interest in the firm. An owner-manager with no external shareholders or creditors bears the full cost of egregious consumption through reductions in the value of the firm. As management's share of ownership decreases, the motivation for opportunistic action increases because external owners share the cost of the manager's consumption. External shareholders (i.e., principals) protect themselves by employing monitoring strategies to limit the aberrant activities of the managers (i.e., agents). These relationships suggest the following research hypothesis.

Hypothesis 1. Ceteris paribus, firms with a lower percentage of manager ownership are more likely to differentiate their monitoring activities.

Variations of this hypothesis have been tested by Chow (1982), Eichenseher and Shields (1985), Pincus et al. (1989), and Bradbury (1990). As defined, manager ownership is a continuous variable.

Management Entrenchment

Francis and Wilson (1988) tested manager ownership as a dummy as well as a continuous variable. The rationale for this approach lies in the argument that some levels of manager ownership lead to management entrenchment (Demsetz 1983; Fama and Jensen 1983a, 1983b). When managers possess significant levels of ownership, they exercise control over directors, which inhibits manager replacement. Because they are sheltered from displacement, they are more likely to shirk their duties, thereby reducing firm performance. The incentive to shirk also is present when low levels of manager ownership exist because the benefits of ownership (i.e., sharing the risks and rewards) are insufficient to motivate optimal performance. Morck et al. (1986) tested the "entrenchment" theory and found evidence that the motive to shirk diminishes within the 5 to 20% range of manager ownership. To reduce the costs associated with managerial shirking, firms with entrenched management structures are expected to differentiate themselves through their monitoring activities. Accordingly, entrenchment was tested through the use of two dummy variables coded as (1,0) for the range below 5 percent and (0,1) for the range above 20%. Correspondingly, the range between 5 and 20% acts as the reference category. Because ownership levels outside the reference range are predicted to motivate differentiated monitoring activity, the direction of the relationship between entrenchment and the likelihood of differentiated monitoring activity is expected to be negative (i.e., if a firm is not in the reference range then that firm is more likely to have an audit committee).

Hypothesis 2. Ceteris paribus, firms with levels of manager ownership that motivate shirking are more likely to differentiate their monitoring activities.

Diffusion of Ownership

A third agency cost proxy identified in three of the earlier studies concerns the concept of diffusion of ownership. Diffusion refers to concentration of ownership and its effect on managerial performance. Alchian and Demsetz (1972) contend that widely dispersed ownership reduces the likelihood of management displacement. This phenomenon occurs because greater diffusion of ownership increases the time, energy, and resources necessary to effect a management change. This limitation on external shareholders' ability to control management motivates opportunistic actions that increase agency costs. Fama and Jensen (1983a, 1983b) argue that large firms solve the agency cost problem through the development of an organizational structure that separates internal decision management and control. Their contention is supported by empirical findings indicating no difference in corporate performance relating to the diffusion of ownership (Demsetz and Lehn 1985).

While the complex control system reduces agency costs associated with diffused ownership, it also requires more elaborate monitoring structures and therefore increases the demand for monitoring. Earlier research has measured diffusion as a percentage of common stock owned by the largest single shareholder. A 10% threshold commonly is used. Diffusion normally is treated as a dichotomous variable indicating whether or not the largest individual owner has less than 10% of the outstanding stock. This approach has been used by Palmrose (1984), Francis and Wilson (1988), and Bradbury (1990). The hypothesized relationship is as follows.

Hypothesis 3. Ceteris paribus, firms with diffused ownership are more likely to differentiate their monitoring activities.

Accounting-Based Incentive Compensation Contracts

Accounting-based compensation plans can increase the demand for monitoring activities. Managers (i.e., agents) who receive bonuses that are tied to income may be motivated to report false profits or to engage in activities that maximize short-term profitibility at the expense of the long-term health of the firm. Accordingly, Jensen and Meckling (1976) hypothesize that the enforcement of accounting-based performance measures increases the demand for monitoring. This agency cost proxy normally is operationalized through the use of a dichotomous variable indicating whether or not the firm has an accounting-based compensation plan (Palmrose 1984; Francis and Wilson 1988). Accordingly, the following hypothesis has been tested.

Hypothesis 4. Ceteris paribus, firms with accounting-based compensation plans are more likely to differentiate their monitoring activities.

Financial Leverage

Debt related agency costs rise from the owner-managers' capacity to induce wealth transfers through investing and financing activities. For example, Watts and Zimmerman (1986, 90) note that in the extreme the owner-manager could "sell off all the firm's assets, pay liquidating dividends, and walk away, leaving the debtholder with the shell of the company." Accordingly, Jensen and Meckling (1976) and Myers (1977) argue that protective debt covenants reduce agency costs, thereby resulting in higher debt security prices. Further, these contracting activities can lead to increases in the value of the firm because they reduce the likelihood of suboptimal investments (Smith and Warner 1979). These benefits are gained at the expense of contracting and monitoring costs. The benefits increase as the firm's use of financial leverage increases (Fama and Miller 1972; Myers 1977; Kalay 1978; Smith and Warner 1979). The measure of firm leverage can be operationalized as a continuous variable representing the ratio of total debt to total equity. The general hypothesis tested in earlier studies can be expressed as follows.

Hypothesis 5. Ceteris paribus, firms with higher debt-to-equity ratios are more likely to differentiate their monitoring activities.

Variations of this hypothesis were tested by Chow (1982), Palmrose (1984), Eichenseher and Shields (1985), Francis and Wilson (1988), Pincus et al. (1989) and Bradbury (1990).

Firm Size

Size of the firm also may act as a proxy for agency costs. As discussed in a later section of this paper, firm size is a problematic proxy in that competing explanations exist for its effect on presence of an audit committee. Accordingly, the reader should exercise due caution in interpreting the results of the test of this hypothesis. Some researchers have used firm size as a proxy for political costs. Political costs, as analyzed herein, are thought to include incremental taxation, political scrutiny, and lobbying. Firms seeking to avoid political costs may acquire monitoring services to reduce political scrutiny and enhance their public image. While empirical findings regarding firm size and political costs are mixed, the preponderance of evidence suggests that political costs affect only extremely large firms (Zimmerman 1983). Consequently, firm size, as it proxies for political costs, would likely affect only a very small portion of the samples that have been tested in earlier studies. However, other reasons exist to expect that firm size may be related to monitoring activity. Chow (1982) indicates that the total amount of potential wealth transfers increases with firm size. He further notes that the cost of monitoring increases disproportionately with firm size. He therefore concludes that the benefits of monitoring and bonding contracts are positively related to firm size. Eichenseher and Shields (1985), Francis and Wilson (1988), Pincus et al. (1989), and Bradbury (1990) also tested hypotheses relating firm size to monitoring activity as follows.

Hypothesis 6. Ceteris paribus, larger firms are more likely to differentiate their monitoring activities.

RESULTS OF EARLIER RESEARCH

Table 1 contains a summary of the results of the findings of the earlier research studies that have addressed the question of the effect of agency costs on monitoring activity. The researchers used a variety of univariate and multivariate tests. Some of the researchers reported specific *p*-values, while others identified the significant variables under differing significance level thresholds. Table 1 identifies the number of univariate and multivariate tests that were performed in each study and reports the number of significant results that were found at a significance level threshold of .10.

Clearly, the results of earlier research are mixed. Conflicts are apparent between studies as well as within studies. For example, when summarizing their results, Chow (1982) and Pincus, et al. (1989) concluded that strong evidence existed in support of the hypotheses for agency costs. In contrast, Bradbury (1990) and Eichenseher and Shields (1985) interpreted their results as indications of minimal support for the hypothesized agency cost relationships. Francis and Wilson (1988) found conflicts within their own study. A "levels" model produced insignificant results, while a "changes" model produced significant results. Although the various results conflict, in all but two of the multivariate tests, the overall model was found to

Table 1.

		Independent Variables													
		MGR		*MGRE*		*DIFF*		*COMP*		*LEV*		*SIZE*		*MODEL*	
Researcher		*U*	*M*	*U*	*M*	*U*	*M*	*U*	*M*	*U*	*M*	*U*	*M*	*Chi-Sq.*	*F-Stat.*
Chow[a] (1982)	Number of Tests	3	6	NA	NA	NA	NA	NA	NA	3	14	3	14	14	OLS
	Number of Significant Results[b]	1	0	NA	NA	NA	NA	NA	NA	3	14	2	5	14	
Palmrose (1984)	Number of Tests	NA	NA	NA	NA	1	NA	1	NA	1	NA	NA	NA	NA	
	Number of Significant Results	NA	NA	NA	NA	0	NA	0	NA	0	NA	NA	NA	NA	
Eichenseher and Shields (1985)	Number of Tests	2	NA	NA	NA	NA	NA	NA	NA	2	NA	2	NA	NA	
	Number of Significant Results	0	NA	NA	NA	NA	NA	NA	NA	0	NA	2	NA	NA	
Simunic (1987)	Number of Tests	1	NA	NA	NA	NA	NA	NA	NA	1	NA	NA	NA	NA	
	Number of Significant Results	1	NA	NA	NA	NA	NA	NA	NA	0	NA	NA	NA	NA	
Francis and Wilson (1988)	Number of Tests	NA	NA	NA	3	NA	3	NA	3	NA	3	NA	3	3	Probit
	Number of Significant Results	NA	NA	NA	0	NA	2	NA	2	NA	3	NA	3	2	
	Number of Tests	NA	NA	NA	3	NA	3	NA	3	NA	3	NA	3	3	OLS
	Number of Significant Results	NA	NA	NA	0	NA	0	NA	2	NA	0	NA	2	2	
Pincus et al. (1989)	Number of Tests	2	2	NA	NA	NA	NA	NA	NA	2	2	2	2	2	Logit
	Number of Significant Results	2	2	NA	NA	NA	NA	NA	NA	1	2	2	1	2	
Bradbury (1990)	Number of Tests	1	4	NA	NA	1	4	NA	NA	1	3	1	2	4	Logit
	Number of Significant Results	1	0	NA	NA	1	0	NA	NA	0	3	1	2	4	
Prior Research—Totals	Total Number of Tests	6	6	NA	6	2	10	1	6	10	25	8	24	26	
	Total Number of Significant Results	4	2	NA	0	1	2	0	4	4	18	7	13	24	

Legend: MGR = Ownership
MGRE = Entrenchment
M = Multivariate tests
DIFF = Diffusion
COMP = Compensation
LEV = Leverage
SIZE = Size
MODEL = Overall multivariate model significance
U = Univariate tests

Notes: [a] Chow classified his proxy for manager ownership as spurious because he was forced to use industry averages rather than specific company measures. Accordingly, the test results have not been included in the totals section at the bottom of this table.

[b] The significance level threshold used in this table is .10.

be significant. Further, while many of their results for individual variables were not significant, in all but two cases, the sign of the agency cost proxy was in the hypothesized direction.

EXPLANATION FOR CONFLICTING RESULTS

The primary hypothesis of the earlier studies is that the level of the companies' monitoring activity is dependent on its respective agency cost structure. To the extent that decisions to enhance monitoring have been based on factors such as regulatory influences, legal pressures, or other forces, the results of the earlier research could be biased. The following discussion suggests that the earlier studies may not have controlled for the presence of such potentially confounding variables.

All of the earlier research that has been cited except Chow (1982) used data drawn from time periods subsequent to 1971. Evidence indicates that firms responded to significant regulatory and legal influences to improve their monitoring structures during the period from 1971 through 1977. Subsequent to 1977, these pressures remained at relatively high levels as evidenced by congressional hearings, the Treadway Commission, and so forth. Accordingly, auditor and audit committee choice decisions may have been impacted by such factors. These factors are likely to have affected the results of studies that tested agency cost motives for differentiated monitoring activity using data from years subsequent to 1971.

Specifically, Mautz and Neumann (1970, 1977) provide evidence of substantial growth in audit committees between 1971 and 1976. Only 32% of the respondents in a Mautz and Neumann 1970 survey indicated that their companies had audit committees. This result contrasted with an affirmative response by approximately 87% of respondents in a 1977 follow-up survey. The results of the follow-up survey indicate that the majority of growth in audit committees occurred within the most recent five-year period covered by the Mautz and Neumann study. Counting back five years from when the questionnaire was distributed in 1976, the data indicate that the surge in growth began somewhere between 1971 and 1972. Mautz and Neumann (1977) attributed this surge in the growth rate of audit committees (i.e., proxy for increased monitoring activity) to pressures from the American Institute of Certified Public Accountants

(AICPA), the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and Big-Eight (now Big-Six) auditors. These assertions are supported by authoritative pronouncements that culminated in a NYSE listing requirement in July 1978 for the establishment of audit committees. Further, Francis and Wilson (1988) and Eichenseher and Shields (1985) provide empirical evidence that Big-Eight (now Big-Six) auditors exert pressure for the adoption of audit committees.

Schwartz (1980, 22-25) provides a chronology of incidents and litigation to support the contention that director exposure to increased legal liability motivated changes in monitoring structures. Also, Maher (1981) notes the increased compliance efforts of firms in response to the 1977 Foreign Corrupt Practices Act. Eichenseher and Shields (1985) provide empirical support for the hypotheses that growth in the popularity of audit committees and the movement to Big-Eight (now Big-Six) auditors are associated with increased legal exposure of corporate boards of directors.

RESEARCH DESIGN

Given the conflicting results of earlier research and the evidence suggesting that confounding variables may have affected the findings of these studies, further research is merited. The current study tests the six hypotheses described above using the research design that is briefly described in the following section of the paper. The details associated with the research methodology are presented in the Appendix.

The study analyzed pre-1971 data for 284 New York Stock Exchange firms. Earlier research suggested that prior to 1971, companies were relatively free from regulatory influence with regard to their decisions to adopt audit committees. NYSE firms were used because they represented a stratum of firms that had not previously been studied. Accordingly, the potential to generalize the findings of previous studies to a broader range of companies was present. Proxy statements filed with the SEC and public financial statements were used to gather data for the agency cost proxies. The sample firms were divided into two groups depending on whether they had an audit committee in existence during their 1970 fiscal year. The dependent variable was coded one for the group of companies with audit

Table 2. Summary of Agency Cost Proxies and Their Expected Associations with the Presence of an Audit Committee

Name of Agency Cost Proxy	*Explanation*	*Sign of Expected Association*
OWNMGR	Continuous variable indicating the percentage of the firm's stock owned by managers/directors.	Negative
OWNMGRE1, OWNMGRE2	Two dummy variables that recognize entrenchment characteristics associated with manager/director ownership. The two dummy variables are coded as (1,0) and (0,1) to represent the range below 5% and the range above 20%, respectively.	Negative
MGRCOMP	Dummy variable used to indicate whether the firm has an accounting-based compensation plan. The variable is coded as a one if a plan exists, and zero otherwise.	Positive
OWNDIFF	Dummy variable used to indicate the level of diffusion of owneship. Coded one if no single shareholder owns at least 10% of the outstanding shares, and zero otherwise.	Positive
DERATIO	A continuous variable representing the ratio of total debt (excluding deferred taxes) to total equity.	Positive
TASSETS	A continuous variable representing the size of the firm in terms of its total assets	Positive

committees (i.e., first group), and zero for the group of companies without audit committees (i.e., second group). Six proxies for agency costs were used in the study. Table 2 contains a summary of these proxies (i.e., independent variables) and the directions of their expected associations with the presence of an audit committee.

RESULTS

The hypotheses were tested using both univariate and multivariate analyses. Parametric t-tests and nonparametric ranked t-tests were performed on the continuous independent variables OWNMGR, DERATIO, and TASSETS. Logarithmic transformed data for OWNMGR and TASSETS were used in the parametric t-tests. Univariate chi-square tests were performed on the dichotomous variables OWNMGRE, OWNDIFF, and MGRCOMP. Dichotomous logistic regression (logit) was used to test the simultaneous effects of all six independent variable associations with the first and second groups.

Earlier research used a variety of benchmarks to assess the significance of the results of the statistical tests that were performed. Some researchers used an alpha level threshold of 5%, while others used 10%. Alternatively, some researchers reported the p-values and left the interpretation of significance to the readers. This study uses a 10% threshold. The higher alpha level was considered appropriate because the signs of the computed variables were consistent with the hypothesized associations. Further, a more liberal interpretation of significance levels appeared suitable in view of the mounting evidence of the body of research associated with agency cost explanations for differentiated monitoring activity. However, the p-values determined in this study also are reported to allow the reader to apply his/her own significance level threshold in assessing whether or not a particular result is statistically significant.

Univariate Test Results

In order to determine if audit committee choice differed between the groups, univariate descriptive statistics were calculated for all of the independent variables. Table 3 contains a summary of the results for the descriptive statistics and univariate tests performed on each of the continuous independent variables. This table contains the results of the means tests, including the parametric t-tests, as well as the results of the nonparametric ranked t-tests. The results of the chi-square tests for the dichotomous variables are reported individually in a later section of the paper.

Tests Results for Continuous Independent Variables

The signs for differences in the means of the continuous variables were in the expected direction. Based on large sample sizes, t-tests were first used to test the hypotheses of no significant difference between the first and second groups for the continuous independent variables. The mean for the independent variable OWNMGR was lower for the first sample (i.e., group with an audit committee) than for the second sample (i.e., group without an audit committee). The lower percentage of manager/director ownership for firms with audit committees is consistent with Hypothesis 1. The t-test confirms a

Table 3. Results from Univariate Tests on Continuous Independent Variables

				Firms	Firms	*Statistical Tests* [a]	
Hypothesis	*Variable*	*Expected Direction*	*Measure*	*With ACs* ($n = 112$)	*W/O ACs* ($n = 172$)	*Student t-test* [b]	*Ranked t-test*
H_1	ln(OWNMGR)	<	Mean	3.3416	4.1256	−3.71 (p = .000)	7023.5 (p = .0001)
			SD	1.8400	1.5610		
			Median	3.8650	4.6100		
H_4	DERATIO	>	Mean	.4879	.4403	2.50 (p = .007)	7250.5 (p = .007)
			SD	.1360	.1780		
			Median	.5110	.4680		
H_5	ln(TASSETS)	>	Mean	6.4210	5.6777	4.15 (p = .000)	6293.0 (p = .0001)
			SD	1.5490	1.2650		
			Median	6.4120	5.5910		

Legend: ln(OWNMGR) = The Natural log of the percentage of common stock owned or beneficially controlled by officers and directors multiplied by 1000. The beneficially controlled category includes stock owned by the immediate families of the directors and officers.
DERATIO = Total liabilities less deferred taxes divided by total assets.
ln(TASSETS) = The natural log of total assets.

Notes: [a] Natural logarithmic transformations were performed on OWNMGR and TASSETS to reduce skewness before *t*-tests were performed. One-tailed *p*-values are reported for the *p*-tests and nonparametric U-test.

[b] Based on significant *f* max tests for homogeneity between subject variances and unequal sample sizes, the separate variance *t*-test result is reported.

significant difference between the two groups with a p-value of .000. As predicted in Hypothesis 4, the mean for DERATIO is greater for the first sample than for the second sample. Accordingly, those firms with audit committees were more highly leveraged than firms without a committee. This result is significant at a p-value of .007. The difference in the means for the independent variable TASSETS also was in the expected direction and significant with a p-value of .000. The firms with audit committees were larger than the firms without audit committees, thereby supporting Hypothesis 5. Finally, the signs for differences in the medians were in the expected directions for all three of the continuous independent variables. P-values from the nonparametric ranked t-tests confirm that differences in the medians were all significant.

Test Results for Dichotomous Independent Variables

Separate chi-square tests were used to investigate differences between the first and second groups for each of the independent dichotomous variables. The analysis indicated that 81.3% of the firms with audit committees were identified as having entrenched management. Comparatively, only 74.7% of the firms without audit committees were identified as having entrenched management. Because entrenchment is associated with increased agency costs, the difference in proportions is in the expected direction. However, the difference between the two groups was not significant with a chi-square statistic of 1.64809 (p-value of .1992). Accordingly, the data do not support Hypothesis 2 that firms with entrenched management (i.e., a proxy for higher agency costs) are more likely to have audit committees.

According to Hypothesis 3, firms with diffused ownership (i.e., a proxy for higher agency costs) are more likely to have audit committees of the board of directors. The data support this hypothesis. Audit committees that were classified as having diffused ownership constitute 82.1% of the firms, while only 65.9% of the firms without audit committees were classified as having diffused ownership. This difference in proportions was significant with a chi-square statistic of 8.92194 (p-value of .0028).

The data concerning accounting-based incentive compensation plans were difficult to interpret. As suggested by Hypothesis 4, a greater proportion of firms with audit committees had accounting-based compensation plans. Audit committees that had accounting-based incentive compensation plans constituted 49.1% of the firms, while 39.4% of the firms without audit committees had such plans. The test for significant difference between these two proportions resulted in a chi-square statistic of 2.58563 (p-value of .1078). This result is slightly higher than the conventional .10 significance threshold. However, because the direction of the difference in proportions was consistent with Hypothesis 4, and the p-value was less than 1% above the conventional .10 threshold, the researchers interpret the findings as being supportive of Hypothesis 4.

Logit Analysis

Logistic regression (i.e., logit) was employed as a multivariate test because of the dichotomous nature of the dependent variable. The logit procedure was performed on two separate forms of the data set. First, the untransformed data were analyzed. The second analysis was performed after logarithmic transformations of the variables OWNMGR and TASSETS. The results of these tests are reported in the following sections. The logit coefficient parameter estimates, chi-square statistics, standard errors, and corresponding p-values for the untransformed data set are reported in Table 4. Also, the Appendix contains an explanation concerning the need for the transformation of the OWNMGR and TASSETS variables.

Application of Results to the Stated Hypotheses

The overall results for both logit models support the general hypothesis that firms with higher agency costs are more likely to differentiate their monitoring activity through the operation of an audit committee of the board of directors. At a significance level threshold of 10%, the individual agency cost proxies for OWNMGR, MGRCOMP, DERATIO, and TASSETS were significant, thereby providing support for Hypotheses 1, 4, 5, and 6. OWNMGRE1, OWNMGRE2, and OWNDIFF were not significant, which suggests that the second and third hypotheses are not supported. The signs of all of the coefficients except OWNDIFF in the transformed data set were in the hypothesized directions.

A review of earlier research suggests that the hypothesized relationships between entrenchment and diffusion and the level of

Table 4. Results from Multivariate Logit Tests (Untransformed Data Set)[a]

Variables	*MLE Coefficient*[b]	*Chi-Square Statistic*	*Standard Error*	*P-Value*
OWNMGR	−3.0310	3.35	1.6552	.0670
OWNMGRE1	−0.0042	0.00	0.3664	.9909
OWNMGRE2	−0.6318	0.78	0.7133	.3758
OWNDIFF	0.1477	0.14	0.3900	.7049
MSGRCOMP	0.5644	4.01	0.2820	.0453
DERATIO	1.7867	4.09	0.8838	.0432
TASSETS	0.0003	6.24	0.0001	.0125
INTERCEPT	−1.5868	7.39	0.5836	.0065
Asymptotic *X*-square [c]	39.653			
Pseudo *R*-square [d]	.267			
Somers' D_{xy}	.326			
Predicstion Accuracy	68.01%			

Notes: [a] The model using the log transformed data produced a likelihood ratio chi-square statistic of 34.72 with 7 degrees of freedom., The test statistic is significant at a *p*-value of .0000. The pseudo-R^2 value (.273) and Somers' D_{xy} statistic (.330) are slightly different for the untransformed data set. The explanatory ability of the model improved slightly from an accuracy rate of 68.0% to one of 68.7%. After transformations, all of the variables have the hypothesized signs except for OWNDIFF. The *p*-values for the five independent variables, the two OWNMGRE dummy variables, MGRCOMP, DERATIO, and TASSETS, were slightly lower; the *p*-values for the other two independent variables, OWNMGR and OWNDIFF, indicated slight increases. At a conventional significance level of .10, the same variables (OWNMGR, MGRCOMP, increases. At a conventional significance level of .10, the same variables (OWNMGR, MGRCOMP, DERATIO, and TASSETS) are significant.

[b] Logit coefficient parameters are estimated by the Maximum Likelihood Estimation (MLE) method which calculates a parameter estimate that would make the likelihood of having observed this particular value of the dependent variables as large as possible.

[c] The computed chi-square value that tests the hypothesis that all coefficients except the intercept are 0. The d.f. is the number of coefficients constrained to be 0. in the null hypothesis. It exhibits the lartge sample properties of unbiasedness, efficiency, and normality.

[d] The pseudo $R^2 = (\text{model chi-square} \times 2p)/(-2L(0))$, where p is the number of variables in the model excluding intercepts, and $L(0)$ is the maximum log-likelihood with only intercepts in the model.

[e] Measure of goodness of fit in the spirit of R^2 (coefficient of determination) equal to $C/(N + C)$, where C is the chi-square statistic for overall fit and N is the total sample size.

monitoring activity may not be strong enough to be detected with traditional statistical tests. Including the tests performed in this study, the hypothesized associations between entrenchment or diffusion and some proxy for monitoring activity have been tested a total of 35 times, with significant results occurring in only four cases. Other agency cost proxies frequently have been found significant within the same studies where entrenchment and diffusion have not been found significant. Accordingly, the findings as a whole call to question the validity of those variables as valid agency cost proxies. When the impact of entrenchment and diffusion is placed in proper perspective, the data provide strong support for the theory that the level of monitoring activity is affected by agency costs.

Competing Explanations

As stated earlier, the primary objective of this paper is to offer an agency cost-based explanation for why certain firms were more likely to differentiate their monitoring activity through the operation of an audit committee of the board of directors. Nonetheless, competing explanations for the presence of differentiated monitoring activity exist and are addressed at this point in the paper.

One competing explanation is that the SEC may have advised higher visibility (i.e., larger) firms to differentiate their monitoring activities (operate audit committees) so that smaller firms also would be more motivated to do the same. To the extent that the SEC achieved its objective, a number of firms would operate audit committees voluntarily, thereby leaving minimal opposition to subsequent regulatory imposed mandates. To the extent that total assets serves as a direct proxy and manager ownership serves as an inverse proxy for firm size, the significance of these variables in the univariate and multivariate analyses reported earlier is potentially attributable to this competing explanation.

Another competing explanation is that firms audited by the then Big-Eight firms voluntarily differentiated their monitoring activities (operated audit committees) in response to lobbying on the part of their Big-Eight auditor. The Big-Eight firms may have engaged in such lobbying efforts to limit their own liability as well and/or to support the AICPA position on audit committees. To the extent that certain variables included in the study (e.g., total assets, manager compensation, manager ownership, and debt-to-equity) proxy either directly or indirectly for auditor type, the significance of such variables in the univariate and multivariate analyses reported earlier is potentially attributable to this competing explanation.

CONCLUSION

The findings of this study support the theory that differential agency costs affected the demand structure for monitoring activity in the pre-

1971 regulatory and legal environment. These findings are consistent with Chow (1982), who investigated agency cost explanations for the audit choice decision. Chow's data were drawn from a 1926 sample period that was relatively free from regulatory and legal influence. He concluded that his results "generally supported the hypothesized effects of leverage and accounting-based debt covenants, and moderately supported the predicted role of firm size" (Chow 1982, 272). In summary, both studies that used pre-1971 sample periods reached similar conclusions. Such consistency is not present in studies using post-1971 data. Accordingly, the researchers interpret the findings of this study when coupled with those of Chow (1982) to suggest that agency theory does provide a credible explanation for differentiated monitoring activity in unregulated environments.

One possible explanation for the inconsistent findings of the studies using data subsequent to 1971 is the confounding effects associated with regulatory and legal influence. Indeed, Mautz and Neumann (1977), Maher (1981), and Francis and Wilson (1988) provide evidence consistent with this explanation. This suggests that policymakers, both regulators and the court system that enforces regulation, have impacted the free market structure as it relates to the association between agency costs and the benefits that accrue from differentiated monitoring structures. Such regulatory imposition has been formalized with listing requirements for audit committees by all three major U.S. stock exchanges. Accordingly, the policy questions that currently are relevant must address the assessment of the impact of existing regulation and the need to intensify or diminish regulatory pressure to enhance the monitoring structures of business enterprises.

Future research should be directed toward the investigation of the effects of regulation on the formation of monitoring structures. What costs have been incurred by companies required to establish audit committees? What benefits have accrued from audit committees that have been established in response to regulatory pressure? Do differences exist in the effectiveness of monitoring structures established in response to regulation versus those adopted on a voluntary basis? Did other monitoring activities undertaken by firms suffer after they were forced to establish audit committees by regulation? These questions represent broad areas of inquiry that need to be addressed. The formation of testable hypotheses and ultimately empirically supportable theories in these areas could enhance regulation research.

APPENDIX: METHODOLOGICAL ISSUES

Sample Selection

The initial sample consisted of all 1,315 New York Stock Exchange companies that were included in Disclosure Incorporated's database of firms that filed proxy statements in 1970. Of these firms, only 374 met both requirements of having 1970 data available on the COMPUSTAT tapes and having a current mailing address available in the Standard and Poor's Industrial Index. The current addresses were required because the companies had to be surveyed to determine the prior status of their audit committees. The survey instrument contained only one question, which asked Chief Financial Officers if their respective companies had operational audit committees during the 1970 fiscal year.

Of the 374 companies surveyed, 271 responded to the initial mailing of questionnaires. An additional 36 companies responded to the follow-up mailing, resulting in a final count of 307 returned survey forms. Of the surveys returned, 23 were unusable because the respondents indicated that they were unable to determine whether their audit committees were operational during 1970. Accordingly, the final sample consisted of 284 firms. Thus, the "usable" response rate was 75.9%. The authors believe that the relatively high response rate was motivated by the fact that the survey form contained one simple question that could be answered by anyone having access to the corporate records pertaining to the establishment of the firms' audit committees. Accordingly, the chief financial officers to whom the request was forwarded could easily delegate the task to clerical personnel. These financial officers evidently believed that the research question was worthy of the minimal effort required to satisfy the request and thereby were motivated to return the survey forms.

Control Procedures

The following section of the paper describes the control procedures that were employed to minimize the effects of confounding influences.

Test for Nonresponse Bias

A chi-square test was performed to investigate for potential nonresponse bias between the initial and follow-up mailing. The chi-square statistic of 10.34569 was found to be significant (*p*-value of .0057). Upon scrutiny of the cell percentages, it becomes clear that the significant result is attributable to a greater percentage of undecided respondents in the second mailing. In the first mailing, the undecided respondents represented 5.9% (16) of the responses, while they constituted 19.4% (7) of the respondents in the second mailing. This result is logical because those firms that were unsure about whether they operated an audit committee during the 1970 fiscal year would be more likely to delay returning the questionnaire in order to have more time to investigate the matter. However, upon a second request, they gave up the search and returned the questionnaire to satisfy the inquirer. The companies that adopted audit committees early would be most likely to have difficulty determining when their committees were formed because of the age of the corporate records documenting the date of establishment. This scenario suggests that the undecided group was not a proxy for firms that most likely did not have audit committees. When the undecided category is excluded, the chi-square statistic (.84398) is no longer significant (*p*-value of .3583). Because the undecided respondents were not included in the final analysis, they could not have affected the results. Accordingly, the data do not suggest a statistically significant nonresponse bias.

Test for Industry Clustering

A two-sample research design was used to test the relations among the variables in this study. The first sample consisted of NYSE firms that had operational audit committees during the 1970 fiscal year, and the second sample consisted of NYSE firms that did not have audit committees operating during that year. Clustering of firms in a particular industry in either sample could create potential problems. Industry membership could proxy for omitted variables that might explain audit committee presence. For instance, firm size (considered in Hypothesis 6) is likely to vary across industries (Ball and Foster 1982). Also, regulated industries may experience more pressure than nonregulated industries to have procedures that enhance monitoring (Pincus et al. 1989). Because industry clustering could affect the results, it was deemed necessary to test for this potential confounding variable. To test for the possibility of industry clustering, a variable was added to account for the industry group of each firm. Based on primary four-digit SIC codes, each firm was assigned to an industry group. A chi-square test of independence was used to test whether the presence or nonpresence of an audit committee is independent of industry membership. The chi-square statistic was 8.77654 (*p*-value of .1865). This *p*-value was not small enough to warrant rejection of the hypothesis that the two groups are independent on industry membership. Accordingly, the test results suggest that industry clustering effects are not statistically significant.

Logarithmic Transformations

In order to statistically determine the difference between those variables associated with audit committees and those not, certain transformations on the data needed to be performed to meet the assumptions of the tests. Toward this end, the continuous variables were analyzed for normality and skewness. Histograms were produced with superimposed normality curves for the continuous independent variables. Visual inspection of the histograms and calculation of skewness indices resulted in the conclusion that OWNMGR and TASSETS were nonnormal and skewed. The DERATIO variable approximates normality without skewness.

After natural logarithmic transformations were applied to OWNMGR and TASSETS, the resultant skewness indices more nearly approached zero. However, the logarithmic transformation of DERATIO actually increased the skewness of this variable. The distributions for OWNMGR and TASSETS indicated significant improvement toward normality. However, the distribution for DERATIO showed no improvement. Based on these findings, logarithmic transformations were performed on OWNMGR and TASSETS to reduce skewness where appropriate prior to running certain statistical tests.

Explanatory Power of the LOGIT Model

The model produced a pseudo-R^2 value of .267. The formula for the computation of the pseudo-R^2 is provided in Table 4 (see note d). While this statistic may provide some insight about the predictive capacity of the model, care must be taken to understand its limitations and to avoid confusing this measure with the coefficient of determination (i.e., R^2) produced in OLS regression. The R2 statistic produced in OLS regression provides a measure of the proportion of the variance in the dependent variable explained by the independent variables. This measure is not reliable with logit, where the mean and the variance are not separable parameters. When these parameters are not separable, minimization of variance is not a sensible criterion, and a measure of the proportion of variance explained is not a useful measure. A number of pseudo-R^2 measures have been developed to assess the goodness-of-fit of particular solutions to the logit model. In addition to the pseudo-R^2 reported above, another goodness-of-fit statistic known as Somers' D_{yx} is available. This statistic for the untransformed data set was .326. Both of these goodness-of-fit measures are developed in the spirit of the coefficient of determination with values approaching 1.0 representing higher levels of predictive capacity.

Explanatory ability can be further assessed by comparing logit predictions with the actual observations for each of the firms in the sample. Firms with an estimated probability greater than or equal to .5 are predicted as having an audit committee in 1970. The prediction then was compared to the presence/nonpresence of an audit committee as reported in the survey response. The logit model was found to be 67.28% accurate in explaining the presence of an audit committee during 1970 for the sample companies.

The accuracy rate also provides an indication of the explanatory power of the logit model. Specifically, it is a useful measure in the spirit of a coefficient of determination in OLS regression subject to the caveat that the correct classification is a biased indicator of explanatory ability because firms used to develop the model also are used to test its accuracy.

Pincus et al. (1989) employed a technique to assess whether a particular accuracy rate indicates an acceptable level of explanatory power. They used a naive model that predicted the presence of an audit committee for all firms in the sample. By definition, this naive model would have an accuracy rate equal to the proportion of firms in the sample that actually had an operational audit committee. The accuracy rate of the logit model could then be compared to that of the naive model. Accuracy rates in excess of the naive model would provide evidence of the explanatory power of the logit model. When Pincus et al. (1989) applied this approach to their data, they reported that their logit model was 25% more accurate than the naive model. They then used a binomial test to assess the significance of the difference between the accuracy rates of the naive and logit models. The difference was found to be significant with a *p*-value of .0001.

An equivalent computation for this study reveals the fact that the logit model was 71% more accurate than the naive model (i.e., [68.0% − 39.8%] / 39.8%). The binomial test for a significant difference between the accuracy rate of the naive versus the logit models produced a *p*-value of .0000. Accordingly, the model in this study appears to have a favorable accuracy rate when compared to the Pincus et al. (1989) study. None of the other studies on the effects of agency cost variables on the formation of audit committees reported accuracy measures for their logit models. Accordingly, it was not possible to make further comparisons for this measure across studies.

NOTE

1. McKessson & Robins, Inc. was a wholesale drug company whose securities were traded on the New York Stock Exchange. The company perpetrated fraud on the public through a fictitious Canadian subsidiary. The fake subsidiary was used to report on nonexistent purchases, sales, and inventories. The case constituted a major management fraud which was operated by the president of the company in collusion with its key officers. The sham operated for several years before its discovery resulted in significant losses on the part of investors and creditors (Robertson 1979, 179).

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PERSPECTIVES

SLAYING THE SACRED COW:
RIDDING OURSELVES OF CONSERVATISM

Donald R. Nichols and Larry M. Parker

ABSTRACT

The purpose of this study was to investigate the meaning and usefulness of the concept of conservatism from a review of the official and quasi-official literature prescribing or describing generally accepted accounting principles. The definitions and descriptions varied considerably from source to source and were not easily interpreted. Statements of Financial Accounting Concepts (SFACs) contain a particularly obtuse discussion of the concept of conservatism. The authors conclude the meaning of conservatism cannot be determined. Furthermore, the SFACs contain a loss recognition principle and other concepts which supplant conservatism as a basis for analyzing current issues involving uncertainty of recovery of carrying value. Consequently, the authors determined that the concept of conservatism is not useful, and should be eliminated from accounting theory.

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Referring directly to conservatism, Paton (1952) stated, "Accounting is plagued with fetishes and sacred cows. It is high time that homage be shifted from these to the primary objective—furnishing owners and managers with essential economic data." Herbert F. Taggart (1953), professor and dean at the University of Michigan at the time, expanded upon these comments in his paper, "Sacred Cows in Accounting." Taggart explained that

> the important fact about the cow is that ... it must not be killed. This interdict is not based on reason but on faith. The sacred cow in accounting is a belief or doctrine which is accepted without critical analysis and which ... it is a sacrilege to destroy. It is based, not on logic or on any necessity of record keeping or financial presentation, but merely on tradition or blind acceptance of what has been (p. 313).

Although Taggart discussed many sacred cows in his paper, he plainly stated (p. 317), "The holiest of holy cows is undoubtedly conservatism." This paper applies reason to conservatism.

The concept of conservatism is discussed throughout accounting literature, including the Statements of Financial Accounting Concepts (SFACs), and is commonly considered part of generally accepted accounting principles (GAAP). Current concerns about the use of conservatism were highlighted at the session of the 1993 American Accounting Association Annual Meeting, "Why Is There a Conservatism Bias in Accounting?" This unusual session consisted of eight highly regarded researchers presenting invited papers on the problems related to conservatism, and how these problems might be examined. The wide ranging nature of these papers and the panel discussion at the session illustrated clearly and thoroughly the confusion and concerns surrounding the topic of conservatism in accounting. However, all of the researchers made the assumption that conservatism is a necessary aspect of professional accounting that needs to be researched to be better understood. This paper takes a more fundamental approach. It questions whether conservatism is necessary, or even useful in any way.

This paper addresses three questions: (1) What is the definition of conservatism?; (2) When and how should conservatism be applied to a specific situation?; and (3) Is there a need for the concept of conservatism? If the meaning of conservatism cannot be reasonably determined, and/or if regulatory bodies such as the Financial

Accounting Standards Board (FASB) and Accounting Standards Executive Committee (AcSEC) do not specify when conservatism should be applied in examining current issues, such as the write-down of impaired operating assets or mark to market accounting, then the concept is of no use, and it should be dropped from accounting theory. The authors found there is no definition of conservatism that can be agreed upon, that conservatism cannot be readily or consistently applied to specific situations, and that other concepts and definitions of terms in the SFACs can be applied more clearly to specific situations, than conservatism, making conservatism unnecessary. The authors conclude that conservatism should be eliminated as an accounting principle or concept.

CONSERVATISM IN THE ACCOUNTING LITERATURE

The purpose of this part of the paper is to investigate the concept of conservatism in the official and quasi-official GAAP framework literature to determine its current definition, descriptions, and implications. Some of the papers prepared for the session on conservatism at 1993 annual meeting of the American Accounting Association (mentioned above) contained literature reviews of conservatism, and the authors of this paper have attempted to avoid any extensive overlap with these papers.

Previous researchers who have investigated conservatism have arrived at differing views of its meaning and importance. Watts (1993, 1) maintains "Conservatism was a controversial topic in accounting at the beginning of this century and it remains so today." Devine (1963) saw little usefulness in the concept, and on the whole, he was critical of it. Sterling (1967), by contrast, concluded that conservatism is the "fundamental principle of valuation in accounting." Attempts to provide a simple, straightforward analysis of conservatism often seem to do the opposite. For example, Flegm (1984, 37) describes conservatism as "a maxim often quoted by accountants, whose author is lost in antiquity, to the effect that accountants, 'should provide for all possible losses but not anticipate any gains'." There is no evidence that the idea of conservatism existed in antiquity, and the author describes an application of the concept of conservatism, rather than the concept itself. Reflecting the confusion concerning conservatism, a popular textbook characterizes it as one of the most misunderstood ideas in accounting (Kieso and Weygandt 1992, 49). Beaver (1993, 3) believes "there are many ambiguities associated with the use of the term, conservatism."

Conservatism became an element of GAAP through practice rather than by official or quasi-official pronouncement. It apparently arose at a time when financial statements were used primarily for credit granting purposes and when the emphasis was on reporting of net assets rather than the income stream. It was believed that statement readers preferred a "conservative" reporting of assets and income, which was interpreted as allowing deliberate understatement of assets and income. It is unlikely that this represents a contemporary view of conservatism, and the FASB has stated that conservative reporting, if interpreted as deliberate understatement of assets and income, should not be an objective of practice today (*SFAC 2*, paragraph 96). Given that deliberate understatement is not the appropriate interpretation of conservatism, the official and quasi-official literature of accounting theory was reviewed to determine the definition and descriptions of conservatism and its implications.

One early quasi-official exposition of accounting theory and practice, *An Introduction to Corporate Accounting Standards*, contains only a brief reference to conservatism as an element of accounting practice in the "cost-or-market" rule (Paton and Littleton 1941). The authors indicate that they do not believe that the rule is appropriate. They express an opinion that conservatism should not be thought of as an accounting principle to guide accounting practice, but rather as a warning of caution in the interpretation of financial statements. Specifically, they state that "conservatism in stating the assets (for their debt-paying capacity) is not a principle to guide accounting calculations of net income, but a rule of caution in interpreting the results of accounting measurements" (p. 128). May (1943, 192), in a discussion of the need for understanding changes in accounting conventions, also mentioned concerns about conservatism when he wrote, "In the early days, conservatism was the cardinal virtue of accounting; now the virtue of conservatism is questioned."

An early official source of GAAP, *Accounting Research and Terminology Bulletins* (*ARB 43*), did not discuss the term conservatism as an element of accounting theory or practice. However, *ARB 43* is the official source of the practice of lower-of-cost-or-market (LCM) for inventory, which is often described as an application of the concept of conservatism. The Committee on Accounting Procedure (CAP) did not refer to the concept of conservatism as a basis for the practice. Rather, they stated that "The purpose of reducing inventory to *market* is to reflect fairly the income of the period" (Chapter 4, Statement 7, original emphasis). Thus, the CAP did not recommend the practice of LCM for inventory because of a concept of conservatism or because it resulted in conservative reporting. Rather, they felt that the practice provided a better measure of income. In addition, the CAP indicated a preference for a fair, rather than a conservative, presentation in another context, the accounting for quasi-reorganizations. They stated,

> A writedown of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts (Chapter 7, paragraph 4).

Thus, in these two instances the CAP indicated that financial statements producing fair reporting were preferable to conservative reporting.

Although not an official pronouncement of GAAP, an early quasi-official attempt to codify the framework of accounting practice was Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises* (Grady 1965). The definition provided in that work is that conservatism is "a quality of judgment to be exercised in evaluating the uncertainties and risks present in a business entity to assure that reasonable provisions are made for potential losses in the realization of recorded assets and in the settlement of actual and contingent liabilities" (p. 35). In addition, Grady viewed the concept of conservatism as dictating that "All known liabilities or losses should be recorded regardless of whether the definite amounts are determinable" (p. 36). Thus, by this time a linking of conservatism with uncertainty, risk, and provision for losses had been made.

In *Statement No. 4*, the Accounting Principles Board (APB) included conservatism as a "modifying convention" in GAAP. In that document, the broadest accounting principles were termed by the APB as "pervasive principles," and there were explicit pervasive measurement principles for both revenue recognition and expense recognition. However, the pervasive measurement principles were viewed as not providing "results that are considered satisfactory in all circumstances. Certain widely adopted conventions modify the application of the pervasive measurement principles" (paragraph 169). Conservatism was one of these modifying conventions, and the meaning of the term conservatism was described as follows.

> Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This had led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the rules that inventory should be measured at the lower of cost and market and that accrued net losses should be recognized on firm purchase commitments for goods for inventory. These rules may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles (paragraph 171).

Thus, in *Statement No. 4*, there is again a linkage between significant uncertainty and conservatism, as well as a statement of a possible preference for understatement rather than overstatement of net income and net assets in uncertain situations. The two specific examples of conservatism presented in paragraph 169 of *Statement No. 4* above both involve a reduction in the carrying amount of inventory and recognition of an associated loss prior to realization.

The latest pronouncements concerning accounting theory and practice are the Statements of Financial Accounting Concepts (SFACs) of the FASB. In discussing qualitative characteristics of accounting information, *SFAC 2*, paragraph 91, quotes the description of conservatism from APB *Statement No. 4* provided above. The FASB also adds the notions of prudence and healthy skepticism.

> There is a place for a convention such as conservatism—meaning prudence—in financial accounting and reporting, because business and economic activities are surrounded by uncertainty... (paragraph 92).... Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered (paragraph 95).... Prudent reporting based on healthy skepticism ... best serves all of the divergent interests that are represented by the Board's constituents (paragraph 97).

However, application of conservatism as described in APB *Statement No. 4* is not consistent with other attributes and principles of accounting information. In recognizing this inconsistency, the FASB indicates that because it "introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics such as representational faithfulness, neutrality, and comparability (including consistency)" (*SFAC 2*, paragraph 92). Thus, the pronouncement explicitly acknowledges the confusion about whether accounting reporting should be unbiased (with representational faithfulness and neutrality) or biased (conservative) in practice; however, no guidance is offered to the accountant about how to resolve the dilemma in practice.

UNCERTAINTY AND CONSERVATISM

The purpose of this section of the paper is to determine if it is useful to apply conservatism in certain situations.

The term uncertainty is prominent in recent definitions of conservatism, although the nature or extent of uncertainty that would dictate a conservative response is not specified. Two examples of conservatism in accounting practice that are often referred to as LCM for inventory and recognition of losses on purchase commitments. Both of these situations involve uncertainty of recoverability of cost or a utility potentially less than recorded cost. In the discussion of the lower-of-cost-or-market, the CAP indicated that a departure from cost is required "when the utility of the good is no longer as great as its cost" (*ARB 43*, Chapter 4, paragraph 7). Similarly, in the accrual of losses on firm purchase commitments, the write-down is again discussed as resulting from a decline in utility. In fact, if utility is not considered to be impaired—that is if price declines have not occurred or are not expected—the discussion explicitly states that a write-down is not appropriate (Chapter 4, paragraph 17).

These events involving write-downs and recognition of loss are expense or loss recognition situations, and considerable conceptual guidance other than a conservatism concept exists concerning these situations. Various pronouncements provide guidelines for recognition of expenses and losses, and it is not obvious that a concept of conservatism is necessary to prescribe loss recognition and asset write-down in situations where recovery of cost is in question.

EXPENSE RECOGNITION PRINCIPLES

APB *Statement No. 4* contained three expense recognition principles as part of the pervasive measurement principles. Recognition principles were (1) associating cause and effect, (2) systematic and rational allocation, and (3) immediate recognition. They are to be applied in order. However, the APB saw a need for a modifying convention of conservatism to supplement the pervasive principles. Thus the concept of conservatism might lead to rules, such as LCM for inventory that "may result in stating net income and net assets at amounts lower than would otherwise result from applying the persuasive measurement principles" (paragraph 171).

The FASB has retained much of the content of three expense recognition principles from *Statement No. 4* in its discussion of various standards that it has promulgated and in its various conceptual framework pronouncements. The concept of matching expenses and revenues in *SFAC 3* refers to, and follows very closely, the three pervasive expense recognition principles of *Statement No. 4* (paragraphs 84-89). Although they are modified slightly, *SFAC 5* also contains the three expense recognition principles (paragraph 86). However, a new and separate section in *SFAC 5* provides for recognition of losses for lack of future benefit as follows:

> As expense or loss is recognized if it becomes evident that previously recognized economic benefits of an asset have been reduced or eliminated or that a liability has been incurred or increased, without associated economic benefits (paragraph 87).

This provision would seem to be a more clear and direct rule than the vague concept of conservatism for the write-down of assets and recognition of losses where recovery of carrying value is uncertain. Given this provision, it would not seem that another guideline, especially one as vague and unclear as conservatism seems to be, would be required to prescribe or guide appropriate accounting in those situations. Thus, it seems that the accounting literature has evolved. In the past there may have been a need for a pervasive concept of conservatism to supplement expense and loss recognition guidelines. But now the expense and loss recognition principles, as described by the FASB in the conceptual framework, would seem to provide adequate guidance without modification. For the two situations mentioned earlier in this paper, LCM for inventory and recognition of losses on purchases commitments, which have long been used in describing the application of conservatism, the provision for recognition of losses for lack of future benefit in *SFAC 5*, paragraph 87, is sufficient—the use of conservatism is unnecessary.

What sorts of situations exist where the FASB sees a need for a concept of conservatism in order to guide appropriate accounting treatment? *SFAC 2* discusses the concept of conservatism, but the discussion is not particularly informative in providing an operational definition or description of conservatism or in providing examples where application of conservatism is necessary or appropriate. In fact, in describing the concept of conservatism, the pronouncement relies on only one example.

> Thus if two estimates of amounts to be received or paid in the future are equally likely, conservatism dictates using the less optimistic estimate; however, if two amounts are not equally likely, conservatism does not necessarily dictate using the more pessimistic amount rather than the more likely one (paragraph 95).

A situation where two future amounts are equally likely would not seem to be a frequently occurring situation in accounting practice, nor does the discussion provide any guidance concerning other situations where conservatism might apply.

Therefore, with the FASB conceptual framework project, there appears to have been a major shift in the concept of conservatism, and perhaps a reduction or elimination of the need for it. Conservatism may have once implied deliberate understatement of assets and income. Over time it appeared to evolve to be primarily a guideline calling for recognition of losses and a write-down of certain assets prior to sale or exchange where recoverability of carrying amount was in question. Conservatism was viewed as a supplement to or modification of the conceptual expense recognition guidelines that were available to deal with these particular situations. Now, with *SFAC 2* and *SFAC 5*, another shift seems to have occurred in the meaning of and need for a concept of conservatism. With *SFAC 5*, the FASB appears to have sufficient specific expense and loss provision conceptual guidelines to provide guidance for uncertain recovery situations, and a concept of conservatism would not appear to be necessary for this purpose. The only example of an application of conservatism that is provided by the FASB in the conceptual framework is a trivial one, involving equally likely amounts. It is difficult to think of other circumstances where their notion of conservatism would be applicable or what sort of accounting practices would result from its implementation.

CONCLUSION

The conclusion of this study is that the concept of conservatism should be eliminated as a concept of accounting theory. Conservatism emerged as an extremely vague and changing concept, without easily identifiable implications for practice. May (1943), discussing accounting conventions, stated, "Conventions, to have authority, must be well conceived." The authors believe we have demonstrated that conservatism is definitely not well conceived. It is contradictory with other accounting objectives, such as neutrality and representational faithfulness. Furthermore, if indeed there was once a need for a concept of conservatism to provide conceptual guidance for expense or loss recognition where recoverability of carrying amount was in question, there is a new guideline for loss recognition in the conceptual framework that would provide guidance in those situations as well as or better than the vague concept of conservatism. The additional discussion of conservation in the conceptual framework is not illuminating, and useful operational implications of the current description of conservatism are difficult to identify. The concept of conservatism adds confusion to the theory and practice of accounting without identifiable benefits. Current topics currently under consideration by accounting regulators such as write-downs of impaired assets and mark to market accounting for investments may seem areas to which the concept of conservatism could be applied. Conservatism can add nothing positive to discussions in these areas, or any others.

The authors believe many accountants will be reluctant to give up the concept of conservatism because of reasons which some may feel underlie conservatism. Some may believe conservatism helps protect investors or lenders, particularly investors or lenders who are risk averse. However, it is clear that proper understanding of investment risk concepts means that investors and lenders, risk averse or risk seeking, are best served by the best possible fair accounting estimates, not conservative ones. As discussed earlier in the paper, traditional applications of conservatism provide biased estimates, which help protect no one.

Perhaps an even more basic reason for the desire of some to keep conservatism is fear of lawsuits. That is, some may believe being conservative will help minimize the chances that accountants will be sued. Conservatism is of no help in this regard, but two terms presented earlier in this paper from *SFAC 2* are helpful—prudence and skepticism. For example, one of the authors read and analyzed the Securities and Exchange Commission (SEC) enforcement releases concerning accountants released between 1972 and 1990 (Campbell and Parker 1992). Conservatism is virtually unmentioned, but discussions of prudence and skepticism, particularly skepticism, permeate many of the SEC's releases during this time. It is prudence and skepticism as prescribed in *SFAC 2* that should imbue the attitude and pervade the practice of professional accountants, not the biased and confusing concept of conservatism.

Finally, some might argue that there are many terms and concepts that are imprecise, so conservatism should not be singled out for elimination—the search for precision in accounting is doomed to failure. However, this paper does not argue for precision—it argues for improvement. We believe we have demonstrated that conservatism is confusing, misleading, and unnecessary (there are plenty of accounting concepts and terms to cover any situation to which conservatism could possibly be applied). The removal of such a concept is an improvement for accounting.

Conservatism is of use in neither conceptual analysis of accounting problems nor in practical concerns of accounting practice. Conservatism should be eliminated from accounting theory.

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REGULATORY BARRIERS TO A FINANCIAL INNOVATION:

SINGLE STOCK MUTUAL FUNDS AND SOME RELATED DISCLOSURE ISSUES

Arthur J. Wilson and Stephen J. Young

ABSTRACT

We examine trading costs for individual investors and propose a financial innovation that may be able to significantly reduce those costs. That innovation, single-stock mutual funds, is effectively prohibited by the Revenue Act of 1936. After considering some reasons for this prohibition and relating later changes in market conditions, we argue that the Act should be revised to allow this innovation. In addition, some suggestions for investor friendly financial disclosure are also sketched out.

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INTRODUCTION: THE PRICE OF BEING SMALL

When retail investors buy or sell a round lot of a NYSE stock (100 shares), for example, Digital Equipment (DEC), they must pay a brokerage fee. For full service brokers, this fee might approach $90. Even for discount brokers, the fee will usually approach $50.[1] By comparison, larger orders can often be done for two or three cents a share, subject to a minimum fee of around $50.[2] A consistent feature of all these commission schedules is that the costs per share fall sharply with larger orders.[3]

What does this transaction fee pay for? The broker will transmit the order to an exchange, which matches it against other traders or against an exchange specialist. Once a match is made, the broker will usually confirm it and then two types of account transfers take place. The money passes from buyer to the buyer's broker to the seller's broker to the seller, and the stock passes from seller to seller's broker to buyer's broker to the buyer (Office of Technology Assessment 1990, esp. chaps. 2, 3, 6).

If these transactions were really so simple, we might expect that brokerage costs would be lower. Of course, the retail stock brokerage business appears to be competitive. Some brokers argue that other services, such as record keeping for margin accounts, dividends, or proxy processing, giving investment advice, or processing physical securities are indirectly paid for by brokerage fees.

Yet, many investors do not want investment advice and do not use margin accounts. Likewise, many stocks do not pay dividends, and most publicly traded firms already pay for proxy processing and to mail stockholder reports. Some brokers also charge separately for mailing physical securities, and many discount brokers do not give investment advice. Certainly, these and other ancillary services clearly have costs and often are valued by investors. However, any of the broker services that are not already paid for by the issuer could be charged for explicitly rather than implicitly. We explore the following question: if the mechanics of basic stock trading are as simple as we believe they now are, why must small investors pay such high fees?

The remainder of this paper is organized as follows: First, we explore the mechanics of stock trading, past and present, and then motivate and explain our single-stock mutual fund proposal. Next, we review the legislative history prohibiting it. We follow with an example, discuss some related disclosure issues, draw conclusions, and explore areas for future research.

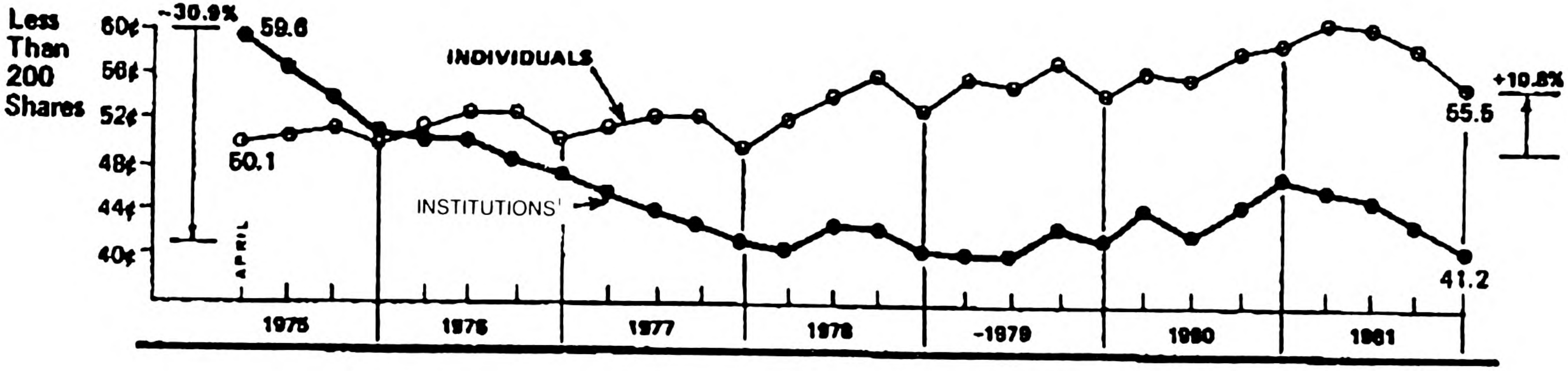
THE MECHANICS OF A TRADE—PAST AND PRESENT

Until recently, transfers of stock certificates and funds were usually physical transfers, with couriers to move cash or depositing transfer instructions in one direction, and more couriers to deliver stock certificates in the return direction. Note that the costs would be similar if 100 or 10,000 shares are traded at a time (i.e., these costs are "fixed").

Physical delivery of and payment for stock transactions was time consuming, labor intensive, and prone to costly errors. As recently as 1968, Wall Street found it necessary to periodically halt trading early in order handle paperwork generated by routine order flows. After the stock market crash of October 1987, Wall Street again found it necessary to halt trading early, this time to accommodate the extraordinarily high levels of trading volume following the crash. The response to each such occasion has been to further automate stock trading.

In fact, automation of stock trading has proceeded to the extent that many trades are now almost entirely electronically processed. For example, when our retail investor buys DEC, his trade is probably matched to a seller by SuperDOT, a computer system run by the NYSE. His funds are usually electronically transferred from his account with his broker, to his broker's account, then to the selling broker's account, and then to the seller's account with the selling broker. Title to the stock certificates moves in the opposite direction. Both sets of transfers are typically facilitated by the National Securities Clearing Corp. (NSCC). The stock is usually held on deposit at a trust bank, such as Depositary Trust Corp. (DTC). For most retail trades, neither the cash nor the stock certificates are physically handled or moved anywhere. As with wire transfers of funds that remain within the banking system, this transaction can be accomplished entirely by electronic means.

This returns us to our earlier question: why does it cost so much to trade stocks? In principle, a stock trade now involves an initial bit of labor (the broker submits the order and then confirms the trade), electronic order matching, and two sets of electronic transfers,


Less Than 200 Shares
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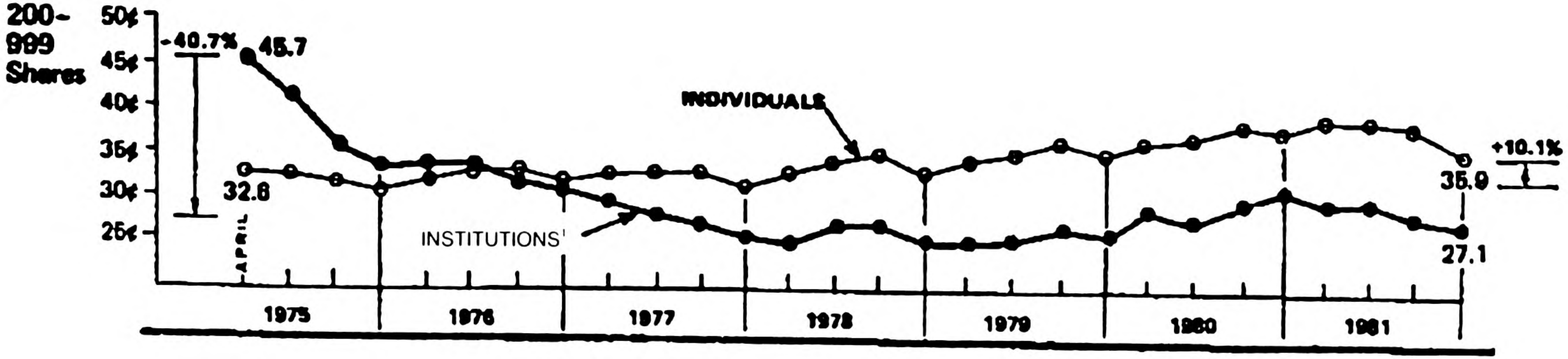
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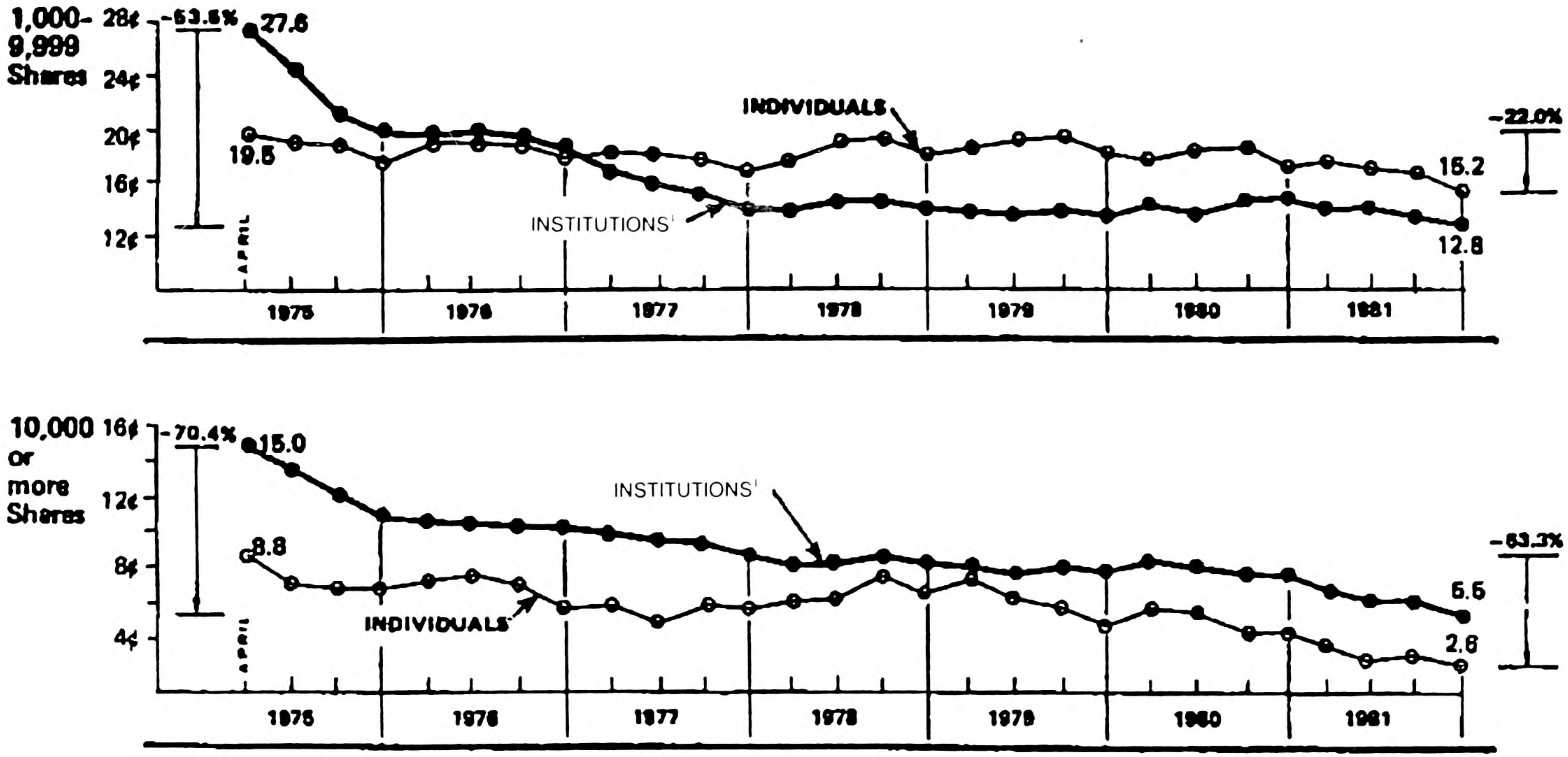

Note: [1] Where institutional and individual customers cannot be precisely identified. COD business is defined as institutional and all other business as individual.

Source: Survey of Commission Charges on Brokerage Transaction, Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission.

Figure 1. Effective Commission Rates—NYSE Member Firms
April 1975 through 4th Quarter 1981
Commission Cents Per Share

of money and stock. Order matching is automated for most small trades.[4] Broker order submission and confirmation procedures and money transfers are not so different from those for a retail certificate of deposit (CD) purchase or redemption, and should be similarly inexpensive. When you buy a CD, you or a bank teller places an order to create a CD, and to transfer funds from a checking or other account to a CD account. Confirmation is usually made at the time of the order because the bank makes a market in retail CDs. Banks do not usually charge separately for retail CD transactions (except via ATMs). Local bankers tell us that if they did it would likely cost no more than a few dollars. Money transfers for stock purchases or sales should be similarly inexpensive. Transfers of stock are similar to money transfers, except for being denominated in shares of stock rather than dollars.[5] Thus, most of the labor once involved in trade processing appears to have been eliminated. Yet, despite the rise of discount and even deep discount brokers, the charge for trading a round lot of stock for retail customers has hardly dropped since deregulation of brokerage commissions in the early 1970s (SEC 1982; see also Blum and Lewellen 1983).

THE MUTUAL FUND SOLUTION AND COMPETITIVE QUESTIONS

We propose that open-end single-stock mutual funds could be used to greatly reduce trading costs to small investors. Whatever the reason for current brokerage fees, there is a way to minimize them. One argument often advanced for investor use of open-end mutual funds is that they reduce total trading costs by combining multiple customer orders. Customer orders are handled by phone and added to an order book until the total (net) order is large enough to exploit the scale economies of trading. A moderate sized open-end mutual fund which invested in a single security could capture much of these transaction cost savings.

Even at current quoted fees, there are huge scale economies in stock trading (see Table 1). The related costs of the many smaller accounts within our mutual fund can be managed as follows. Record keeping and dividends can easily be handled at the mutual fund company level, as they are for diversified mutual funds. Margin accounts are not allowed for diversified mutual funds, so their absence would not make single-stock mutual funds any less attractive than diversified funds.[6] Most proxy handling costs are usually paid for by the company, and remaining costs could be explicitly passed on to mutual fund investors who chose to vote.[7] To prevent the mutual fund from influencing firm managers, unvoted proxies would be automatically allowed to lapse by the mutual fund company.[8] The ability of such a fund to aggregate the trades of small investors could provide substantial savings for investors and profits for fund managers.

Unfortunately, the single-stock mutual fund solution cannot yet be realized. Single-stock mutual funds are effectively prohibited because of mutual fund diversification rules in what became the Revenue Act of 1936.

One might ask why the highly competitive mutual fund industry has not sought to relax this regulatory barrier to offering new products to investors.[9] Fidelity Funds, among others, has pushed the limit with its sector funds. Sector funds are mutual funds composed entirely of stocks chosen from a given industry or sector. They remain partially diversified, but leave much more scope for investor decision making by allowing investors to switch easily between sectors. Fidelity's sector funds proved to be extremely popular. In fact, one problem for Fidelity was that some investors traded so often that Fidelity's fund managers had difficulty processing the cash flows (see Clements 1992).

Table 1. Current Brokerage Fees

	500 shares at $20/share	*100 shares at $30/share*	*Minimum Commission*
National			
Dean Witter	$230	$84	$50
Merrill Lynch	238	86	None
Prudential	252	90	55
Regional			
Piper Jaffray	236	82	None
Raymond James	218	80	45
Discount			
Charles Schwab	110	55	39
Fidelity	110	54	39
Super-Discount			
Pacific Brokerage	42	25	25

Source: Fortune 1993 Investor's Guide, (1992, 158-159)

Fidelity solved its problem by raising the switching fees between sector funds. The problem and solution are consistent with the fact that transaction costs are an important reason for mutual fund popularity. Had these not been managed portfolios, Fidelity could easily have accommodated investor fund flows among them. But Fidelity and other fund companies sell management as well as transaction services. Payment for both services comes jointly out of invested funds. Because most mutual funds fall short of beating the market,[10] it may be as accurate to say that many mutual funds capture economic rents from the economies of scale in transactions costs—charged as management fees.

LEGISLATIVE HISTORY

Since the passage of depression era financial legislation, regulation of U.S. securities markets has usually been considered a success. Even so, much has been written on the need to revise Glass-Steagall in order to allow commercial and investment banks to evolve in response to market forces. Here we argue that some of the legislation governing mutual funds may also be in need of substantial revision.[11]

Since the Depression, capital markets and trading technology have changed in ways that could not have been foreseen at that time. Widespread stock market abuses have been made illegal and otherwise contained. Improved controls on the manner and content of financial reporting have facilitated the rise of institutional investors. The SEC's decision to encourage negotiated brokerage commissions beginning in the 1960s, and dramatic improvements in communications and computer technology have allowed trading costs to fall very sharply, especially for large institutional investors (see Figure 1). Nevertheless, many of these improvements in transaction costs are not fully available to small investors, except indirectly by participating in mutual funds.

We argue that the limits placed on mutual funds by the Revenue Act of 1936 unnecessarily constrain small investors in the 1990s. We have already explored current trading costs for small investors. Below we explore the legislative history and possible reasons for the parts of the Act that concern mutual funds.

The provision that effectively prohibits use of single-stock mutual funds was added, with surprisingly little discussion, at the House-

Senate conference committee to the bill that became the Revenue Act of 1936 (see Congressional Record, Vol. 80, p. 9070). The passage was then incorporated, without substantial modification, into the Internal Revenue Code of 1939, and in turn into subsection 851 of the 1954 compilation of the Internal Revenue Code (IRC). It has not been modified since that time. Section 851 of the IRC requires mutual funds to (1) hold less than 10% of the voting securities of any company and (2) restricts investment in any one company to no more than 5% of the fund's assets. In return for meeting these requirements, a mutual fund can "pass through" its income to unit holders. This pass-through feature allows mutual funds to avoid corporate income taxes, preventing double taxation of investment income. Any fund which could not pass through income would face a severe competitive disadvantage.[12]

The first restriction, concerning corporate control, was probably a response to investment company abuses in the 1920s and was apparently intended to separate holding companies from mutual investment companies, and prevent the former from obtaining the favorable tax advantages intended for the latter. This part of the law would not prevent a mutual fund from holding a single stock, unless that fund were extremely and unnecessarily large.

It is less clear why the second restriction on investment of fund assets was required. There is a resemblance to older state level legislation from the 1910s and 1920s. Some historians have suggested that other state securities laws were ineffective because of administrative or jurisdictional limitations (see Cowing 1965 on state "Blue-Sky" laws). One possibility is that this was a federal extension of those older state laws. Nevertheless, we know of no studies that found that the state laws had any useful effect. On the other hand, several federal studies associated with the Securities Acts and the Public Utilities Holding Companies Act[13] noted general appreciation of the value of investment diversification. Thus, it is not clear why legislators wanted to *require* mutual funds to be diversified.

One might suppose the second restriction was also enacted to curb perceived investment company abuses. Yet, given the weight of evidence available by the late 1930s, there was no need to legally require diversification. While there was some concern over the lack of diversification of some funds (Stock Exchange Practices 1934), several contemporary SEC studies showed that in both the United States and in Great Britain as far back as the 1830s investment funds had been normally and deliberately diversified (Cowing 1965). The evidence suggests that diversification would have been the norm for most mutual funds with or without this legislation.

Another possibility is that the authors of the Revenue Act of 1936 anticipated the value of diversification based on modern financial theory, such as the Capital Asset Pricing Model. Because the Act predates the theory by close to two decades, this would be surprising. Even so, the value of diversification was clearly appreciated on an intuitive level, and was offered as a motive for mutual fund investing in the 1920s and earlier.

In any case, diversification can now be achieved with index funds or directly by investors. In a world of zero transaction costs, diversification at the level of the firm, or at the level of the mutual fund has little value, because investors can achieve whatever diversification they want by combining investments in several firms or several mutual funds.[14]

A better argument for professional management of diversified mutual funds is that transaction costs are not zero. By pooling funds, the lower per share transaction costs for large trades could be passed on to small investors. Professional management can ensure that the portfolio is suitably diversified, although this can now also be achieved with index funds.

The authors of this legislation may also have expected more from professional fund managers. If the fund managers are good at stock picking, there may be a gain from outperforming portfolios selected by less talented managers. However, as noted above, we now know that professional fund managers have not consistently outperformed the market.[15]

The outright banning of a specific investment form is also inconsistent with the intent of much of the financial regulation legislation of the 1930s (Douglas 1933). The Securities Acts, passed in 1933 and 1934, were intended to "level the playing field," primarily by forcing disclosure. They were not intended to make investment decisions for investors. Yet, two years later, Congress was apparently willing to do just that.

That second provision of the 1936 Revenue Act, limiting the portion of a fund's assets that can be invested in one company, is what effectively prohibits single-stock mutual funds. This one provision, with little legislative history or justification, now restricts a trillion dollar industry and constrains how the public invests vast sums of money. We believe it is also unnecessary. The historical record suggests that individuals understood the case for diversification and were able and willing to diversify without legislation, with or without mutual funds. Instead of protecting them, by discouraging single-stock mutual funds, this law imposes unnecessary transaction costs on many small investors.

An Example

Our proposal may be clearer with an example. Suppose a mutual fund company sets up a fund that invests solely in IBM stock. When investors send money to buy shares of the fund, the fund buys more IBM. When investors sell shares of the fund, the fund sells IBM, returning the proceeds. The fund manager would try to maintain a fully invested position in IBM. With such limited scope for fund management, high management fees would be unwarranted. As long as the fund stays close to fully invested, shares in the fund would be a close substitute for shares in IBM.

Because hundreds of thousands of investors hold IBM stock now, it seems reasonable to suppose that perhaps 10,000 of them might be willing to hold shares in this mutual fund—as long as transaction costs were really lower. A fund with an average of 10,000 members holding an average of 100 shares of IBM each would have $50,000,000 in assets. Investors typically turn over their portfolios every two years or so, despite brokerage fees of near $50 per round lot trade. If that rate continued, within the fund there would be perhaps 10,000 trades per year, or 40 round lots per day.[16]

If small investors trade independently of one another, most of the time these trades will offset, so the typical net order would be a few hundred shares. The fund could charge small investors $10 per trade, and with reasonable scale economies could easily cover operating costs and the one big brokerage fee.

Even if small investors' trades were perfectly correlated (perhaps by influential news articles), and trading frequency was not increased despite lower transaction costs, the combined order would be perhaps 4,000 shares, which would cost the fund much less than 40 orders for 100 shares each.

If they traded the net daily trade at the close, there would be at most a single daily transaction fee. A $10 trading fee for individual investors would raise at least $400 per day or $100,000 per year. The single large trade would cost about $50 per day or $12,500 per year. A telephone answering operation would need to answer perhaps 100 calls a day for up to 5 minutes each. If telephone fees averaged $1 per call, and receptionist time cost $12 per hour, the variable cost of each call would be $2, which would amount to $200 per day or $50,000 per year. Automated phone answering could lower costs further. Note also, the same receptionist or group of receptionists could handle more than one mutual fund, so there need not be high levels of excess capacity. Likewise, any other fixed costs could be spread over a number of single-stock mutual funds. Thus, even this tiny fund would net $37,500 per year after variable costs. Even allowing for substantial fixed costs, it may be economically viable. Further, there will be days when no trade is needed to remain fully nearly invested. Still further, as the fund grew, its revenues would increase with size, while brokerage costs would not increase that fast—larger funds would be increasingly profitable.

If investors responded to the lower costs by trading more often, the fund's fee income would increase in proportion, while the costs would not.[17] With dramatically lower trading costs, investor trading would surely increase, ensuring that the scale economies could be captured.[18]

These numbers are consistent with the costs of some of the more efficient money market or stock index mutual funds. There are "government only" money market funds with annual management costs of 0.15% of assets, or $150,000 per $100 million in the fund. Some index funds have costs around 0.20% of assets, or $200,000 per $100 million invested. Note, those funds cover operating costs, *and* pay for management expertise. Single-stock mutual funds would have much less scope (or need to pay) for management expertise.

Could such a fund remain near fully invested? Fund managers could take various approaches to the problem. They might combine every 10 orders into one large one, trade every hour, or every day, or whenever an imbalance of given size developed, depending on the size of the fund or on explicit fund policy. In the above example, with 10,000 investors holding the equivalent of one million shares, trading 4,000 share equivalents on an average day (most of which would probably offset internally), a single daily trade could ensure that the fund would almost always be within 0.4% of fully invested.[19]

Consider what a portfolio of such funds would mean to a typical direct investor. Suppose John Q. Public holds a $50,000 portfolio.

John understands diversification, so he holds 20 round lots of 20 stocks, averaging $25 per share. Assume 20 stocks are enough to capture most of the gains from diversification. As a typical investor, he turns over his portfolio every two years, selling 10 stocks a year, and buying 10 others. He trades for liquidity reasons, to manage his taxes, to keep his "BETA" near one, as well as on perceived information that comes his way. Also assume the market return and his "pre-brokerage fee return" are 10% per year. For him, this is $5,000 per year. With 20 trades a year, he must pay 20 times $50 ($1,000) to Charles Schwab. Thus his "after-brokerage fee return" is 8%. A comparable index fund might yield 9% after management fees. Now, suppose John held single-stock funds, holding the same twenty round lots indirectly. Twenty trades per year would cost 20 times $10 ($200). His return would have been 9.6%. Of course, if lower trading costs lead John to trade more often, his total costs will increase. This will be offset by his being better able to manage his liquidity, his taxes, his portfolio "BETA," and perhaps even act on some new types of information.

In our example, investors trade off direct ownership of the stock for dramatically lower transaction costs. They lose immediate execution because of the mutual funds' combining orders, but retain control over how their funds are invested. As long as significant numbers of investors value lower transaction costs even at the expense of somewhat less immediate execution, such a mutual fund would be a huge success.

DISCLOSURE ISSUES

The financial reporting requirements of single-stock funds pose some interesting problems for accountants. Traditional financial statements (balance sheet, income statement, etc.) would be of little value to investors who wished to use the fund as a trading vehicle. Fidelity-IBM Fund should differ relatively little from Dreyfus-IBM Fund or Vanguard-IBM Fund.

On the other hand, a big advantage of single-stock mutual funds is that they would appeal to a single well-defined group, small individual investors. Disclosure standards can be tailored specifically to their needs. By comparison, current mutual fund disclosures are based on the traditional statement model. While developing a complete disclosure standard for such funds is beyond the scope of this paper, we offer some preliminary suggestions.

Some less traditional information would be much more valuable to these investors. Data on average commissions, fees, and other operating costs would be useful for analyzing the cost advantages of the fund—given the fund's objectives. Additionally, the fund should periodically report its tax basis to facilitate investor tax planning (Laderman 1993).

Further, compensation for single-stock mutual fund managers should take a different form. In conventional diversified mutual funds, managers are compensated roughly in proportion to assets, usually disclosed as some percentage of assets under management. Although management fees have no necessary relation to income, they are recorded as an expense out of fund income.

Single-stock mutual fund managers would cover all costs out of the transaction fees. The income statement for the fund manager (transaction fees, net of brokerage and administrative costs) would be completely separate from the income statement for the fund (dividends and capital gains). Apart from the transaction fee, investor funds would be invested solely on behalf of investors. In addition, some of the most difficult issues involving management compensation and administrative costs for conventional mutual funds would become irrelevant (e.g., see Chance and Ferris 1991).

Another problem arises from the batch trading system we have described in this paper. Of course these mutual funds would be marked-to-market daily. Prices actually received by mutual funds in market transactions will often differ from prices prevailing when individual orders were submitted. If most traders in the fund tend to buy on days when prices are rising (trend traders?), they will tend to pay higher prices because of the necessary delay. Conversely, if most traders in the fund tend to buy on days when prices are falling (contrarians?), they would tend to pay lower prices. Summary information on this differential might be valuable.

Note that whichever side (buyers or sellers) is outnumbered on a given day will tend to buy at the bid, or sell at the ask. The fund automatically internalizes the spread for orders that offset. This would be equitable, because most of the liquidity apparent to individual investors would come from other investors in the fund. Because the fund would mark-to-market daily, some investors may find (depending on the size of the spread) that it is worth investing in funds whose typical investment tendencies (trend, contrarian, etc.) differed from their own. There may thus be value for investors in finding a way to describe such tendencies and provide appropriate information.

Finally, because our funds would be marked-to-market daily, we would not have to be concerned about a problem that can occur with other types of mutual funds. For example, money market funds are allowed to use "amortized cost accounting," to smooth fluctuations in share value due to changing interest rates. This creates an arbitrage opportunity to buy-in when rates are falling and sell-out when rates are rising (see Lyon 1984). This problem can be avoided by insisting that single-stock funds be marked-to-market daily.

CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH

We have argued that the Internal Revenue Code needs to be revised to reflect modern financial market conditions. Single-stock mutual funds, with little role for fund management, would allow small investors to capture trading efficiencies available to larger investors without surrendering control over how their funds were invested. We have also sketched out some disclosure issues that may need to be addressed to make single-stock mutual funds most useful to investors. Finally, we note that single-stock mutual funds may shift the balance between direct and third party professional management of stock mutual funds, by severing the current link between professional management and the scale economies inherent in securities trading. This empowerment of individual investors could be a very significant benefit from our proposal.

Several areas remain for future research.

1. We have little information on how many investors would find single-stock mutual funds useful. These funds would lower costs while offering less immediate execution. We may need to update existing studies on the demand for brokerage services, including the importance of prompt execution to individuals.
2. We may also wish to further explore issues of market fragmentation. Fragmentation has become a serious concern recently

as trading volume has migrated away from the NYSE and even from the regional stock exchanges. Increasingly, large institutional block traders, rather than exchange specialists, determine prices and even where the market is. On the one hand, diverting small trades to single-stock mutual funds may further reduce market liquidity, if only slightly. On the other hand, inducing small traders to trade more often, and inducing conventional diversified mutual fund investors to use single-stock funds, may increase market liquidity.

3. We do not know why brokerage fees are as high as they are now. Conceivably, a significant reduction of those fees could make single-stock mutual funds unnecessary. This seems unlikely, but may warrant further study.

4. With increasing automation of brokerage services, we can expect an increasing portion of total costs to be fixed costs. Under pure competition, market prices are limited by variable or "marginal" costs rather than total or fixed costs. Brokerage firms may have increasing difficulty fully recovering their fixed costs.[20] Some economists argue that high fixed-cost industries tend to become less competitive over time, as ways are found to ensure recovery of fixed costs, or weaker firms are merged or driven out of business. We may wish to explore to what extent this would occur, and if so what public policy implications would follow.

ACKNOWLEDGMENT

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NOTES

1. In addition to these transaction charges, some brokers add account maintenance or account transfer charges as well as other miscellaneous fees. This may cause us to understate transactions costs for small investors. Nevertheless, we ignore these types of costs because they can often be avoided by changing brokers.

2. Discount brokers, like Muriel Seibert, Inc., advertise that they will trade OTC stocks at two cents per share, or listed stocks at three cents per share, subject to a $48 minimum brokerage fee.

3. Another part of transactions costs, not otherwise addressed here is due to incomplete market integration for exchange traded stocks (see Lee 1993). Brokers are usually required to obtain the best posted price for clients, as reported on the

Intermarket Trading System (ITS). This requirement is satisfied if regional markets or OTC dealers match ITS prices. Unfortunately, ITS price spreads may be too wide. On several major markets including NYSE, a large fraction of trades take place inside quoted spreads. In recent years the practice of paying for order flow has developed among leading brokers and OTC dealers. Thus these brokers' clients may get the best posted price, but not necessarily the best available price. While it is not explicitly addressed, this difference is also a part of the transactions costs of trading stocks, especially so for less sophisticated investors. While we do not address this problem beyond this comment, note that single-stock mutual funds would internalize most of the bid-ask spread so that most costs due to excessive spreads would be recaptured by fund investors.

4. As of March 1993, NYSE-SuperDOT routinely crosses trades up to 2,099 shares automatically.

5. As noted above, most stock transfers are facilitated by NSCC, which nets trades and gives account transfer instructions to DTC, which usually holds the securities—before *and* after the trade. NSCC's 1992 Annual Report indicates gross revenues of $109 million, for processing 575,000 transfers daily (145 million annually). Even if we suppose other NSCC operations produced no revenue (an extreme assumption), this seems to imply a maximum cost of 74 cents per trade for NSCC services. NSCC also recorded $13 million in payments to DTC. According to the 1992 Annual Report, DTC completed 83 million book-entry transfers, 37 million of which were for NSCC. Note also, the average transfer for NSCC was much smaller than transfers for other DTC customers. DTC's net (less refunds to participants) service revenues were $236 million for all lines of business combined. A conservative estimate is that DTC charges 236/83 or $2.84 per stock transfer. The actual charges are probably much less than that.

6. Investors who wish to borrow on margin may still prefer to hold the stock directly.

7. ADP Corporation, which handles proxy solicitations for many of the largest public corporations, typically charges slightly less than $1 dollar per solicitation.

8. An interesting alternative that we do not explore here would be to allow protagonists in proxy contests to defray stockholder proxy costs, or even buy votes. Firms that find single-stock mutual fund investors convenient may want to defray proxy costs. As for buying votes, with proper controls, a distinct market for corporate control might be interesting. For example, this might become another way for small stockholders to extract some of any rents controlled by entrenched managers or sought by potential corporate raiders. Of course, firm and protagonist funds must be kept separate. Nevertheless, we prefer to avoid such interesting issues by insisting that unvoted proxies be allowed to lapse.

9. Proponents of investment company innovations have sought and sometimes obtained SEC exemptions from various provisions of the Investment Company Act of 1940 under section 6(c) of that act. In recent decades, securitization of mortgages, auto loans, and credit card receipts has been facilitated by these section 6(c) exemptions. However, section 6(c) does not appear to give SEC authority to exempt investment companies from other legislation or IRS rules. For more detail, see SEC (1992, chap. 13).

10. There is an extensive literature in finance on this topic. For example, see Jensen (1968) and, more recently, Grinblatt and Titman (1989).

11. A recent SEC staff report did review regulation under the Investment Company Act of 1940, and offered numerous suggestions for reforms. That report did not address IRS diversification rules (see SEC 1992).

12. Section 5(b) of the Investment Company Act of 1940 also deals with diversification issues. For clarification, look to Release No. 738, dated January 11, 1945. However, despite the greater prominence of these rules, the IRS rules governing tax status are the ones that really matter.

13. The SEC (1939) released its comprehensive study titled "Investment Trusts and Investment Companies" in 1939. Investment trusts in the United States and other countries were studied with a view to guiding future regulation of them. In Great Britain (SEC 1939, 45) and the United States (SEC 1939, 531), investment companies and trusts had been generally well diversified—containing scores or even hundreds of securities—long before any federal legal restrictions were enacted.

14. This is a result of standard financial market model assumptions as is discussed in more detail in texts such as Van Horne (1992, chap. 8).

15. In addition to the articles by Jensen (1968) and Grinblatt and Titman (1989), for a more recent discussion of related issues from the fund industry's perspective, see Bogle (1992).

16. We assume round lot purchases and sales of stock amounting to half the total portfolio, each year.

17. Epps (1976) estimated demand elasticity for brokerage services using 1968 data (before commissions were deregulated) for a selection of NYSE stocks. Elasticity was typically near −0.25 and ranged between −0.15 and −0.6, depending on the stock. While it would not be reasonable to blindly apply his results to our proposal under so very different conditions, we can certainly be assured that dramatically lower transaction costs will be associated with significantly increased trading activity.

18. Some readers have expressed another concern—would single-stock mutual funds grow to be so big that they would begin to influence stock prices? This is unlikely for several reasons. First, most large institutional investors already have access to the low per share trading costs that large trades afford. A pension fund that could trade now at three cents per share would find no advantage to trading through a mutual fund that might charge $10 per round lot, or 10 cents a share. Only small investors, who make up perhaps 20% of daily trading volume and are still subject to the high fees quoted above, would find this an improvement. Thus, the vast majority of trading volume would be unaffected. Second, some individual traders and many institutional investors place great value on the immediacy that direct trading allows. Single-stock mutual funds would not attract much of their business. Still, if single-stock mutual funds grew to have billions of dollars in assets each, a single closing order might potentially affect prices. A trading rule that allowed more frequent trading whenever there was a sufficiently large internal order imbalance would still allow large funds to capture most scale economies, while greatly reducing the impact of any single trade.

19. If we allowed fund managers a wider range around being fully invested, say plus or minus 1%, we would further reduce brokerage costs, by aggregating into

larger orders and allowing the fund to skip trading on some days. On the other hand, this would increase scope for management, and may increase management costs and tracking errors even as it cuts brokerage costs.

20. Something like this may already have occurred among money center banks (see Steiner and Teixeira 1990). The authors argue that as money transfers become increasing automated, capacity expands and prices tend to fall. This prevents banks from fully recovering the fixed costs of the technology, and may be part of the reason for the current wave of consolidation in banking.

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THE FUTURE OF FINANCIAL REPORTING

Edmund L. Jenkins

Editor's Note: In November 1993 the initial published report of the AICPA Special Committee on Financial Reporting's Study of the Information Needs of Today's Users of Financial Reporting was published. On February 19, 1993 Edmund L. Jenkins, chairman of the Committee and a partner in the national office of Arthur Andersen & Co., presented the following remarks at Case Western Reserve University about the status of the committee's work at the start of 1993. As the recommendations of this important committee begin to influence the structure and content of financial reports, it is likely that the views of the committee members, over the term of its activities, will be of interest. The following paper, published as a perspective on the process of professional self-regulation of reporting, is being undertaken as a contribution to documenting the process.

Good afternoon. It's a pleasure for me to be with you at this Mid-Winter Clinic. I'm sure I was asked to speak to you as a result of

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my role as Chairman of the AICPA Special Committee on Financial Reporting. The requirements for that role do not include an ability to predict the future. Further, even though I've been involved full-time in financial reporting issues for nearly 35 years, I've still not learned how to predict the future. I thought about buying a "Magic 8 Ball," which the *N. Y. Times* says is making a comeback. Some of you may remember the "Magic 8 Ball," the oversized billiard ball. You asked it a question, turned it over, and it gave an answer. But, I remembered that it often was less than "crystal ball" clear, with answers like, "better not tell you now." So, I'm not going to tell you or predict the future of financial reporting. Rather, I'd like to discuss with you:

- a rather impressive body of knowledge that is critical of today's financial reporting,
- some ideas about why that criticism is occurring,
- the way the Special Committee I chair is evaluating the criticism and making recommendations for change, and
- some thoughts on how financial reporting might change in the future.

I hope we have time for a discussion as I look forward to hearing your comments and ideas.

CRITICISMS OF FINANCIAL REPORTING

Let me start by summarizing the reasons for the criticisms with a comment of a City of London financial analyst as reported in *Accounting Age*:

> Only 11% of investors believe company reports and accounts give a true and fair view; a percentage which is worryingly less than the number of people who believe Elvis Presley is still alive.

Just last fall, David Tweedie, Chairman of the U.K. Accounting Standards Board, presented a paper here, at this school on The Accounting Profession and Financial Reporting titled, "Why Should Anyone Believe us?"

With this sort of smoke, there has to be a fire someplace!

But, you say, criticism of standard setting and financial reporting isn't new. That's true. In the early 1970s the Accounting Principles Board was criticized and replaced with a more independent Financial Accounting Standards Board and the Trueblood Study tried to lay the groundwork for the concepts the FASB should follow. And certainly, nearly every standard-setting project of the FASB is in response to concerns about some aspect of financial reporting. Concerns about our historical cost, transaction-based model have been around forever—it seems. But then again, various proposed fair value models are also vigorously criticized.

Over the past several years concerns over financial reporting seem to have intensified. Let's look at some of the activities that led to the formation of the AICPA Special Committee, as illustrations.

October 1988—Issuance by the AICPA's Strategic Planning Committee of a document that urged the AICPA to:

- play a more effective role in the accounting setting process, and
- develop an aggressive program designed to enhance the relevance, reliability, and cost-effectiveness of financial reporting.

November 1988—Report of the Future Issues Committee: "The Changing Significance of Financial Statements—The Relative Disparity Between Content and Needs."

- Stated that financial reports are losing their significance because they are not future oriented and do not provide value-based information.

April 1990—Publication of an article in the *JofA* by Tom Rimerman on "The Changing Significance of Financial Statements." It called for a new blue-ribbon commission to study relevance in financial reporting.

August 1990—Issuance of a research paper by the AICPA staff that detailed the following issues relating to financial reporting.

- Are financial reports useful in making investment and credit decisions?

- What kinds of information not provided in financial reports are used in making such decisions?
- What kinds of information should be added to financial reports?
- Should all financial statement users receive the same information?
- Can some financial reporting standards have negative effects on the economy?
- Do currently accepted broad accounting principles make financial reports as useful as possible?
- What effects do current changes in the economic environment have on financial reporting?
- Should management reports accompany financial reports?

October 1990—The AICPA sponsored the Wharton Symposium on Financial Reporting and Standard Setting to discuss issues raised by the research report. A report on the symposium, edited by Gary John Previts, made these conclusions.

- The demand for relevant information from the current financial reporting model exceeds the supply.
- Don't scrap the current model, but re-engineer it.
- First we want research on what different users really need.
- The re-engineered model must be better in that it must accommodate several different levels of users and provide added amounts of relevant information based on user needs.

January 1991—Discussion by Financial Accounting Standards Advisory Council (FASAC) of whether current reporting is relevant in the 1990s. It addressed these issues.

- Are current notions regarding financial reporting out-dated? Is a fundamental change in the accounting model needed or can the problems that have been identified be corrected in the current model?
- Should the primary emphasis in financial reporting continue to be on meeting user needs—and do "users" encompass "preparers"—in the way users are normally defined?
- Is it time for a special study group to consider financial reporting? Past study groups such as Trueblood, Wheat, Cohen, and Treadway have led to fundamental changes in standard

setting and auditing. Do current concerns warrant such an in-depth study of financial statements and financial reporting?

At the same time a number of activities were going on outside the United States. The United Kingdom has issued five reports since 1975:

1. "The Corporate Report," issued in 1975 by the Accounting Standards Steering Committee of the Institute of Chartered Accountants in England and Wales, in association with other accountancy bodies in the United Kingdom and Ireland institutes.
2. "Making Corporate Reports Valuable," issued in 1988 by the Institute of Chartered Accountants of Scotland.
3. "Melody PLC—Annual Reporting," issued in 1990 by the Institute of Chartered Accountants of Scotland presented a specimen annual report of an actual trading company with the recommendations of *Making Corporate Reports Valuable* applied.
4. *The Way Forward* (1990) reported on a 1989 conference promoted jointly by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland.
5. *The Future Shape of Financial Reports* (1991) was authored by five accountants comprising an action group set up by the Research Board of the Institute of Chartered Accountants in England and Wales and the Research Committee of the Institute of Chartered Accountants of Scotland. The purpose of the group was to see that the momentum generated from *Making Corporate Reports Valuable* and *The Way Forward* was not lost.

While each study reached somewhat different conclusions, there was a great deal of consensus as well.

- Annual reports are no longer useful to most users.
- Financial reporting should be much more future oriented.
- A fundamental need is for information about an entity's total wealth now, the change in wealth for the period and the reasons for the change.

- Overall strategies and objectives of the entity as well as information about the entity's market position should be disclosed.
- Too many liabilities are off-balance sheet.
- Information should be driven by the needs of external users.

In Canada, the MacDonald Report (1988) focused on the need for disclosures about: (1) risks and uncertainties, and (2) the degree of estimations inherent in financial statements and the basis for those judgments.

The academic community also issued a report during this same period, the AAA's Report of the Committee on Accounting and Auditing Measurements, 1989-90, chaired by David Solomons. Among its several recommendations was this over-arching conclusion: "The defects of present historical cost accounting system are examined and are found to be formidable."

Recently, others have also expressed concerns over financial reporting and are in the process of exploring possible improvements. For example, the preparer community through the Financial Executive Research Foundation of the Financial Executive Institute has established a project, "Economic Reality in Financial Reporting." This project was established because: "There is considerable question whether current external financial reporting is adequate for today's purposes."

As another example, the Association for Investment Management and Research, The Financial Analysts Association, has recently issued a preliminary position paper prepared by Professor Peter H. Knutson of the Wharton School titled, "Financial Reporting in the 1990's and Beyond." That position paper points out that globalization, increase in computer power, access to databases, and the shift from manufacturing to a service environment all create the need and the opportunity to improve external reporting. The paper then makes a number of specific recommendations for change.

WHY THE CRITICISMS?

There are a variety of reasons for all of the concerns and criticisms I have just recited. Let's talk about some of them.

At or near the top of the list would be the increasing number of business failures—most notably the savings and loans. These highly publicized, Congressionally focused failures pointed the finger at inadequate financial reporting (and auditing) as a main culprit in the high losses that arose from these failures. Whether true or not, the perception about poor financial reporting was there and it remains today.

Another reason is the globalization of the financial markets. As prospective investors and creditors look worldwide for opportunities, differences in available information—including financial information—become more apparent and more important.

The ongoing transformation from the industrial to the information age has increasingly required different, better, and more timely information. And this new set of information is required both internally and externally. Our current financial reporting model simply doesn't fill the need in a service oriented, high technology environment. For the first time ever the United States now has more white collar than blue-collar workers.

Closely aligned is the explosion of new financial instruments over the last decade. While most of these instruments are designed to achieve sound business objectives in a global, information age, some also have been used to take advantage of our accounting standards to realize less than optimum financial reporting as well. Either way, present standards weren't designed for and can't keep up with these sophisticated, multifaceted instruments. Over seven years ago, I described in a speech on this issue that: "We were trying—not very successfully—to fit financing transactions unheard of even a few years ago into accounting standards that are outdated and rule specific: 10 pounds of complex financial instruments into a 5 pound sack of standards."

The bottom line is that financial reporting is seen as not being very relevant to meeting today's needs. Users want information not only for an accounting of the past, but more importantly perhaps for making investment, strategic, and operating decisions about the future. Information for decision making would seem to be a more important guide for the future than accounting for transactions—the primary basis of today's reporting.

THE AICPA SPECIAL COMMITTEE ON FINANCIAL REPORTING

This brings me to the AICPA Special Committee. The committee's charge is to recommend (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information. The charge also requires that in developing its recommendations, the Special Committee should (1) determine the understanding of the information currently provided by financial statements and the perception of the assurances provided by auditors and (2) evaluate the full-range of information and assurances that should be made available.

The committee's charge is comprehensive. It focuses not only on changes necessary in financial reporting, but also on the extent to which auditors should be involved in enhancing the reliability of such information. Further, the charge requires that the Special Committee consider whether its recommendations would apply to all entities or only some and that the committee also consider whether there is a need for any structural changes in the standard-setting process in order to increase the likelihood that the recommendations will be in fact implemented.

With respect to the timetable for the work of the Special Committee, we expect that a final report should be available in May 1994.

THE PROCESS OF REACHING OUR RECOMMENDATIONS

Early on the Special Committee recognized that it would need to develop a new specific process for evaluating and reaching decisions with respect to the recommendations we would make. We are approaching our work from a user perspective. Finding out what users need and then developing recommendations to meet those needs is what we are all about. We defined users, in part for practical reasons, as present and potential investors and creditors who lack the authority to prescribe the information they need directly from the enterprise in order to fulfill their decision information needs. We agreed, however, that all of that information would not necessarily be appropriate for inclusion in a reporting model for business enterprises. Therefore, we plan to limit the set of information we consider to information that would assist these users in predicting the amount, timing, or uncertainty of future cash flows.

We further agreed that while our emphasis would clearly be on the relevance of information to users, such information also needs to meet a certain reliability threshold if it is to be included in our recommendations. Finally, we decided to consider recommendations only where the company is the best source for that information and where the benefits to users exceed the cost to preparers.

The set of information resulting from this screening process would then further be subjected to a determination as to whether the information should be provided for all business enterprises or only for some. For example, should there be a distinction between the information provided by a private company versus a public company. The next step would be to determine how to communicate and transmit the information and then to consider the extent to which the auditor should be involved in enhancing the reliability of such information based on the ability to establish standards, liability concerns, and other factors.

Out of this entire process the Special Committee expects to make recommendations that are faithful to the multiple aspects of our charge.

SUBCOMMITTEES

The committee established subcommittees to explore: improvements in the current historical cost model reporting; recommendations for a new model—including certain fair value approaches; disclosures with respect to prospective information; information relating to nonfinancial business matters; and issues relating to timing and methods for accessing information. Another subcommittee is focusing on changes in the structure and process for determining external financial reporting standards.

FOCUS ON USERS' NEEDS

As you know by now, the focus of our activities is on users' needs. We want our recommendations to be responsible to the information needs of users. It has been difficult to determine this information with respect to users, but our work continues.

We have performed an exhaustive search of the literature and have developed a computer database of information with respect to users' needs consisting of several hundred different documents and texts. The result of that literature search indicates that there is a great deal of information with respect to what others—accountants, academics, and so on—believe users need but very little direct information from users themselves as to what they in fact need.

We are committed to finding out about users' needs directly from them. In this regard, we believe our effort is significantly different from earlier studies with respect to the need for change in financial reporting. It seems to us that too often standards have been set and disclosures required based on what accountants, preparers, or academics believe users need rather than on what users in fact require in order to make investment and credit decisions. In connection with this effort we are:

- Holding a series of meetings with a group of equity investors and a parallel series with a group of creditors to explore in some depth both groups' needs for specific information and how they use that information.
- Conducting research. Paul Healy of MIT and Krishna Palepu of Harvard are conducting research that will identify and categorize the types of information supplied by for-profit-companies to investors and creditors outside of the audited financial statements.

  In addition, Gary John Previts and several associates have researched the types of information supplied in reports written by financial analysts about industries and companies that influence, determine, or support investment or lending decisions.

  Further, we are utilizing research just completed at the FASB with respect to identifying and categorizing the views of sophisticated investors and creditors about disaggregated disclosures.
- Studying various business and investment models, including Porter, Rappaport, and Graham and Dodds, used to analyze companies and determine shareholder values.
- Planning a broad-based survey of users to confirm their information needs and determine whether the committee's recommendations are responsive to those needs.

I believe that one of the major contributions this Special Committee will make will be communicating the information needs of users. In our discussions with both the FASB and the SEC we learned that they have precious little data about the information that sophisticated investors and creditors actually use in making decisions. We intend to enhance the credibility of our report by basing our recommendations on that type of information.

CHANGING FINANCIAL REPORTING

Finally, let's turn to some thoughts on how financial reporting might change in the future. I need to say that the Special Committee has not reached any recommendations at this point in our work. These thoughts are mine alone and are based on what I have read, heard from users, and intuitively feel.

It's clear to me that financial reporting must change if it is to provide relevant information to users. Financial reporting has over the years lost much of that relevance. As Walter Schuetze, SEC Chief Accountant, said recently: "Accounting should not be done for the benefit of accountants. Accounting should result in financial statements that ordinary people will understand and therefore be able to use to make investment and credit decisions." To accomplish this goal, financial reporting must change to:

- Focus on forward-looking information. Reporting should report leading indicators (often nonfinancial in nature) that focus on (1) competitiveness; (2) ability to innovate, adapt, and continuously improve; and (3) intangible assets.
- Provide faster reporting of information to assist in early detection of risks and uncertainties.
- Adopt global reporting standards consistent with users opportunities for investment.
- Consider flexible, customized reporting, including the auditors' report, to better articulate the risks, opportunities, and subjectiveness inherent in financial reporting.
- Provide better disaggregated information on both an industry and geographic basis to better enable users to estimate future cash flows and risks and opportunities.
- Improve the presentation of core earnings to better facilitate the prediction of future cash flows.
- Present forward looking, nonfinancial business information. This has potential to add significant value to reporting.

- Increase the recognition of fair values in financial reporting because of its relevance. However, very significant concerns about the reliability of this information is a barrier to achieving this change. Reliability concerns relate not only to the subjectivity of the values, but also with the methodology of various fair value models (e.g., how useful is the exit value of an asset?)
- Provide alternative ways of disseminating information through data bases, on-call reporting and other approaches.
- Recognize intangible assets created by the company as key to providing information about future cash flows in a service-oriented, high technology age.

In summary, we must change the very definition of accounting and financial reporting. We must change from measuring assets and liabilities and reporting on transactions to providing information for decision making and developing a business reporting model to communicate that information.

Thank you very much.

THE NOBLESSE OBLIGE OF ACCOUNTING

Gerhard G. Mueller

ABSTRACT

The discipline of accounting has a broader social consequence than is readily acknowledged in public circles. Our discipline is sustained by its ability to adapt and remain useful. In this sense it fulfills its moral imperative to serve society, its "noblesse oblige." In Spain, over the last two centuries, the progress in education for commerce is best understood in terms of the context of the founding of the Bilbao School of Commerce in 1818. Just as education has moved from technical to professional over time, so too major developments in accounting have transpired. Accounting has developed from a skill to an increasingly independent intellectual discipline, a vibrant field which serves as a store of human knowledge. The author provides two sets of propositions to detail the manner in which our discipline responds in its role to adapt and to serve, including the demographic growth of accounting professionals, the sophistication of valuation and reporting, and the movement from rote action based on individual

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judgment to complex theories, developed and shared and debated as part of a common body of knowledge. Today, accounting continues to adapt, to become more operations oriented and more future oriented, while facing still other new environmental influences and addressing relative cultural interfaces which affect its disciplinary role and its human agents.

To inquire about the noble obligation to be honorable and generous and to behave in responsible fashion as far as the discipline of accounting is concerned might strike casual observers as lofty and unduly academic. Nevertheless, accounting both as a discipline and as a profession is generally more consequential than public opinion allows. Next year we will celebrate the fifth centennial of the first known published treatise on double-entry bookkeeping. With this work, Pacioli (Frater Lucas de Burgo Sancti Sepulchre) surely became a significant contributor to medieval trade extending from Italy into Southern Germany, the Lowlands, and eventually England. There is even speculation that the industrial revolution might not have blossomed as well as it did without double-entry bookkeeping.

Some of the world's most well-known literati have referred to accountants and their work (e.g., William Shakespeare and Johann Wolfgang von Goethe). Chairman Mao's *Redbook* covers accounting, and its methods and procedures have been pressed into service on behalf of peace and war. Efforts like the Marshall Plan in post-World War II Europe would have been much less effective without accounting controls and relevant financial reporting. On the other side of the coin, the Nazi regime in Germany used tight uniform accounting methods to control all available national resources and mobilize for war.

The venerable history of accounting is surely a source of pride to its scholars and practitioners. If accounting did not produce a net national social benefit in literally every single sovereign nation around the globe, it would have long since withered away. But the fact that over the centuries accounting has contributed and today is still contributing to the welfare of human kind, imposes a major obligation—the noblesse oblige of accounting, if you will. In the paragraphs to follow, we reference today's joyous occasion and sketch how accounting knowledge has progressed over the last 175 years. We then point to a few ways in which accounting has responded to changing environmental conditions and how the discipline is maturing toward a component of contemporary culture. Although our commentary is brief, it should suffice to demonstrate that accounting has indeed fulfilled its *noblesse oblige*.

A NOBLE OCCASION

In 1818, about 175 years ago, the first Spanish School of Commerce was founded in Bilbao. History decreed that this would be the fifth such school worldwide. What a noteworthy event! What a noble occasion! The establishment of a new institution of higher learning in 1818 is most remarkable when put into the historical circumstances of the time. Napoleon had met his final defeat at Waterloo in 1815. In the same year, the Congress of Vienna redrew the boundaries of Europe. Writers and philosophers (e.g., Byron, Hugo, and Hegel) glorified personal and political freedoms. Spain found the Bourbons firmly restored to the throne. In 1819, they ceded their Florida territory to the United States. Most Spanish colonies in South America gained independence. The seeds of the Chinese Opium War had been sown, which, among other consequences, brought severance for Hong Kong. One can fairly observe that a major academic event happened quietly in Bilbao while the world at large was confused and very uncertain of itself. While many around the globe lost, Bilbao certainly had a win.

It was also a noble occasion for accounting. In the much recognized special book prepared for the 15th Annual Congress of the EAA (*Accounting in Spain 1992,* Coordinated by Professor Jose A. Gonzalo), there is mention of a "Period of Silence" in Spanish accounting affairs just prior to the establishment of the Bilbao School of Commerce. No doubt the school exercised major influence in bringing business studies into the mainstream of modern thinking. Therefore, we have every reason to celebrate today. A noble occasion warrants it.

THE NOBILITY OF ACCOUNTING KNOWLEDGE

History is our witness that accounting knowledge has continuously increased over the last few centuries—clearly at an accelerating rate during the present century. Bookkeeping was, at best, a skill during

Pacioli's time. Today, accounting has earned recognition as an intellectual discipline (Mueller 1988). The literature of a field is one index of its scope and importance. At present there are hundreds of accounting journals published periodically and more than a thousand new accounting books come into print every year. Not each of these contributes to the growth of accounting knowledge, but in total they attest to the vibrancy of the field.

Just how far have we come as a store of knowledge? I submit 10 points to you to support my case.

1. We started with simple double-entry bookkeeping and now we have accounting and sophisticated financial and managerial reporting. Several million people earn their daily livelihood as accountants. The International Federation of Accountants (IFAC) alone represents well in excess of one million practicing accountants. This excludes most accountants working in industry, the public sector, and academe. It also excludes huge systems like those of the former Soviet Union and the People's Republic of China. The knowledge base needed to keep millions of accounting professionals at work is impressive indeed.

2. A second major thrust pertains to asset valuation. When Bilbao's Business School started, bookkeepers had not even thought about valuation concepts and valuation consistency. A most eminent accounting historian, Professor Basil Yamey (1978, 8) of the London School of Economics, put this matter into succinct perspective.

> [W]hat today we would regard as incomprehensible inconsistencies in valuation, were commonplace in practice. In the same ledger, one would find some fixed assets valued at cost, historic cost; others would be revalued whether upwards or downwards and others would simply be the arithmetical balance after deducting all the credit entries from all the debit entries so that the more successful the asset the lower its value would be shown in the accounts. All this and other evidence suggest that these matters were not central or even peripheral to the concerns of those who kept accounts and those who used them.

3. A similar knowledge growth has occurred between former almost purely cash-based wealth assessment and present-day profit measurement. Today's income statement is a sophisticated assessment of the economic effects triggered by all the events and transactions undertaken by an entity during a specified period of

time. Here is how Professor Yamey (1978, 8) quotes another influential English writer who described earlier profit and loss accounts as "the receptacle for the refuse and dregs when the accounts were to be closed and the new ledger was to be started." Our knowledge about profit measurement has now become so comprehensive that no one person can possibly know it all any more.

4. My fourth point involves the evolution of accounting knowledge from pure judgment to sophisticated theory. Historians agree that as late as the eighteenth century there was no accounting theory. Then, literally within the present century, accounting theory exploded. European scholars like Professors Schmalenbach in Germany and Kaefer in Switzerland developed erudite, conceptual structures of the double-entry system, and rationalized uniform charts of accounts from this work. In the United States, Colonel Charles Ezra Sprague published *The Algebra of Accounts* (1880) and *The Philosophy of Accounts* (1907). Sprague's work, with its careful logic and meticulous notation, laid the foundation for the scientific dimensions of accounting in North America. Accounting theory is without doubt a twentieth-century phenomenon.

5. When it comes to scholarly pursuits, we already intimated that early double-entry bookkeeping was a skill acquired by tutorial and practical experience processes, often through lengthy and authoritarian apprenticeship arrangements. Today the field has evolved to full recognition as a university discipline. Organized accounting curricula exist at institutions of higher learning throughout the world and accounting research is as structured and as robust as it is in any other field in the social sciences. During yesteryear, one learned by observation and replication. At present, one learns by analysis and abstraction. A common body of knowledge now exists in accounting and it has become the learning benchmark for new accounting students. One must carefully safeguard this precious gift of accounting knowledge.

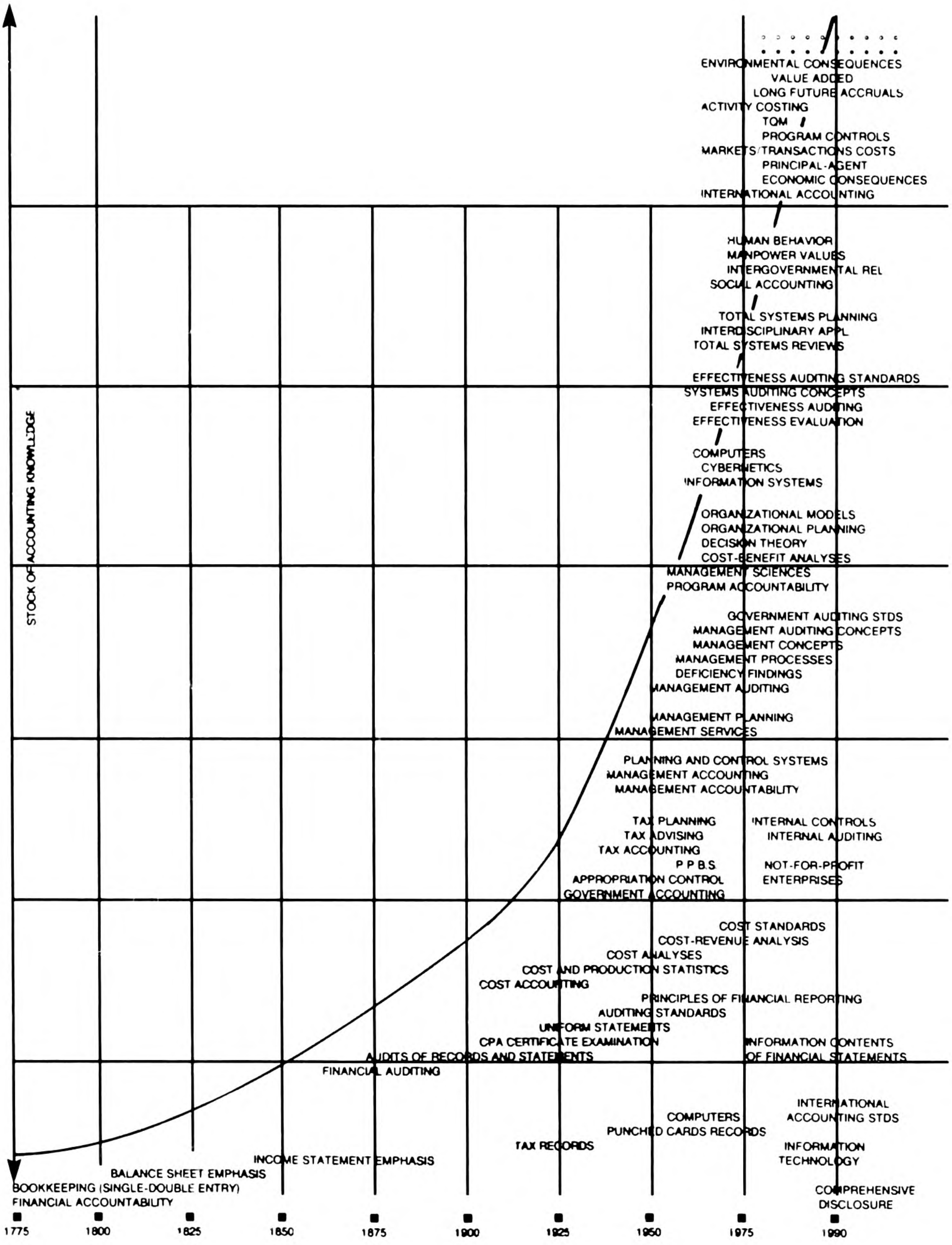
6. My sixth point of evidence brings to bear the change in the tools of knowledge from arithmetic and reckoning in proportions to analytic and probabilistic techniques. Much extant accounting knowledge utilizes tools of higher mathematics and statistics. This is also the case with applied accounting knowledge. In-depth financial analysis today relies heavily on quantitative methodologies and functions like auditing would be much less cost efficient were it not for analytical techniques. High speed electronic computing, of course,

aids all of these processes. Today, an enormous amount of accounting data and accounting related data is generated in mega amounts. Little of it could be used or would be useful in the absence of sophisticated accounting knowledge.

7. Next is the huge knowledge expansion from a purely financial to a comprehensive managerial scope. Most of what we now know about managerial accounting has been added to the accounting knowledge base within the last one-hundred years. The most important aspects of this new knowledge are the allocations of costs to particular activities or processes—especially common or joint costs. Many famous testimonials exist on this point. The British porcelain manufacturer, Wedgewood, is said to have salvaged his firm from financial ruin by using cost accounting to find out which Wedgewood products were making profits and which were making losses. Andrew Carnegie, in the United States, mastered the cost accounting of his steel mills and is noted to have claimed that his financial successes were in part due to his ability to know his costs in the steel industry. Activity costing is the latest edition to the managerial accounting knowledge base.

8. The eighth point addresses the nature of our knowledge. Throughout most of its existence, accounting has been more or less the twin of economics. In our accounting knowledge work, we have relied on economic models and economic benchmarks. Economic concepts like agency contracts, transaction costs, and market efficiency have readily found their way into accounting knowledge. This "twin relationship" with economics is currently breached with significant accounting knowledge-building attention to the behavioral sciences, the study of culture and anthropology, and in a more technological sense, the entire spectrum of information technology. These new horizons augur well for the continuing vitality of accounting knowledge.

9. "The past is prologue"—as is widely believed among historians and philosophers. What about accounting? We have always looked backwards so as to be objective and verifiable regarding our data. Thus, both our knowledge and our data had a strictly historical perspective. We left it to others to interpolate our historical information for the future. Once again, the scope of our knowledge expanded. We now include in our knowledge domain the forecasting of events and their probable future consequences. Industrial accountants prepare budgets routinely, and cash flow forecasts have



Source: Adapted by G. Mueller, November 1993.

Figure 1. Growth of Accounting Knowledge 1775-1990

become typical for credit applications and new public issues of corporate securities. Accounting knowledge is increasingly future oriented.

10. My tenth and final point about the noble growth and continuing maturity of accounting knowledge relates to its recent integration with computer-literate information systems. Bookkeeping/accounting systems have been free-standing for centuries. Now this "financial" information system needs to be fully integrated with the "operational" computer-based data processing system. Peter F. Drucker (1992), the American management guru, observes:

> for operational accounting, money is simply a notation and the language in which to express non-monetary events. Indeed, accounting is being shaken to its very roots by reform movements aimed at moving it away from being financial and toward becoming operational.
>
> There is the new "transactional" accounting that attempts to relate operations to their expected results. There are attempts to change asset values from historical cost estimates to expected future returns. Accounting has become the most intellectually challenging area in the field of management, and the most turbulent one.

For a graphic view of the world of accounting knowledge, I present Figure 1 which I owe to a former Deputy Comptroller General of the United States, Leo Herbert. Herbert's original chart ended in 1975 and I took the liberty of updating it to the present. The top line on the original chart reads "Human Behavior." To be noble is to have outstanding qualities. Given the developments just cited, there can be little question that accounting knowledge is representative of this characteristic.

CONTINUOUS RESPONSE TO THE HUMAN CONDITION

Aside from meeting its noblesse oblige through energetic development and expansion of its knowledge base, accounting has also managed over the centuries to respond firmly and often substantially to changes in environmental conditions. This has been a reciprocal process. Accounting developments have produced a wide range of political, economic, and social (i.e., environmental) consequences (Someya 1993). Equally strong, the field of accounting has responded to relevant changes in the environment. We now consider 10 points in support of this observation.

1. First and foremost, accounting has had a national orientation which now is international in scope, conceptual framework, standard setting, and application. Double-entry bookkeeping is often referred to as "Italian." British accounting and its "true and fair" concept differentiates itself sharply from uniform accounting fostered by the French "plan comptable." These national orientations held sway for a long time. Nonetheless, due to changed environmental conditions, today's accounting frontiers are international. This is fully evidenced in the work of the European Commission, the IFAC, and the International Accounting Standards Committee (IASC). Today's accounting textbooks contain comparative illustrations and international cross-references. Accounting research increasingly utilizes international data and organizations like the European Accounting Association are international in everything they do. The international perspective is now commonplace in the discipline.
2. Another pervasive environmental influence has shifted the output focus of accounting from governmental agencies and creditors as primary parties at interest to serving the needs of capital market participants. While government agencies and taxing authorities still receive various accounting reports, and while bankers and other creditors continue their interest in an organization's ability to pay interest and return borrowed capital on time, the information needs of actors in capital markets have moved to the forefront. Measuring and reporting earnings has become a new accounting priority. Comprehensive financial disclosure is now a paramount characteristic of effective financial reporting. Secrecy and undue conservatism are no longer desirable accounting qualities.
3. It is also appropriate to recognize that the discipline and professional practice of accounting are focusing more and more on public service dimensions. We have already pointed out that the accounting function in society has served purposes of peace as well as purposes of war. It has served the vanquished as well as the aggressors. It has become an integral part of the economic information systems of highly industrialized countries and it contributes to development processes in the Third World. The adaptability of accounting activities is really quite remarkable. Its

social (i.e., public) service orientation is still gaining momentum. This is clearly in step with the social concerns of our age.

4. In addition to the growth of accounting's public service dimension, there is also some evidence of a developing social consciousness within the field. At the United Nations, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has a major agenda item dealing with environmental disclosures. Entire accounting conferences and large accounting research projects are devoted to measuring and reporting environmental costs and benefits of various industrial actions. This movement has become known as "Green Accounting" and is clearly gaining momentum. A similar example relates to value-added calculations and reporting. Preparation of value-added accounting reports is still sporadic but nevertheless another indicator of the growing perceptiveness exhibited by accountants in their work regarding higher levels of social consciousness.

5. The fifth point may be so self-evident that separate mention is superfluous. The point is that until relatively recently the accounting function was more or less a peripheral appendage for most organizations. In the English language there is the often derogatory reference to "bean counters." Accounting functions were typically regarded as questionable overhead. Organizationally speaking, these functions were widely considered as a necessary evil. All of this changed when critical and reliable information became the nucleus of managerial decision making. Nowadays, corporate accounting executives are part of top management teams. The importance of audit and financial management functions in high level government activities is widely acknowledged. The service contributions of professional accounting firms now reach far beyond the traditional audit and tax return preparation functions. In an organizational sense, accounting activities have moved to center stage. This has occurred in response to the structural changes that have moved organizational behavior from hierarchical/authoritarian management styles to flat/participatory patterns of management.

6. The anniversary we are celebrating today is a testimonial on how earlier technically oriented colleges of commerce have blossomed broadly into schools of business administration. We used to train technicians—expert bookkeepers, specialists in commercial law, and clerks skilled in the preparation of trading documents. We

developed office skills such as typing and arithmetic computing and courses were offered in how to manage a business office.

As business enterprises became larger and more complex, our focus shifted to the more general needs of business managers. Today's business graduates have been exposed to concepts of accounting, finance, and marketing. They are versed in the application of sophisticated computer software and they know the theory and practice of human resources management. We cover operations management and strategic modeling. International business concepts are now commonplace in our curricula, and specialty topics like environmental management and government regulation of business affairs receive attention. In short, we have responded to the educational needs of the modern, sophisticated business enterprise.

7. Yet another noteworthy response to the changing business environment surrounding us is the rapid development of new analytic tools that we put at the disposal of our graduates. Theories of agency, efficient markets, and information economics have moved to center stage of financial reporting research. We now have workable algorithms for such tasks as prospective costing and transfer pricing. Concepts of total quality management (TQM) have found their way into managerial accounting courses and case studies dealing with special industry applications like health care, insurance, and public sector enterprises have broadened the usefulness of higher education for business. Together with our advisors from the real world of daily business, our faculties and administrators keep a continuous watch over the changing environmental conditions which need to be incorporated into our academic routines. It is my judgment that we have not only done this, but have done it well.

8. Related to the aforementioned extension of our discipline to new management tools is the very impressive response of business school activities to all aspects of the electronic computing age. Here is a new environmental condition that has changed literally everything students and faculty do in today's business schools. When I visited various universities in Black Africa in 1987, the first thing the then Vice Chancellor of the University of Ghana in Accra showed me with great pride was the small battery of personal computers he had just acquired for his students and faculty. At the time, there was not enough to eat for the citizens of Ghana, but attention to the electronic computing age at the university was deemed indispensable. The organization of the Certified General Accountants of Canada

provides extensive distant learning programs to those seeking a professional qualification in accounting but unable to attend colleges or universities. They use computer-based technology throughout their tutorials. One easily could recite example after example. The point, once again, is the pervasive response of the discipline of accounting to changing conditions in its environment.

9. My ninth point is more prosaic and deals with an educational tension that is as old as our western culture (Shenkir and Crunk 1992). This tension dichotomizes what is deemed "liberal" in contrast to what is deemed "useful."

> Traditionally, "liberal studies" or the "liberal arts" were those pursued by men and women who were "free", which usually meant free from the constraints of having to labor for a livelihood. Accordingly, liberal studies have traditionally included the contemplation of speculative questions about the human condition, as encountered in philosophy, religion and literature; the pursuit of systematic knowledge—for its own sake—regarding the physical and social worlds, as encountered in the sciences; and the various expressions of the human spirit encountered in the fine arts.
>
> The liberal arts have thus been contrasted traditionally with the practical arts, which, quite simply, are those "arts" that one requires to make a living. In addition to basic competencies with language and numbers, the practical arts include the specific knowledge and skills required for the practice of specific trades or professions (Shenkir and Crunk 1992).

10. Of course, accounting has always been classified as a practical art. Historically, this has led to narrow and technically focused educational patterns for accounting students. Increasingly though, academic patterns in accounting are turning toward a liberalized professional paradigm. We are making our students aware of the intrinsic values of accounting and of the crucial role the practice of accounting is playing in matters of economic resources allocation, economic development, and the social welfare and community of nations. We recognize the ethical responsibilities of accounting practitioners and teach the moral imperative of "accountability" for the socioeconomic dimensions of our existence. The intellectual, moral, and social aspects of accounting, thus brought into the discipline, are surely elements of the "liberal arts." The fusion thus created augurs well for contributions likely to be made by future generations of accountants.

Summing up this section of the paper, there is ample evidence that the intellectual discipline and the professional practice of accounting (together with the related educational and professional development processes) seek out, learn to understand, tolerate, and actively pursue *change*. This characteristic alone is worth celebrating today. Change in academic accounting affairs is the raison d'être of the Accounting Education Change Commission in the United States whose chairmanship commands a high order of priority among my present assignments. Change also appears to be in the air everywhere in Europe these days. The European Federation of Accountants (FEE) has become the advocate of a Europe-wide accounting perspective. The EU authorities in Brussels are generating accounting directives which have altered accounting standards and regulations in all member countries. The AICPA in the United States is proposing significantly expanded obligations for independent auditors and is about to release some major recommendations on the nature and content of financial reporting. At the international level, the IASC is achieving ever-growing recognition and use of its international accounting standards, and IFAC can now claim full acceptance of its international auditing standards by securities market regulators. Therefore, change continues to drive our discipline. Some may fear change and defend against it. The tradition in accounting is otherwise—change is welcome and continuously utilized. Were it not for open receptivity to change, accounting would have probably withered centuries ago.

AN HONORABLE PURSUIT: INTEGRATING ACCOUNTING AND CULTURE

In this final section of my paper, I seek your indulgence on a topic more speculative than the earlier topics. In the natural sciences, there is presently some attention to the new paradigm of "chaos theory" (see, for example, Briggs and Peat 1989). Is there an accounting dimension to things that are supposed to be orderly but are not, and to various illogical and/or random events that restore order in various systems without logical explanation? Many phenomena in accounting appear unscientific, illogical consequences of one another, and to stretch the earlier reference, somewhat "chaotic." Maybe a linking of accounting phenomena with cultural phenomena will help.

To start with, no clear definition of culture exists (just like with accounting). The 15th edition of the *Encyclopedia Britannica* (1975) provides a classic definition of culture by the nineteenth-century English anthropologist Edward Burnett Tylor "Culture ... is that complex whole which includes knowledge, belief, art, morals, law, custom and any other capabilities and habits acquired by man as a member of society."

As anthropology has matured its definition of culture has multiplied and diversified. For present purposes it is important that culture today seems to be regarded as an abstraction and in a more specifically conceptual sense "an abstraction from behavior." U.S. anthropologists Kroeber and Kluckhohn (1952) reasoned if culture were behavior it would be the subject matter of psychology. Hence their conclusion that culture "is an abstraction from concrete behavior but is not itself behavior." This may be cutting meanings somewhat finely but it is important that the accounting context does not muddle human behavior and abstraction from such behavior. Put differently, culture is learned behavior—not behavior itself. In terms of a selected textbook definition culture is an

> integrated system of learned behavior patterns that are characteristic of the members of a society and that are not the result of biological inheritance.... culture is therefore acquired behavior. But it is as much a part of the natural universe as the stars in the heavens, for it is a natural product of man's activities, and man is a part of nature (Violet 1983, 3)

Therefore, as human beings we are born cultureless. Learning processes then impress or impose a vast number of conditioned reflexes and habit patterns on receptive infants so that they can eventually live effectively in a particular kind of sociocultural system whatever or wherever it might be. Is accounting somehow one of the conditioned reflexes or habit patterns that are learned by humans?

One way to look at accounting through cultural perspectives is to consider the rationalization which accounting provides in organizational contexts. So long as a manager can point to supportive accounting (or other quantitative) information, he or she gains a rationale for any decision made. Therefore, accounting provides the rationale for organizational systems of control. This implies, among many other things, that locating rationality in accounting lessens the need for explicit rationalization in other parts of organization structures. Therefore, organizations with fuzzy organizational lines, overlapping of responsibility, and a lack of clarity in decision responsibility typically have complex and extensive accounting systems. Another way of putting it is that organizations lacking tight rationalized structures rely on bloated accounting functions to provide needed myths of integration and rationality. Should we begin to explore this type of linkage with our students?

Another cultural perspective concerns language. Accountants generally refer to their discipline as the language of business. Defining and employing accounting as a language gives the discipline symbolic expression in a given cultural domain. In turn, such symbolic expression defines the role of accounting in society. If this is indeed the case, then accounting does possess the attributes of a language. This language serves as a means of communication between and among organizations and individuals of a culture. Every time a part of this language changes or accounting language expressions become so specific that only accountants can understand them, misinformation (or worse) results. Do we as accountants understand the pitfalls and consequences our language behavior has on others in our respective cultures? The importance of language in placing technical aspects of accounting into a larger social/cultural context is explored rather elaborately by proponents of critical theory (Habermas and others).

What if we reach even more broadly beyond culture to the tenets of philosophy? A recent paper on this topic asserts

> On the basis of an analysis of the relationship between philosophy (with emphasis on metaphysics) and culture, the paper argues that adopting a view of accounting as part of culture is more useful in understanding current developments in accounting.

One of the relationships explored in this paper contrasts western and eastern precepts in relation to accounting. For example, it is argued that

> The western concept of freedom as one concerning the right to make a choice and act, as well as the separation of the subject and object has created a culture based on the concept of rights; while the eastern concept of freedom and the emphasis on the unity of knowledge and action has contributed to the development of a culture based on obligations.

This precept is illustrated and summarized in Table 1.

Table 1. Metaphysics, Epistemology, Culture and Accounting: An East-West Dichotomy

	West	*East*
Self	1. Egocentric-Contractual 2. Dualism	Sociocentric-organic Monism
Freedom	From external constraints	From internal desires
Epistemology		
● Main interest	Physical environment	Self-understanding
● Method	Sense experience	Sense experience and insight
Cultural Values	Individualistic Small power distance Strongly masculine or strongly feminine	Collectivistic Large power distance Weak masculinity
Accounting Role	1. Reduce power distance 2. To evaluate performance of contractual obligations	Behavior influencing
Development	By innovation and revolution	Incremental and evolution

Source: Sivakumar and Perera (1992).

The observations just made and many similar others now found in the accounting literature suggest that there exists a definable and, therefore, researchable relationship between culture and accounting. Intuition and personal observation tend to confirm this. Traveling internationally one is quickly convinced that practicing professional accountants, let us say in all of the OECD countries (to take an industrialized national subgroup), exhibit a remarkable degree of similarity in personal characteristics as well as professional orientation. At the quinquennial International Congresses of Accountants it is not always simple to pick the home country of an individual congress participant. In this sense, professional accountants exhibit the same integrative tendencies as, let us say, pilots of major airlines, physicians interested in certain medical specialties, or scientists working in a given field.

Also think about the "corporate culture" slogan. Offices of larger CPA firms have a distinctly different appearance than do law offices or corporate business offices. Bank offices are different again. Quite apart from physical appearance, professional accounting firms "do things" in certain distinctive ways. Among firms both nationally and internationally there are dress codes for staff, behavior patterns at continuing professional education events, jokes of a certain type, largely predictable alcohol consumption patterns, and so on. Furthermore, psychological inventory studies point to the fact that professional accounting attracts individuals with certain characteristics—competitive, systematic, quantitatively oriented, above average intelligence, politically conservative, socially traditionalist, and so on. Observably, a special type of "corporate culture" exists across large professional accounting firms.

Can we take this one step further and speculate that accountants and accounting have become a cultural segment within the total fabric of culture? Maybe this is reaching too far but the international dissonance among technical accounting items (e.g., standards, statements, and measurement and disclosure practices) seems far greater than the dissonance among professional accountants as persons. There is also little difference among the fundamental vocational elements of accounting. Double-entry bookkeeping as a process occurs worldwide and it occurs procedurally alike everywhere. Introductory procedurally oriented accounting education is the same from Australia to Japan to North America and Western Europe. Maybe a distinct accounting segment of culture is building.

If the segment premised speculation is more right than wrong, we might begin to find explanations for the rather astounding growth and influence success of private world accounting organizations like the International Federation of Accountants. One would not have expected such growth concurrent with the seemingly increasing nationalism of financial accounting standard setting. Furthermore, the cultural relativism evident, for example, in professional audit practices and reports would not have suggested overwhelming success for worldwide organizational efforts. These seeming contradictions beg for analysis and reconciliation.

In conclusion it is my conviction that the accounting discipline has grown in substance as well as social importance steadily throughout the centuries. The case has been made that accounting both influences and is influenced by its environment. Several new developments in accounting are worthwhile to explore—one of them is the linkage between accounting and culture. In my judgment, our field can welcome the new millennium in another seven years with considerable confidence. The future of the field seems assured; I am equally confident that the same holds for the Bilbao School of Business.

ACKNOWLEDGMENT

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BOOK REVIEWS

The Knowledge of Strategy: Foundation for an Intelligence of Strategy

by Nathan D. Grundstein's
Reviewed by **Walter J. Kennamer**

The Knowledge of Strategy: Foundation for an Intelligence of Strategy is the third in a trilogy of books exploring the philosophy of management strategy. All of the books relate the work of eminent figures in the western philosophical tradition—Kant, Hobbes and Locke, for example—with management strategy.

The Knowledge of Strategy is heavy going. Perhaps the best introduction to it is the opening paragraphs of the book itself:

> By the knowledge of strategy is meant that which undergirds the understanding of strategy as an activity sourced in human knowing and directed by it. Three questions about this knowledge are addressed in this work. Query into these questions is query into the foundation of the intelligence of strategy.
>
> The first question: What is the knowledge of reason of which it may be asserted that there can be a knowledge of strategy?
>
> The second question: Considered by itself, what is strategic knowledge?
>
> The third question: The knowledge of strategy exists as a knowledge for whom?
>
> In relation to the first question, strategic knowledge is derivative knowledge. It is derived from a more foundational knowledge, one which is identified with human understanding itself. The latter is the knowledge by which posited consciousness critically structures an understanding both of its own knowing and of what knowledge it can have of the material world in which it exists as an agent. Controverted from the time of its formulation, but still dominant,

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> nevertheless, Locke's template of knowing operates as a limitation on the knowledge of strategy.
>
> The second question is addressed to strategy as a particular ordering of a body of knowledge particulars. In the face of a variety of events, actions, processes, actors and phenomena, strategy as knowledge searches for patterns of relation and significance. What is constructed is the cognitive ordering of a domain of knowledge that serves as the knowledge of the domain for strategizing. As knowledge, strategy then exists as a varietal knowledge that has been subordinated to the directives of domain focused teleonomic knowing. It is these directives that particularize the knowledge of strategy.
>
> The third question addresses the matter of the strategic knowers. The knowledge of strategy is knowledge to whom and for whom? The economist Alfred Marshall associated a business organization component with the command of capital.... It consisted of a power of organizing the application of machinery and other fixed capital and of raw material of goods. Here, however, the strategic knowers are taken to be those in actual command of capital, rather than those who are engaged in the organized activity of auxiliary capital management. So it is that here the knowledge of strategy is the knowledge of command cognition—the knowledge of a category of strategic actors.

From this, I came to the conclusion that the basic ideas of the book are:

1. Business strategy is based on the ability of managers to predict and choose among different possible futures.
2. It is based on mental models managers construct about how the world works.
3. There is a large body of philosophical material on mental processes, especially in the writings of John Locke, that can illuminate business strategy.

If I understood the theme correctly, these are intriguing ideas, linking the ideas of philosophers of mind like Locke and Leibniz and the works of economic historians such as Braudel and Schumpeter with management strategy. They embed the formulation of management strategy in a broader context and show its connection with more general theories of mental processes. This approach is original and worthwhile. I hope that Grundstein carries on his analysis to include more of the recent research in cognitive science that extends the work of Locke.

Grundstein illustrates his points with lengthy examples drawn from the biotechnology, telecommunications, and aerospace industries. I found these case studies to be the most interesting parts of the book.

It is a shame that the book is written in such a way that the best ideas are heavily disguised. For example, I am told that chapter VII, titled "The Knowledge of Internal (Inward) Variety: Physics as Possibilities," is most relevant to accounting regulation. After a careful reading, I can neither confirm nor deny that allegation.

Grundstein's writing shows great erudition and his topic is fascinating and important. The foreword called *The Knowledge of Strategy* "a bold flirtation with wisdom" and I am prepared to believe this might be true. Unfortunately, the writing is convoluted and abstract to the point of mysticism. The book badly needed a good editor. As it is, it is nearly impossible for a layman to understand what the author is getting at.

It is clear that Grundstein did not intend this book for a general readership. I think *The Knowledge of Strategy* would be most interesting to professional philosophers and others willing to mine the nuggets and put up with the tailings.

Capital Ideas: The Improbable Origins of Modern Wall Street
by Peter L. Bernstein
(New York: The Free Press, 1992; $14.95 paperback, 340 pp.)

Reviewed by **Stephen J. Young**

Economic ideas have always attracted the attention of politicians and businessmen. In *Capital Ideas,* Peter Bernstein describes the influence that a small group of academics has had in revolutionizing financial markets. Bernstein sets out to describe a small circle of financial economists whose ideas have shaped the growth of global markets over the last forty years. His unique position allowed him to observe both the academic innovations and their practical impact. Bernstein wraps both into a fascinating tale of frustration in development, persuading sceptical professionals, and eventual success.

He begins by describing the major theoretical contributions of several distinguished economists, including several Nobel Prize winners. In describing events like a term paper written by Harry

Markowitz for a linear programming course and the frustrations of solving partial differential equations experienced by Fischer Black and Myron Scholes, Bernstein provides an entertaining forum for an explanation of such complex subjects as random walk theory and option pricing models.

The latter part of the book describes how these theories have, after some delay, been put into practice by investment professionals. Managing risk, a topic not even worthy of professional discussion in the early 1970s, is the focus of modern portfolio management. The author explains how some professional sceptics were slowly convinced that the new ideas had merit and should be adopted. The older methods of investment had no real hope of winning. They were soon overwhelmed by these intense young academics with their higher mathematics and computer programs. Professional investors have never looked back.

To assess the importance of this research, one does not have to look far. Sophisticated options trading strategies, index funds run by computer, and program trading all were born in the classroom, not in the boardroom.

What is not brought out by the author is how this rapid increase in sophistication has affected the individual investor. Fewer and fewer manage their own money. Financial markets are dominated by sophisticated institutions who can digest huge amounts of information and implement complex financial strategies.

Many newer ideas in financial economics are not addressed by the author. For example, agency theory, which provided impetus for the takeover and leveraged buyouts in the 1980s, is not even mentioned. Instead, attention is confined mainly to the ideas of the so-called Chicago School of thought.

Recently, these theories have come under increasing attack in academic circles. Controversies surrounding the actual relevance of such concepts as beta are intensifying. The results are simply not yet conclusive. The theories Bernstein introduces are beginnings, not endings and not final truths. Finance is still a very young field and there remains much to be done.

For me, the book provided flesh to the names in academic finance whose ideas I have studied and puzzled over for several years now. For those not in academia, *Capital Ideas* provides an understanding of what has shaped the changes in our capital markets and explores why. Anybody who wants to understand why prospective young

MBAs and academics flock to finance will understand after having read this book.

Like all histories, this one is incomplete. Ideas in financial economics have not slowed since the early 1970s; if anything the pace has increased. Many more ideas could have been included. This is not the fault of the author; all histories must have a beginning and end somewhere.

In this book, Bernstein has captured the essence of academic finance and provided a unique perspective on how these ideas were translated into practice. In the process, he has created the most lucid and entertaining book in the area since Burton Malkiel's *A Random Walk Down Wall Street* (New York: W.W. Norton, 1973). There is one last subtle lesson of this book. The academics mentioned taught their students these theories. It should come as no surprise that business schools' best and brightest are applying what they have learned.

CUMULATIVE INDEX:
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