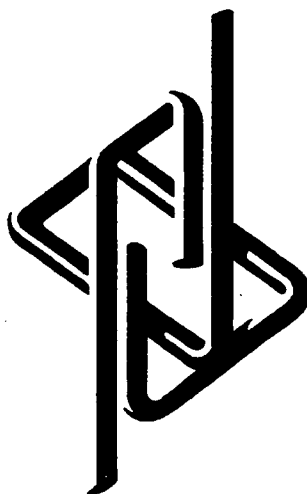


**The Canadian Academic Accounting Association
L'Association Canadienne des Professeurs de Comptabilité**

**PROCEEDINGS
COMPTE RENDU**

**1991 ANNUAL CONFERENCE
CONGRÈS ANNUEL DE 1991**



June 1991/ Juin 1991

**Queen's University
Kingston, Ontario**

**PROCEEDINGS OF
THE CANADIAN ACADEMIC ACCOUNTING ASSOCIATION
ANNUAL CONFERENCE**

June 6 - 8, 1991

**COMPTE RENDU
CONGRÈS ANNUEL DE L'ASSOCIATION
CANADIENNE DES PROFESSEURS DE COMPTABILITÉ**

Queen's University at Kingston, Ontario



SCHOOL OF BUSINESS

Queen's University
Kingston, Canada
K7L 3N6

To the Members of the
Canadian Academic Accounting Association

The 1991 Annual Conference of the Canadian Academic Accounting Association was held at Queen's University, Kingston, Ontario on June 6 through June 8. A total of 26 papers were submitted for review of which 15 were selected for presentation. In addition, two invited concurrent sessions and three plenary sessions were also held.

These proceedings include the conference programme and a synopsis of all papers presented. Certain of these papers are printed in full at the author's discretion; papers withheld from publication are available from the author. In addition to the refereed papers, Abraham Briloff's plenary address with discussion by Ross Skinner and Morley Lemon has been included.

The following page lists the Conference sponsors and reviewers, I would like to acknowledge their important contribution to the success of this conference.

Sincerely,

A handwritten signature in cursive script that reads "Alan J. Richardson".

Alan J. Richardson
1991 CAAA Conference Chair



SCHOOL OF BUSINESS

Queen's University
Kingston, Canada
K7L 3N6

A l'intention des membres de l'A.C.P.C.

Le Congrès 1991 de l'Association canadienne des professeurs de comptabilité a eu lieu à l'Université Queen's à Kingston en Ontario du 6 au 8 juin. Les participants ont eu droit à la présentation de 15 des 26 mémoires soumis et ont pu assister à deux séances simultanées et trois séances plénières.

Vous trouverez ci-joint le programme du congrès et un résumé des mémoires présentés. Nous avons eu la permission de reproduire certains de ces mémoires et vous pourrez vous procurer les autres en faisant la demande aux auteurs. Nous joignons également le discours d'Abraham Briloff ainsi que les commentaires de Ross Skinner et Morley Lemon.

Je tiens à remercier les parrains et réviseurs dont les noms apparaissent sur la page suivante, leur contribution a été fort appréciée.

Recevez l'expression de mes sentiments les meilleurs.

A handwritten signature in cursive script that reads "Alan J. Richardson".

Alan J. Richardson
Président du Congrès 1991 de
L'A.C.P.C.

The CAAA Annual Conference would not be possible without the support of our sponsors and reviewers. We gratefully acknowledge their contribution to the success of this conference.

S P O N S O R S

Canadian Institute of Chartered Accountants
 Certified General Accountants' Association of Canada
 Institute of Chartered Accountants of Ontario
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 Research Program, School of Business, Queen's University
 School of Business, Queen's University
 Society of Management Accountants of Canada

R E V I E W E R S

| | | | |
|-------------------|---------------------------------|-------------------|------------------------|
| Fodil Adjaoud | University of Ottawa | Duane Kennedy | Un. of Waterloo |
| Ibrahim Aly | Concordia University | Jeong B. Kim | Concordia University |
| Joel Amernic | University of Toronto | Norm Macintosh | Queen's University |
| Teresa Anderson | University of Ottawa | Michael Magnan | McGill University |
| Tom Beechy | York University | Alan MacNaughton | Un. of Waterloo |
| Michel Blanchette | Université du Québec à Hull | Mort Nelson | Wilfrid Laurier Univ. |
| David Cooper | University of Alberta | Dean Neu | University of Toronto |
| Denis Cormier | Université du Québec à Montréal | Becky Reuber | University of Toronto |
| Ron Davidson | University of Calgary | Gordon Richardson | University of Waterloo |
| Tony Dimnick | University of Western Ontario | Rick Robertson | Univ. of Western Ont |
| Ramy Elitzur | University of Toronto | Chris Robinson | York University |
| Jim Gaa | McMaster University | Shirley Taylor | Queen's University |
| Michael Gibbins | University of Alberta | Howard Teal | Wilfrid Laurier Univ. |
| Irene Gordon | Simon Fraser University | John Williams | Queen's University |
| Jeffery Kantor | University of Windsor | | |

We would also like to acknowledge those individuals, listed in the program overleaf, who participated in this conference as moderators, discussants, panel members, plenary speakers and paper presenters, and Pat Murphy, Queen's University, for her administrative support of the conference.

Alan J. Richardson
 Conference Chair
 Queen's University

John J. Williams
 Local Arrangements
 Queen's University

Le congrès annuel de l'A.C.P.C. est rendu possible grâce au soutien de nos commanditaires et du conseil de lecture. Aussi, nous les remercions sincèrement de leur contribution au succès de cet événement.

COMMANDITAIRES

L'Institut Canadien des Comptables Agréés
 L'Association des comptables généraux accrédités du Canada
 L'Institut des comptables agréés de l'Ontario
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 Le programme de recherche de la School of Business de Queen's University
 La School of Business de Queen's University
 La Société des comptables en management du Canada

CONSEIL DE LECTURE

| | | | |
|-------------------|------------------------------------|-------------------|----------------------------------|
| Fodil Adjaoud | Université d'Ottawa | Duane Kennedy | University of Waterloo |
| Ibrahim Aly | Université Concordia | Jeong B. Kim | Université Concordia |
| Joel Amernic | University of Toronto | Norm Macintosh | Queen's University |
| Teresa Anderson | Université d'Ottawa | Michel Magnan | Université McGill |
| Tom Beechy | York University | Alan MacNaughton | University of Waterloo |
| Michel Blanchette | Université du Québec à Hull | Mort Nelson | Wilfrid Laurier University |
| Ron Davidson | University of Calgary | Dean Neu | University of Toronto |
| David Cooper | University of Alberta | Becky Reuber | University of Toronto |
| Denis Cormier | Université du Québec à Montréal | Gordon Richardson | University of Waterloo |
| Tony Dimnik | University of Western Ontario | Rick Robertson | University of Western Ontario |
| Ramy Elitzur | University of Toronto | Chris Robinson | York University |
| Jim Gaa | McMaster University | Shirley Taylor | Queen's University |
| Michael Gibbins | University of Alberta | Howard Teal | Wilfrid Laurier University |
| Irene Gordon | Simon Fraser University | John Williams | Queen's University |
| Jeffrey Kantor | University of Windsor | | |

Nous aimerions également remercier tous ceux et celles, dont les noms apparaissent dans le présent programme, qui ont participé au congrès à titre d'animateurs, d'intervenants, d'invités et de conférenciers, ainsi que Pat Murphy de l'université Queen's pour son soutien administratif.

Alan J. Richardson
 Président du congrès
 Queen's University

John J. Williams
 Arrangements sur place
 Queen's University

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S P Robinson, University of Western Australia

1991 CAAA CONFERENCE PROGRAM

Queen's University

Thursday, June 6

8:00 a.m. - 4:00 p.m.

REGISTRATION

6:00 p.m. - 10:00 p.m.

CAAA WELCOME RECEPTION

Sponsored by the Canadian Institute of Chartered Accountants

Location: South Bellevue Room Holiday Inn

Friday, June 7

8:00 a.m. - 4:00 p.m.

REGISTRATION

7:30 a.m. - 8:45 a.m.

BREAKFAST

Sponsored by Irwin Dorsey of Canada

Location: Levana Dining Room, Ban Righ Hall

9:00 - 9:15 a.m.

WELCOME*

Speakers: Bill Miklas, Associate Dean of the School of Business (Queen's)
Derek Acland, CAAA President (Concordia)
John J. Williams, Local Arrangements Co-ordinator (Queen's)

Location: Walter Light Hall Room 205

* Simultaneous translation will be provided for these sessions (sponsored, in part, by Nelson Canada)

9:15 - 10:45 a.m.

PLENARY SESSION 1* Useable Knowledge: Ethics and Accounting Education

Chairperson: Nabil Elias, CAAA President Elect (University of Manitoba)

Speaker: Abraham J. Briloff
Emanuel Saxe Distinguished Professor Emeritus
City University of New York
(Sponsored by McGraw Hill Ryerson)

Discussants: Ross Skinner (University of Toronto)
Morley Lemon (University of Waterloo)

Location: Walter Light Hall Room 205

10:45 - 11:00 a.m.

BREAK

Sponsored by The Institute of Chartered Accountants of Ontario

11:00 - 12:30 p.m.

CONCURRENT SESSIONS 1A, 1B AND 1C

SESSION 1A* Market Reactions to Accounting Standards

Chairperson: Michel Blanchette (UQAH)

Speakers: Michel Legault (Laval) and Francine Turmel (Sherbrooke)
 "Facteurs Determinants De L'Impact Des Changements
 Comptables Obligatoires sur Le Prix des Actions: Le Cas De La
 Norme Americaine sur la Comptabilisation des Frais D'Interêt"
 [Stock Price Adjustments and the Adoption of SFAS 34]

Jeong Kim (Concordia) and Ibrahim Aly (Concordia) "Systematic
 Risk and the Full Cost Accounting Method".

Discussant: Gordon Richardson (Waterloo)

Location: Walter Light Hall Room 205

SESSION 1B International Accounting Education

Chairperson: Jeffrey Kantor (University of Windsor)

Speakers: Irene Herremans and Michael Wright (University of Calgary)
 "Are Canadian Universities Ready to Meet the Need of Canadian
 International Firms Regarding International Accounting
 Education?"

Discussants: Alister Mason (Deloitte & Touche)
 Zelma Rebmann-Huber (Simon Fraser)
 Stephen Salter (Texas A & M)

Location: Walter Light Hall Room 210

SESSION 1C The Auditor/Client Relation

Chairperson: Kelly Gheyara (Concordia)

Speakers: Teresa Anderson (Ottawa) "Audit Quality and Client Satisfaction:
 An Exploratory Study"
 Dean Neu (U of T), Murray Davis (Calgary) Michael Wright
 (Calgary) "Price is not enough: The Influence of the 'Social' in
 Auditor/Client Relations"

Discussant: Daryl Lindsay (Saskatchewan)

Location: Walter Light Hall Room 212

12:45 - 2:30 p.m.

CAAA AWARDS LUNCHEON

Sponsored by the Certified General Accountants Association of Canada

Chairperson: Derek Acland CAAA President (Concordia)

Presentation of Awards Haim Falk Award for Distinguished Contribution to Accounting Thought

Speaker: Don MacPherson, CA Deputy Superintendent of Deposit Taking Institutions

Location: Wallace Hall, John Deutsch University Center

2:45 - 4:15 p.m.

CONCURRENT SESSIONS 2A, 2B AND 2C

SESSION 2A* Audit Evidence

Chairperson: George Kanaan (Concordia)

Speakers: Denis Cormier (UQAM), Michel Magnan (McGill) and Bernard Morard (Genève) "La Continuité D'Exploitation et le Vérificateur: Une évaluation comparative des outils diagnostiques"

Ramy Elitzur (U of T). "The Effect of Contract Type, Auditor's Efficiency, Auditor Effectiveness and Auditor's size on the Choice of Audit Risk and Planned Evidence"

Location: Walter Light Hall Room 205

SESSION 2B Accounting Monographs and Texts: Publishers' and Authors' Perspectives (Sponsored by the CAAA Education Committee)

The Authors: Bob Crandall (Queen's University)
Jim Gaa (McMaster)

The Publishers: Hilda Gowans
Dan Simunic (CAAA Monographs, University of British Columbia).

Location: Walter Light Hall Room 210

SESSION 2C Positive Accounting Theory: Evidence and Critique

Chairperson: Roger Collins (Concordia)

Speakers: Norman Betts (Queen's/UNB) "Classificatory Smoothing of Net Income Before Extraordinary Items - The Canadian Evidence"

Lawrence Boland (SFU) and Irene Gordon (SFU) "Criticizing Positive Accounting Theory".

Discussant: Dan Thornton (Calgary)

Location: Walter Light Hall Room 212

4:15 - 4:30 p.m.

BREAK

Sponsored by the Institute of Chartered Accountants of Ontario

4:30 - 5:45 p.m.

CAAA ANNUAL MEETING*

Chairperson: Derek Acland CAAA President (Concordia)

Guest: David Wilson, Vice President, AAA

Location: Walter Light Hall Room 205

6:00 - 9:00 p.m.

CAAA MEMBERS RECEPTION

Sponsored by John Wiley & Sons

Location: Memorial Hall, Kingston City Hall

Saturday, June 8

9:00 - 10:30 a.m.

PLENARY SESSION 2 Useable Knowledge: A Practitioners' Perspective

Chairperson: Tricia O'Malley (Partner, Peat Marwick Thorne)

Speakers: Brenda Eprile (Chief Accountant, Ontario Securities Commission)

Brian MacDonald (Assistant V.P. Corporate Banking
ABN Amro Bank of Canada)

Eric Sprott (Sprott Securities Ltd.)

Location: Walter Light Hall Room 205

10:30 - 10:45

BREAK

Sponsored by the Institute of Chartered Accountants of Ontario

10:45 - 12:15 p.m.

CONCURRENT SESSIONS 3A AND 3B

SESSION 3A

Chairperson: Chris Robinson (York)

Speakers: Raafat Roubi (Brock), Richard Barth (Memorial) and Alex Faseruk (Memorial) "The Relationship Between Environmental Uncertainty and the Level of Sophistication Employed in Evaluating Capital Budgeting Projects by Major Canadian Corporations"

Phil Creighton "Terminating Building Societies: 1846-1855"

Location: Walter Light Hall Room 210

SESSION 3B Gender Issues in Public Accounting

Chairperson: Carol McKeen (Queen's)

Panel: Brenda Vince (Price) Tricia O'Malley (Peat)
Kathleen O'Neill (Price) Catherine McCutcheon (Anderson)
Martha Tory (Ernst)

Location: Walter Light Hall Room 212

12:30 - 2:00 p.m.

CAAA MEMBERS LUNCHEON

Sponsored by the Society of Management Accountants of Canada

Chairperson: Nabil Elias CAAA President Elect (Manitoba)

Speaker: Greeting from the Society of Management Accountants of Canada

Location: Levana Dining Room Ban Righ Hall

2:15 - 3:45 p.m.

PLENARY SESSION 3 Useable Knowledge: Post-Modernism, Post-Structuralism and Accounting

Panel: Norm Macintosh (Queen's University)
David Cooper (University of Alberta)
Eleanor MacDonald (Political Studies-Queen's University)

Location: Walter Light Hall Room 205

3:45 - 4:00 p.m.

BREAK

Sponsored by the Institute of Chartered Accountants of Ontario

4:00 - 5:30 p.m.

CONCURRENT SESSIONS 4A, AND 4B

SESSION 4A Predicting Business Failure: Empirical Findings and Methodological Issues

Chairperson: Cam Morrill (Queen's)

Speakers: Ibrahim Aly (Concordia) and Jeong Kim (Concordia) "The Incremental Information of Supplementary Financial Disclosures in Predicting Business Failure: Some Empirical Evidence"

Duane Kennedy (Waterloo) "Classification Techniques in Accounting Research: Empirical Evidence of Comparative Performance".

Location: Walter Light Hall Room 205

SESSION 4B Accounting Standards: Process and Preferences

Chairperson: Howard Teall (Wilfrid Laurier)

Speakers: Ross Walker (University of New South Wales) and Peter Robinson (University of Western Australia) "Related Party Transactions: A Case Study of Interactions between Government and the Profession over the 'Development' of Disclosure Rules"

Marc Swartz (Ernst and Young), Gordon Richardson (Waterloo) and Peter Clarkson (SFU) "A Survey of Attitudes towards the inclusion of Ranges on Future-Oriented Financial Information"

Location: Walter Light Hall Room 210

*Thank you for your support of the CAAA.
Make plans to attend next year's conference at the University of Prince Edward Island!*

PROGRAMME DU CONGRÈS 1991 DE L'A.C.P.C.

Queen's University

Le Jeudi 6 juin

De 8 h à 16 h

INSCRIPTION

De 18 h à 22 h

RÉCEPTION DE BIENVENUE DE L'A.C.P.C.

Commanditée par l'Institut Canadien des Comptables Agréés

Lieu: Salle South Bellevue du Holiday Inn.

Le vendredi 7 juin

De 8 h à 16 h

INSCRIPTION

De 7 h 30 à 8 h 45

PETIT DÉJEUNER

Commandité par la firme Irwin Dorsey of Canada

Lieu: Salle à manger Levana du pavillon Ban Righ

De 9 h à 9h 15

BIENVENUE*

Conférenciers: Bill Miklas, vice-doyen de la School of Business (Queen's)

Derek Acland, président de l'A.C.P.C. (Concordia)

John J. Williams, coordinateur des arrangements sur place (Queen's)

Lieu: Salle 205 du pavillon Walter Light

* L'interprétation simultanée sera offerte pour les séances marquées d'un astérisque (commandité, en part par la firme Nelson Canada).

de 9 h15 à 10 h 45

PLÉNIÈRE n°1* Science pragmatique : éthique et enseignement des sciences comptables

Président : Nabil Elias, président désigné de l'A.C.P.C. (Manitoba)

Conférencier : Abraham J. Briloff, honorable professeur émérite d'Emanuel Saxe

City University of New York

(Commandité par la firme McGraw Hill Ryerson)

Intervenant : Ross Skinner (University of Toronto)

Morley Lemon (University of Waterloo)

Lieu : Salle 205 du pavillon Walter Light

De 10 h 45 à 11 h

PAUSE

Commanditée par l'Institut des comptables agréés de l'Ontario

De 11 h à 12 h 30

SÉANCES SIMULTANÉES 1A, 1B et 1C**SÉANCE 1A* Réactions du marché aux normes comptables****Président:** Michel Blanchette (UQAH)**Conférenciers:** Michel Legault (Laval) et Francine Turmel (Sherbrooke), "Stock Price Adjustment and the Adoption of SFAS no.34"

Jeong Kim (Concordia) et Ibrahim Aly (Concordia), "Systematic Risk and the Full Cost Accounting Method"

Intervenant: Gordon Richardson (Waterloo)**Lieu :** Salle 205 du pavillon Walter Light**SÉANCE 1B L'enseignement de la comptabilité internationale****Président :** Jeffrey Kantor (Windsor)**Conférenciers:** Irene Herremans et Michael Wright (Calgary), "Are Canadian Universities Ready to Meet the Need of Canadian International Firms Regarding International Accounting Education?"**Intervenants:** Alister Mason (Deloitte & Touche)
Zelma Rebmann-Huber (Simon Fraser University)
Stephen Salter (Texas A&M)**Lieu:** Salle 210 du pavillon Walter Light**SÉANCE 1C La relation entre le vérificateur et le client****Président:** Kelly Gheyara (Concordia)**Conférenciers:** Teresa Anderson (Ottawa), "Audit Quality and Client Satisfaction: An Exploratory Study"

Dean Neu (Toronto), Murray Davis (Calgary) et Michael Wright (Calgary), "Price is not enough: The Influence of the 'Social' in Auditor/Client Relations"

Intervenant : Daryl Lindsay (Saskatchewan)**Lieu :** Salle 212 du pavillon Walter Light

De 12 h 45 à 14 h 30 DÉJEUNER ET REMISE DES PRIX DE L'A.C.P.C.

Commandités par l'Association des comptables généraux accrédités du Canada

Président : Derek Acland, président de l'A.C.P.C. (Concordia)

Remise des prix: Haim Falk décerné aux auteurs de contributions remarquables à la pensée comptable

Orateur : Don MacPherson, C.A., Dept. Supt. of Deposit Taking Institutions

Lieu : Salle Wallace du John Deutsch University Center

De 14 h 45 à 16 h 15 SÉANCES SIMULTANÉES 2A, 2B et 2C

SÉANCE 2A* Information probante

Président : George Kanaan (Concordia)

Conférenciers : Denis Cormier (UQAM), Michel Magnan (McGill) et Bernard Morard (Genève), "La continuité d'exploitation et le vérificateur : une évaluation comparative des outils diagnostiques"

Ramy Elitzur (Toronto), The Effect of Contract Type, Auditor's Effectiveness and Auditor's Size on the Choice of Audit Risk and Planned Evidence."

Lieu : Salle 205 du pavillon Walter Light

SÉANCE 2B Monographies et manuels comptables : le point de vue des éditeurs et des auteurs (Commanditée par le comité d'enseignement de l'A.C.P.C.)

Les auteurs : Bob Crandall (Queen's)
Jim Gaa (McMaster)

Les éditeurs : Hilda Gowans
Dan Simunic (Monographies de l'A.C.P.C., UBC)

Lieu : Salle 210 du pavillon Walter Light

SÉANCE 2C La théorie comptable positive: preuve et étude critique

Président : Roger Collins (Concordia)

Conférenciers : Norman Betts (Queen's /UNBSJ), "Classificatory Smoothing of Net Income Before Extraordinary Items - The Canadian Evidence"

Lawrence Boland (SFU) et Irene Gordon (SFU),
"Criticizing Positive Accounting Theory"

Intervenant : Dan Thornton (Calgary)

Lieu : Salle 212 du pavillon Walter Light

De 16 h 15 à 16 h 30

PAUSE

Commanditée par l'Institut des comptables agréés de l'Ontario

De 16 h 30 à 17 h 45

RÉUNION ANNUELLE DE L'A.C.P.C.*

Président : Derek Acland, président de l'A.C.P.C. (Concordia)

Invité : David Wilson, Vice President AAA

Lieu : Salle 205 du pavillon Walter Light

De 18 h à 21 h

RÉCEPTION À L'INTENTION DES MEMBRES DE L'A.C.P.C.

Commanditée par John Wiley & Sons

Lieu : Salle Memorial de l'hôtel de ville de Kingston

Le samedi 8 juin

De 9h à 10 h 30

PLÉNIÈRE n° 2 Science pragmatique : une perspective de praticiens

Présidente : Tricia O'Malley (associée à la firme Peat Marwick Thorne)

Conférenciers : Brenda Eprile (chef comptable en exercice pour l'Ontario Securities Commission)

Brian MacDonald (vice-président adjoint de
Corporate Banking ABN Amro Bank of Canada).
Eric Sprott (Sprott Securities Ltd.)

Lieu : Salle 205 du pavillon Walter Light

De 10h 30 à 10 h 45 **PAUSE**
Commanditée par l'Institut des comptables agréés de l'Ontario

De 10 h 45 à 12 h 15 **SÉANCES SIMULTANÉES 3A ET 3B**

SÉANCE 3A

Président : Chris Robinson (York)

Conférenciers: Raafat Roubi (Brock), Richard Barth (Memorial)
et Alex Faseruk (Memorial), "The Relationship Between
Environmental Uncertainty and the Level of Sophistication Employed
in Evaluating Capital Budgeting Projects by Major Canadian
Corporations"

Phil Creighton, "Terminating Building Societies: 1846 - 1855"

Lieu: Salle 210 du pavillon Walter Light

SÉANCE 3B Questions féminines en comptabilité publique

Présidente : Carol McKeen (Queen's)

Invitées : Brenda Vince (Price) Tricia O'Malley (Peat)
Kathleen O'Neill (Price) Martha Tory (Ernst)
Catherine McCutcheon (Anderson)

Lieu : Salle 212 du pavillon Walter Light

De 12 h 30 à 14 h **DÉJEUNER DES MEMBRES DE L'A.C.P.C.**

Commandité par la Société des comptables en management du Canada

Président : Nabil Elias, président désigné de l'A.C.P.C. (Manitoba)

Orateur : Mot de bienvenue par la Société des comptables
en management du Canada

Lieu : Salle à manger Levana du pavillon Ban Righ

De 14 h 15 à 15 h 45 **PLÉNIÈRE n° 3 Science pragmatique : le post-modernisme, le
post-structuralisme et les sciences comptables**

Invités : Norm Macintosh (Queen's)
David Cooper (Alberta)
Eleanor MacDonald (Political Studies - Queen's)

Lieu : Salle 205 du pavillon Walter Light

De 15 h à 16 h

PAUSE

Commanditée par l'Institut des comptables agréés de l'Ontario

De 16 h à 17 h 30

SÉANCES SIMULTANÉES 4A et 4B

SÉANCE 4A La prévision de faillites : résultats empiriques et questions d'ordre méthodologique

Président : Cam Morrill (Queen's)

Conférenciers : Ibrahim Aly (Concordia) et Jeong Kim (Concordia), "The Incremental Information of Supplementary Financial Disclosures in Predicting Business Failure: Some Empirical Evidence"

Duane Kennedy (Waterloo) "Classification Techniques in Accounting Research: Empirical Evidence of Comparative Performance"

Lieu : Salle 205 du pavillon Walter Light

SÉANCE 4B Normes comptables : procédé et préférences

Président : Howard Teall (Wilfrid Laurier)

Conférenciers : Ross Walker (New South Wales) et Peter Robinson (Western Australia), "Related Party Transactions: A Case Study of Interactions between Government and the Profession over the 'Development' of Disclosure Rules"

Marc Swartz (Ernst and Young), Gordon Richardson (Waterloo) et Peter Clarkson (SFU) "A Survey of Attitudes Towards the Inclusion of Ranges on Future-Oriented Financial Information"

Lieu : Salle 210 du pavillon Walter Light

*Nous vous remercions de votre appui à l'A.C.P.C.
Il faut déjà penser à participer au congrès de l'année prochaine à l'université de
l'Île-du-Prince-Édouard!*

STOCK PRICE ADJUSTMENT AND THE ADOPTION OF SFAS NO.34

Francine Turmel, Université de Sherbrooke

Michel Legault, Université Laval

The purpose of this study is to determine if the price of U.S. corporate stock is affected by the interest expense reporting standard (SFAS 34) and to identify the factors contributing to this effect. To do this, we first identify the portion of market performance which can be attributed to each of the announcements that preceded the adoption of the standard. Significantly abnormal returns have been observed for each of the nine announcements studied. The second step of the analysis consists of testing the statistical relationship between the observed abnormal returns and some of the firms' characteristics. These characteristics have been chosen in the spirit of positive accounting theory research. The results show that abnormal returns are associated with the capital structure and the size of the firms. The study identifies two opposite effects associated with debt. On the one hand, firms with a high debt ratio are favoured by the revenue increase caused by the standard, possibly because the probability of breaking their loan contract is reduced. On the other hand, firms with an above industry average debt ratio are penalized by the standard possibly because the probability that the creditors demand an amendment to the loan contract is increased. An artificial decrease in the debt ratio means that at the maximum level of debt agreed upon in the contract the level of risk is higher than that considered acceptable by the creditor. The study also shows that when public hearings were held and the content of the standard disclosed, stock prices of large firms were adjusted upward. This indicates that large firms represent powerful political adversaries and that they are favoured by the standard. Positive theory suggests that large firms are penalized by a revenue increase but are favoured by a decrease in the variation of the revenues. It seems that the second effect is more important than the first, since stock prices of large firms were adjusted upward. Overall, the study shows that the debt ratio of a firm and the position of the debt ratio as compared to the industry average ratio must be considered to explain the impact of a standard via the loan contract. It also suggests that the effect of the standard on the revenue variation is more important than that of the revenue increase and that this effect is incorporated in the price of the stock.

FACTEURS DETERMINANTS DE L'IMPACT DES CHANGEMENTS COMPTABLES OBLIGATOIRES SUR LE PRIX DES ACTIONS: LE CAS DE LA NORME AMERICAINE SUR LA COMPTABILISATION DES FRAIS D'INTERET

L'objectif de cette étude est de déterminer si le prix des actions des entreprises américaines a été affecté par la norme sur la comptabilisation des frais d'intérêt (SFAS 34) et d'identifier des facteurs déterminants de cet effet. La méthode d'analyse consiste d'abord à identifier la portion du rendement boursier qui peut être attribuée à l'une des annonces qui ont précédé l'adoption de la norme. Des rendements anormaux significatifs sont observés pour chacune des neuf annonces étudiées. La deuxième étape de la méthode d'analyse consiste ensuite à tester la relation statistique entre les rendements anormaux observés et certaines caractéristiques des entreprises. Le choix de ces caractéristiques s'inscrit dans le courant de recherche de la théorie positive. Les résultats indiquent que les rendements anormaux sont associés avec l'endettement et la taille des entreprises. L'étude identifie deux effets contraires reliés à l'endettement. D'abord, les entreprises qui ont un ratio d'endettement élevé sont favorisées par l'augmentation de bénéfice induite par la norme, possiblement parce que la probabilité d'enfreindre leur contrat de prêt est diminuée. D'autre part, les entreprises dont le ratio d'endettement est supérieur au ratio moyen de l'industrie sont défavorisées par la norme possiblement parce que la probabilité que les créanciers exigent la modification du contrat de prêt est augmentée. Une réduction cosmétique du ratio d'endettement implique qu'au niveau d'endettement maximum convenu au contrat de prêt correspond un niveau de risque supérieur à ce que le créancier considère acceptable. L'étude révèle également que lors de la tenue d'audiences publiques et du dévoilement du contenu de la norme, le prix des actions des grandes entreprises a été ajusté à la hausse. Ceci indique que les grandes entreprises constituent des adversaires politiques puissants et qu'elles ont été favorisées par la norme. La théorie positive suggère que les grandes entreprises sont défavorisées par une augmentation de bénéfice mais sont favorisées par une diminution de la variation des bénéfices. Il semble ici que le deuxième effet soit plus important que le premier puisque le prix des actions des grandes entreprises a été ajusté à la hausse. De façon générale, l'étude démontre que le ratio d'endettement de l'entreprise ainsi que la position du ratio d'endettement de l'entreprise par rapport au ratio moyen de l'industrie doivent être considérés pour expliquer l'impact d'une norme via le contrat de prêt. Elle suggère aussi que l'effet de la norme sur la variation des bénéfices est plus important que celui de l'augmentation des bénéfices, et que cet effet est incorporé dans le prix des actions.

SYSTEMATIC RISK AND THE FULL COST ACCOUNTING METHOD

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Accounting regulators (the Financial Accounting Standards Board and the SEC) have consistently argued that full cost accounting is inferior to successful efforts accounting and that the full cost method should be eliminated. But intense (and successful) opposition forced the regulators to retreat.

This study evaluates the regulators' position by assessing the way in which capital markets process oil and gas accounting information. Building upon the theoretical literature on the determinants of systematic risk, we employ statistical tests to determine whether information generated by successful efforts and full cost companies differentially affects the market's assessment of risk. The results support differential effects. Specifically, we find that: (1) successful efforts information possesses superior explanatory power for the behaviour of firm-specific risk; (2) successful efforts regression co-efficients are better behaved than are the full cost co-efficients (that is, they more frequently have correct signs and are statistically more significant); and (3) the subsets of accounting economic variables for successful efforts companies possess statistically significant incremental explanatory power. Neither subset is significant for full cost companies. These results are consistent with the Board's justification for the elimination of the full cost method.

SYSTEMATIC RISK AND THE FULL COST ACCOUNTING METHOD

Les organismes de réglementation comptable (le Financial Accounting Standards Board et la SEC) ont toujours soutenu que la capitalisation du coût entier est inférieure à la capitalisation du coût de la recherche fructueuse et que la première devrait disparaître. Cependant une opposition intense (et fructueuse) a forcé ces organismes à se replier.

La présente étude évalue la position des organismes de réglementation; pour ce faire, nous examinons la façon dont les marchés de capitaux traitent l'information comptable relative au pétrole et au gaz. À partir de la littérature théorique sur les facteurs déterminants du risque systématique, nous nous servons de différentes techniques statistiques en vue de déterminer si l'utilisation de l'une ou l'autre des méthodes par diverses firmes aura un effet marginal sur l'évaluation du risque par le marché. Les résultats révèlent des effets différentiels. Plus précisément, ils indiquent que 1) la capitalisation du coût de la recherche fructueuse a un pouvoir explicatif supérieur quant au comportement du risque spécifique à une firme; 2) le comportement des coefficients de régression de la capitalisation du coût de la recherche fructueuse est plus constant que celui des coefficients de la capitalisation du coût entier (c'est-à-dire qu'ils portent le bon signe plus fréquemment et qu'ils sont statistiquement plus significatifs); et 3) les sous-ensembles de variables économique-comptables des firmes utilisant la méthode du coût de la recherche fructueuse possèdent un pouvoir explicatif différentiel statistiquement plus significatif. Aucun de ces sous-ensembles n'est significatif pour les firmes utilisant la méthode du coût entier. Ces résultats concordent avec la justification du FASB à l'égard de l'élimination de la méthode de capitalisation du coût entier.

**ARE CANADIAN UNIVERSITIES READY TO MEET THE NEED OF
CANADIAN INT. FIRMS REGARDING INT. ACCOUNTING EDUCATION?**

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Michael Wright, University of Calgary

Education must adapt to changes stemming from an intensely competitive world. Students must acquire new talents in international business to answer the challenges resulting from increasing globalization. This article addresses the international accounting expertise that will prepare students for that competitive challenge. The survey method of research is used to determine the importance of international accounting education and specific international accounting topics based on the perceptions of Canadian academicians and the needs of Canadian international business firms. The focus of international accounting education at Canadian universities as we move toward the year 2000 is suggested. The findings show considerable consistency, for the most part, between international firms and academicians when defining which international accounting topics are most important. However, international firms place a greater importance on international accounting education, both overall and on specific topics, than do academicians. International firms also expect the universities to be major providers of international accounting education especially at the graduate level as we move toward the year 2000. Current and prospective course offerings show that Canadian universities are not prepared to meet that challenge. Course content and curricula improvement are recommended for both undergraduate accounting and MBA programs.

**ARE CANADIAN UNIVERSITIES READY TO MEET THE NEED OF CANADIAN INT. FIRMS
REGARDING INT. ACCOUNTING EDUCATION?**

Il est nécessaire d'adapter l'enseignement aux changements qui découlent de l'intense compétition existant à l'échelle mondiale. Les étudiants doivent acquérir des talents nouveaux en commerce international afin de pouvoir relever le défi de la mondialisation. Le présent article aborde les connaissances spécialisées en comptabilité internationale utiles pour la préparation des étudiants dans ce contexte. Comme méthodologie de recherche, nous servons d'un sondage pour déterminer l'importance de l'enseignement en comptabilité internationale et de sujets particuliers portant sur le domaine en fonction des perceptions des universitaires canadiens ainsi que les besoins des firmes canadiennes internationales. Les résultats suggèrent la mise en relief de l'enseignement de la comptabilité internationale dans les universités canadiennes au fur et à mesure que l'an 2000 se rapproche. Ils indiquent également que, en général, universitaires et praticiens s'entendent sur la détermination des sujets de comptabilité internationale les plus importants. Toutefois, les firmes accordent une plus grande importance à l'enseignement de la comptabilité internationale, tant en matière de sujets généraux que particuliers, que les universitaires. De plus, les firmes s'attendent à ce que, d'ici à l'an 2000, les universités prennent en main la majeure partie de l'enseignement de la comptabilité internationale, notamment au deuxième et au troisième cycles. Les listes actuelles et futures des cours offerts montrent que les universités canadiennes ne sont pas prêtes à relever le défi. Aussi, nous recommandons l'apport d'améliorations aux programmes et au contenu des cours tant au premier cycle qu'au M.B.A.

AUDIT QUALITY AND CLIENT SATISFACTION: AN EXPLORATORY STUDY

M. Teresa Anderson, University of Ottawa

The purpose of this paper is to investigate the determinants of audit quality and client satisfaction by means of a client questionnaire, which was developed and circulated to 175 companies. Client satisfaction is expected to be a function of service saliency, expectation confirmation, perceived quality and cost. Perceived quality is expected to consist of two components: (1) technical quality, a combination of the auditor's competence and integrity, which is consistent with DeAngelo's (1981) definition of audit quality, and (2) functional quality which encompasses the customer service dimensions of how the audit firm deals with the client. Through examination of the literature and discussions with audit partners eight aspects of functional quality were identified: reliability, responsiveness, courtesy, access, communications, security, understanding and caring.

The questionnaire consisted of 34 structured questions with a 7-point response scale and an unstructured part that allowed the client to relate incidents that left him/her feeling either satisfied or dissatisfied with the audit firm's services, to make further comments. The 69 responses that were received from a sample that is spread across six client types and a wide size range. The responses are analyzed both descriptively and statistically.

In general, the responses indicate a high level of client satisfaction with auditor services. In particular, the scores on questions about competence, courtesy and integrity are high. Despite the negative press coverage there is no concern about the technical quality of the audits performed for them. In fact, they perceive the quality of the audit services they receive to be higher than the quality of the tax services they receive from the same firm. In terms of customer service, the data suggest one area that could be improved is the auditor's propensity to act in an anticipatory manner.

Of the 10 quality dimensions investigated in this study, the factors that contribute most to the clients' satisfaction with auditor services are competence and effective communications. They account for 66% of the variability in the overall satisfaction score. Apart from quality, there are no other detectable differences in the way clients view tax services versus audit services, despite the fact that audit services may be purchased for very different reasons than are tax services. Despite the fact that a number of clients mentioned how high they felt their fees were, no statistically significant relationship is detected between cost and overall client satisfaction.

This study should be viewed as exploratory in nature. The small sample size and the fact that all the surveyed clients are audited by one firm limit the generalizations that can be drawn from the results presented here. The issues of audit quality and client satisfaction are important ones to the auditing profession. It is hoped that this paper despite its limitations, will help to motivate future research in this area.

AUDIT QUALITY AND CLIENT SATISFACTION: AN EXPLORATORY STUDY

La présente étude examine la relation entre la perception du client à l'égard de la qualité du service et la satisfaction du client envers les services du vérificateur. Elle se penche également sur les aspects du service qui influencent l'évaluation de la qualité de la vérification par le client. Selon les réponses à un questionnaire adressé à des firmes canadiennes, nous pouvons conclure que la direction ne montre aucun signe d'inquiétude en ce qui concerne la qualité technique des vérifications exécutées à son intention. Ces réponses révèlent un degré élevé de satisfaction envers les services du vérificateur. Plus précisément, les vérificateurs ont obtenu de bons scores pour les questions portant sur leur compétence, leur intégrité et leur courtoisie. En termes de service à la clientèle, toutefois, il semble que des améliorations sont encore possibles, notamment en ce qui touche la capacité du vérificateur à anticiper les besoins du client. De plus, dans l'échantillon étudié, la direction perçoit la qualité des services de fiscalité comme étant moindre par rapport à celle des services de vérification. Par ailleurs, des dix aspects du service abordés dans cette étude, compétence et client communications efficaces s'avèrent ceux qui contribuent le plus à la satisfaction du quant aux services exécutés par le vérificateur. Ces deux aspects comptent pour 66 pour cent de la variation de la totalité des points attribués à la satisfaction. En dépit d'une certaine préoccupation des clients concernant le coût d'une vérification, nous n'avons décelé aucune relation statistiquement significative entre le coût et la satisfaction du client en général.

**PRICE IS NOT ENOUGH:
THE INFLUENCE OF THE 'SOCIAL' IN AUDITOR/CLIENT RELATIONS**

Dean Neu, University of Toronto
Murray Davis, University of Calgary
Michael Wright, University of Calgary

This study is about auditors and auditing. Starting from the narratives of our research participants, we explore and develop an alternative understanding of auditor/client relations. By emphasizing the ways in which auditors and clients experience such relations, we explicate the complex, contingent and diverse nature of auditor/client relations and thus avoid reductionism as an implicit teleology. By doing so, the analysis affirms the importance of the 'social' in these relations and contributes to the possibility for an understanding of auditing that does not reduce auditor/client relations to unitary, economic explanations of behaviour.

**PRICE IS NOT ENOUGH
THE INFLUENCE OF THE 'SOCIAL' IN AUDITOR/CLIENT RELATIONS**

La présente étude traite des vérificateurs et de la vérification. Avec comme point de départ les récits des participants à notre recherche, nous explorons et élaborons un nouveau modèle permettant de comprendre les relations entre le vérificateur et le client. En mettant l'accent sur les façons dont les vérificateurs et les clients vivent ces interactions, nous expliquons la nature variée, contingente et complexe de telles relations et évitons ainsi le réductionnisme en tant que téléologie implicite. De cette façon, l'analyse confirme l'importance de l'aspect social dans ces relations et contribue à rendre possible une compréhension de la vérification qui ne réduit pas les relations entre le vérificateur et le client à des explications économiques et unitaires du comportement.

LA CONTINUITÉ D'EXPLOITATION ET LE VÉRIFICATEUR UNE ÉVALUATION COMPARATIVE DES OUTILS DIAGNOSTIQUES

Denis Cormier, Université du Québec à Montréal

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Bernard Morard, Université de Genève

The general purpose of this research is to facilitate the work of the auditor by providing effective statistical discrimination procedures under the going concern assumption. The definition of business failure used appears to be appropriate since its meaning is economic rather than strictly legal. Four different multivariate techniques will be considered: linear discriminant analysis, logistic analysis, objective programming and recursive partitioning. These statistical techniques will allow us to discriminate between a sound firm and a firm in financial trouble. This study differs on several levels from previous literature. Firstly, the variables representing systematic risk, both qualitative and quantitative, are incorporated in the failure prediction model. This will provide the auditor with new analytical tools. Secondly, our study defines non-continuity as a dynamic phenomenon, which leads us to examine the changes which occurred in the firm's situation during the target period. Finally, our model of financial statement analysis fits well with the auditor's objectives and strategy.

LA CONTINUITÉ D'EXPLOITATION ET LE VÉRIFICATEUR: UNE ÉVALUATION COMPARATIVE DES OUTILS DIAGNOSTIQUES

L'objet général de la présente recherche vise à faciliter le travail du vérificateur par la mise à disposition de procédures de discrimination statistiques efficaces dans le cadre de l'hypothèse de continuité de l'exploitation. La définition de non-continuité d'exploitation que nous utilisons nous apparaît appropriée puisqu'elle a une signification économique plutôt que strictement légale. Quatre techniques multivariées différentes seront considérées : l'analyse discriminante linéaire, l'analyse logistique, la programmation par objectif et le partitionnement récursif. Ces techniques statistiques nous permettront de discriminer entre une entreprise saine et une entreprise en difficulté financière. Cette étude se distingue de la littérature antérieure sur plusieurs plans. Tout d'abord, les variables représentatives du risque inhérent, tant qualitatives que quantitatives, sont incorporées au modèle de prévision de non-continuité, ce qui fournira au vérificateur de nouveaux outils d'analyse. Par ailleurs, notre étude définit la non-continuité de l'exploitation comme étant un phénomène dynamique, ce qui nous amène à considérer les changements intervenus dans la situation de l'entreprise au cours de la période cible. Enfin, notre modèle d'analyse des états financiers cadre bien avec les objectifs et la stratégie du vérificateur.

**THE EFFECTS OF CONTRACT TYPE, AUDITOR'S EFFICIENCY,
AUDITOR'S EFFECTIVENESS AND AUDITOR'S SIZE ON
THE CHOICE OF AUDIT RISK AND PLANNED EVIDENCE**

Ramy Elitzur, University of Toronto

This study analyzes the effects on optimal level of planned evidence of several factors. These factors include: the type of engagement, the comparative efficiency of auditors, the relative effectiveness of auditors, and auditor's size. The analysis is conducted under the recent pronouncements of the CICA in this area, i.e., Section 5130 and the related Auditing Guidelines. The results indicate that hourly fee contracts lead to a higher level of planned evidence (or lower detection risk). Next, it is shown that when one auditor dominates another in respect to efficiency, the result is a higher level of evidence, on the other hand, the previous result is reversed when one auditor is more effective than the other. Lastly, it is shown that larger auditors will gather more evidence due to the 'deep pockets' phenomenon.

**THE EFFECTS OF CONTRACT TYPE, AUDITOR'S EFFICIENCY, AUDITOR'S EFFECTIVENESS
AND AUDITOR'S SIZE ON THE CHOICE OF AUDIT RISK AND PLANNED EVIDENCE**

La présente étude analyse l'effet de plusieurs facteurs sur le niveau optimal d'information probante attendue. Comptent parmi ces facteurs, le type de mission, l'efficience comparative des vérificateurs, l'efficacité relative des vérificateurs et la taille de la firme de vérification. Nous avons mené l'analyse dans le cadre des dernières déclarations de l'I.C.C.A. dans ce domaine, soit la section 5130 et les directives de vérifications y afférentes. Les résultats révèlent que les contrats à taux horaire entraînent un niveau élevé d'information probante attendue (ou un faible risque de non-détection). Ils montrent également que la domination d'un vérificateur sur un autre en termes d'efficience, se solde par un niveau plus élevé d'information probante. Cependant, l'effet inverse se produit lorsqu'un vérificateur est plus efficace qu'un autre. Enfin, il semble que les vérificateurs appartenant à des firmes importantes recueilleront plus de preuves en raison du "bien-être financier" de ces firmes.

**CLASSIFICATORY SMOOTHING OF NET INCOME
BEFORE EXTRAORDINARY ITEMS - THE CANADIAN EVIDENCE**
Norman Betts, Queen's University/University New Brunswick

Smoothing of reported income has been defined as the dampening of fluctuations about some level of earnings currently considered to be normal for a firm (Biedleman, 1973), and the management of smoothed earnings through choice of accounting techniques has been advocated as a utility maximizing objective of management.

Most empirical tests of the smoothing hypothesis have focused on the smoothing of "bottom line" net income, while it is generally recognized that net income before extraordinary items (NIBEI) is of primary focus to financial analysts and the investment community in general. Thus, the incentive for allocation between 'above the line' income statement accounts and extraordinary items (EI's), i.e. classificatory smoothing, exists. This paper tests the classificatory smoothing hypothesis in the recent Canadian setting. The paper is particularly relevant to the Canadian institutional environment because, until the recent amendments of Section 3480, Canadian managers had relatively wide discretion in classifying certain items as extraordinary, in contrast to the U.S. where APB No. 30 severely restricted such discretion since 1973. The spirit of the pre-amendment Section 3480 implicitly suggested that management had a comparative advantage in identifying transactions which by their nature were more transitory, not reflective of ongoing business operations, and therefore less relevant for firm valuation in the marketplace. Also implicit was the assumption that management would apply this supposed comparative advantage consistently to the benefit of investors. The classificatory smoothing hypothesis tested in the paper is in contrast to the second of these implicit assumptions underlying Section 3480. The former assumption, i.e. that management had a comparative advantage in identifying transitory components of income, awaits future research.

Tests of the smoothing hypothesis are necessarily tests of joint hypothesis, i.e. in the absence of smoothing behaviour by management the smoothed variable (NIBEI) and the smoothing variable (EI) follow a particular process and management adopts accounting procedures or classifications to reduce the variance of that process. Normal earnings are specified by two models - a linear time trend model and a random walk model - and deviations from normal earnings determined. Utilizing a sample of 170 Canadian firms, deviations from normal levels of extraordinary items are determined assuming a constant trend. Correlations between the deviations of NIBEI and EI from their normal levels are used to assess the existence of classificatory smoothing behaviour. The results strongly support behaviour indicative of classificatory smoothing.

**CLASSIFICATORY SMOOTHING OF NET INCOME
BEFORE EXTRAORDINARY ITEMS - THE CANADIAN EVIDENCE**

On définit le nivellement des bénéfices comme étant l'action d'atténuer les fluctuations à un niveau actuellement considéré comme étant normal pour une firme (Biedleman, 1973). La gestion de ces bénéfices par l'entremise de techniques comptables est recommandée comme objectif de maximisation de l'utilité de la direction. La majorité des tests empiriques portant sur l'hypothèse de nivellement a été axée sur le nivellement du bénéfice net final, tandis qu'il est généralement reconnu que le bénéfice avant postes extraordinaires est un élément de première importance pour les analystes financiers et pour le cercle des investisseurs en général. Par conséquent, il existe une bonne raison d'exercer une certaine répartition entre les comptes de l'état des résultats figurant au-dessus de "la ligne" et les postes extraordinaires, c'est-à-dire un nivellement par la classification des comptes. Le présent article teste l'hypothèse de nivellement par classification dans un contexte canadien récent.

Cet article est d'un intérêt particulier pour l'environnement institutionnel canadien puisque, jusqu'aux dernières modifications de la section 3480, les gestionnaires canadiens jouissaient d'une discrétion relativement grande dans le traitement de certains postes classés comme étant extraordinaires, contrairement à leurs homologues américains qui, depuis 1973, voyaient leur discrétion très réduite par l'APB n° 30. L'esprit de la section 3480, avant la modification, suggérait de façon implicite l'existence d'un avantage comparatif qu'a la direction de déterminer les transactions qui, de par leur nature, n'étaient que transitoires et non pas un reflet de l'exploitation courante des affaires, donc moins pertinentes quant à l'évaluation de l'entreprise sur le marché. On supposait également de façon implicite que la direction se servirait de cet avantage dans l'intérêt des investisseurs. L'hypothèse de nivellement par classification testée dans cet article s'oppose à la deuxième supposition. La première, soit celle voulant que la direction possédait un avantage comparatif dans la détermination des éléments transitoires de revenu, nécessite encore de la recherche.

Les tests portant sur l'hypothèse de nivellement ne peuvent être que des tests d'hypothèse jointe, c.-à-d. qu'en l'absence de nivellement de la part de la direction, la variable nivelée et la variable de nivellement suivent une évolution particulière et la direction adopte des procédés comptables, ou classifications, pour réduire la variation de cette évolution. Les revenus normaux sont précisés par deux modèles, modèle de tendance temporelle linéaire et modèle aléatoire; par la suite, on détermine les écarts par rapport aux revenus normaux. Nous nous servons d'un échantillon de 170 firmes canadiennes pour déterminer les écarts des postes extraordinaires par rapport aux niveaux normaux en supposant une tendance constante. Nous utilisons des corrélations entre les écarts du bénéfice avant postes extraordinaires et des postes extraordinaires, par rapport à leurs niveaux normaux respectifs, pour évaluer l'existence d'un comportement de nivellement par classification. Les résultats attestent clairement l'existence d'un tel comportement.

CRITICIZING POSITIVE ACCOUNTING THEORY

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One theoretical approach recently emphasized in the accounting literature is 'positive accounting theory'. Synonymous with this theoretical view are the 1978 and 1979 articles published by Ross Watts and Jerold Zimmerman. These two articles prompted criticism from three different perspectives. There are critiques which refer to technical research methods problems, critiques concerned with philosophy of science issues and critiques centred on the limitations of economics-based accounting research. In their 1990 article Watts and Zimmerman responded to most of the published critiques. They specifically claimed that methodological criticisms have failed to have any influence on accounting research. The present paper provides a critical examination and assessment of these alleged failures by examining two types of critiques, economics-based critiques and those based on issues of the philosophy of science. The critiques discussed include those to which Watts and Zimmerman responded as well as several other critiques which either Watts and Zimmerman failed to discuss or which were not published until after their 1990 article appeared.

This paper is organized in five sections. The first presents positive accounting theory as applied economic positivism by outlining the various reasons Watts and Zimmerman give for developing this form of accounting research. Additionally, this section explains that there are only two lines of criticism which may be successfully pursued when criticizing economics-based positive accounting theory. A reader's guide to the critiques of positive accounting theory is given in the second section. This examination finds that while critiques based on philosophy of science are not useful, economics-based critiques which emphasize the limitations of equilibrium-based economic analysis offer an effective avenue for methodological critiques of positive accounting theory. The third section traces the historical background of positive accounting research through its economic roots and shows that the 'positive' aspect of the Watts and Zimmerman approach is more rhetoric than methodology. The fourth section explains how positive accounting theory represents a problem shift towards a domain of research that is appropriate for Chicago School economics. The final section examines a prominently published economics-based critique which offered an effective critique of positive accounting theory but which was ignored by Watts and Zimmerman.

Key Words: positive accounting theory, economics-based accounting research, methodology, Watts and Zimmerman.

CRITICIZING POSITIVE ACCOUNTING THEORY

La littérature comptable met en lumière depuis quelque temps une perspective théorique; il s'agit de la "théorie comptable positive". Ross Watts et Jerold Zimmerman ont publié en 1978 et 1979 deux articles dans cette veine. Ceux-ci ont soulevé des critiques venant de trois points de vue différents. Certaines abordent des lacunes sur le plan technique de la méthodologie, d'autres se penchent sur des questions de philosophie de la science et d'autres encore se concentrent sur les limites de la recherche économico-comptable. Watts et Zimmerman ont répondu à la plupart des critiques publiées dans un article paru en 1991. Ils y affirment plus précisément que les critiques d'ordre méthodologique n'ont eu aucune répercussion sur la recherche comptable. Le présent article s'avère un examen et une évaluation critiques de ces prétendus échecs. Nous y examinons deux types de critiques : celles d'ordre économique et celles portant sur les questions de philosophie de la science. Nous discutons des critiques auxquelles Watts et Zimmerman ont répondu de même que de celles qu'ils ont ignorées ou qui n'ont été publiées qu'une fois l'article de 1990 paru. Notre article comporte cinq sections. La première présente la théorie comptable positive comme étant du positivisme économique appliqué en mettant en évidence les diverses raisons données par Watts et Zimmerman pour justifier l'élaboration de ce type de recherche comptable. En outre, cette section explique que seulement deux avenues de critiques peuvent être suivies en matière de critique de la théorie économico-comptable positive. La deuxième section se veut un guide à l'intention du lecteur pour ce qui est des critiques existantes. Elle montre que si les critiques se fondant sur la philosophie de la science ne sont d'aucune utilité, en revanche, les critiques d'ordre économique mettant l'accent sur les limites de l'analyse économique basée sur l'équilibre représentent effectivement une avenue pour les critiques d'ordre méthodologique de la théorie comptable positive. La troisième section brosse un tableau historique de la recherche comptable positive en retraçant ses racines économiques et montre que l'aspect "positif" de la perspective de Watts et de Zimmerman tient plus de la rhétorique que de la méthodologie. La quatrième section explique comment la théorie comptable positive constitue un tournant difficile vers un domaine de recherche approprié pour la Chicago School. La dernière section examine une critique d'ordre économique publiée à grande échelle qui représente une critique constructive de la théorie comptable positive mais à laquelle Watts et Zimmerman ont fermé les yeux.

Mots clés : théorie comptable positive, recherche économico-comptable, méthodologie, Watts et Zimmerman.

THE RELATIONSHIP BETWEEN ENVIRONMENTAL UNCERTAINTY AND
THE LEVEL OF SOPHISTICATION EMPLOYED IN EVALUATING
CAPITAL BUDGETING PROJECTS BY MAJOR
CANADIAN CORPORATIONS

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This paper provides empirical evidence on the correlation between the level of environmental uncertainty and the use of more sophisticated vis-a-vis naive capital budgeting evaluation models. Previous research indicated the lack of relationship between market-based risk measures such as firm's beta or industry beta and the use of more sophisticated capital budgeting models. By introducing an additional measure of risk based on management's (i.e., respondent's) self-assessment and two revised measures of sophistication, the researchers concluded that respondents' perception of environmental uncertainty is significantly correlated with the reported use of more sophisticated capital budgeting models. This conclusion is based on empirical evidence obtained from analyzing relevant questionnaire data collected from a sample of 80 of the 1989 Financial Post's Top 500 Canadian Corporations.

Partial rank correlation is employed to test a total of six research hypotheses to allow for all possible correlations between two measures of sophistication (i.e., methods used and degree of risk adjustment employed) and three variables measuring the degree of firm-specific environmental uncertainty (i.e., firm's systematic risk or firm's beta, industry's systematic risk or industry beta, and management's self assessment of corporate risk). The statistical analysis is repeated twice to allow for control of two moderating variables, size and financial risk. The empirical evidence obtained in the current study lend support to the results of previous empirical studies in that the level of sophistication is not related to the market-based risk measures (i.e., firm's beta or industry beta). However, the current study provides empirical evidence that there is a statistically significant correlation between level of sophistication and management's self assessment of corporate risk.

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Le présent article fournit des preuves empiriques sur la corrélation entre le niveau d'incertitude environnementale et l'utilisation de modèles sophistiqués plutôt que de modèles naïfs d'évaluation de choix d'investissement. La recherche antérieure a montré l'absence de relation entre les mesures du risque de marché, comme le beta d'une firme ou le beta de l'industrie, et l'utilisation de modèles de budgétisation des investissements plus sophistiqués. En introduisant une mesure supplémentaire de risque fondée sur l'auto-évaluation du gestionnaire (c.-à-d. le répondant) et deux mesures de sophistication révisées, les chercheurs ont conclu que la perception qu'ont les répondants de l'incertitude environnementale est corrélée de façon significative avec l'utilisation de modèles sophistiqués de budgétisation des investissements. Cette conclusion se fonde sur les preuves empiriques obtenues de l'analyse des données pertinentes recueillies à partir d'un échantillon de 80 des 500 premières sociétés canadiennes en 1989 selon le Financial Post.

Nous utilisons la corrélation de rangs partielle pour tester six hypothèses de recherche afin de tenir compte de toutes les corrélations possibles entre deux mesures de sophistication (c.-à-d. méthodes utilisées et ajustement du degré de risque employé) et trois variables mesurant le degré d'incertitude environnementale spécifique à la firme (c.-à-d. risque systématique ou beta de l'entreprise, risque systématique ou beta de l'industrie et auto-évaluation du risque de la firme par les gestionnaires). Nous répétons l'analyse statistique deux fois afin de rendre possible le contrôle de deux variables modératrices, soient la taille et le risque financier. Les résultats empiriques obtenus de la présente étude viennent appuyer ceux des études empiriques antérieures en ce que le niveau de sophistication n'est pas lié aux mesures de risque de marché (c.-à-d. beta de l'entreprise ou de l'industrie). En revanche, notre étude fournit une preuve empirique de l'existence d'une corrélation statistiquement significative entre le niveau de sophistication et l'auto-évaluation du risque d'entreprise par les gestionnaires.

TERMINATING BUILDING SOCIETIES

Phil Creighton, Independent Scholar

The terminating building societies represent the first attempt, in Upper Canada, to accumulate capital locally for the development and improvement of real estate. These building societies flourished in the period 1846 - 1855. The societies were fascinating to the contemporary newspapers, not only because they were new numerous, but also because the basis for revenue recognition adopted by the societies made them appear astonishingly successful, in their start-up period.

The concept of the terminating building society is simple. Each shareholder subscribes for one or more par value shares and agrees to make a specified payment each month until the society terminates. Contemporaries expected the society to last nine to ten years.

The contributed funds are offered, monthly, to the shareholders who wish to borrow from the society, and who can offer first mortgage security. The would-be borrowers bid against each other, offering to discount the amount of cash they are willing to take. Highest discount offered gets the loan. The borrowers must be shareholders and can borrow no more than the par value of the shares they have subscribed. Contemporaries knew this discount as a "bonus".

The borrowers paid 6% interest on the undiscounted amount of their loans. This was the ceiling rate imposed by the Usury Act.

When the sum of the share subscriptions, interest, discount, sundry fees less costs of operation equals the par value of the shares subscribed then the society terminates, with the loans to the borrowers discharged and the other shareholders' shares redeemed at par.

One of the major problems encountered by both the investors and the newspapers was the inability to determine the effective rate of interest on either the loans made or the earnings of the societies. The future value of the redeemed share was known, as was the present value of the net advance from the loan, and the amount of the monthly payment. However, neither the duration of the society or the effective rate of interest could be determined without knowing the other one.

Models showing the life span of a representative society became popular as a means providing a measure of certainty for both management and investors. Not before, however, a substantial, ill informed, and vituperative correspondence had appeared in much of the contemporary press. Presumably, because of this uncertainty concerning the effective rate of interest some societies made bad investment decisions in their middle years.

The discount is the difference between the stated rate of interest, 6%, and the effective rate. The societies took this discount into income in the period in which the related loan was made. As has been noted above there was no certain way to amortize the discount over the remaining life of the loan. It may be that, as the discount, was in effect received in cash that this action justified the recognition of the revenue.

As the terminating building societies moved toward termination in the early to mid 1850s, their shareholders realized that they liked the services supplied by such societies but found their temporariness an inconvenience. The permanent society was born. The first such societies were really a succession of terminating societies which appeared to be continuous. The act was finally amended to permit the incorporation of a permanent society.

TERMINATING BUILDING SOCIETIES

Phil Creighton, Universitaire Indépendant

Les sociétés immobilières temporaires représentent la première tentative, en Ontario, d'accumuler localement du capital en vue de la mise en valeur et de l'amélioration de l'immobilier. Ces sociétés ont fleuri entre 1846 et 1855. Elles fascinaient les journaux de l'époque, non seulement parce qu'elles étaient nombreuses mais aussi parce que la base de constatation des produits adoptée par ces sociétés les rendait étonnamment prospères lors de leur démarrage. La notion de société immobilière temporaire est simple. Chaque actionnaire souscrit, à la valeur nominale, une action ou plus et accepte de verser une somme précise tous les mois jusqu'à l'extinction de la société. On s'attendait alors à ce que la société dure neuf ou dix ans. Chaque mois, les fonds ainsi amassés sont offerts aux actionnaires qui souhaitent emprunter de la société et qui peuvent cautionner une première hypothèque. Les emprunteurs potentiels se font compétition; chacun offre d'escompter le montant qu'il désire recevoir. Celui qui offre l'escompte le plus élevé obtient le prêt. Les emprunteurs doivent être actionnaires et ne peuvent emprunter plus que la valeur nominale des actions qu'ils ont souscrites. L'escompte représentait à l'époque un "bonus".

Les emprunteurs payaient 6 pour cent d'intérêt sur le montant non escompté de leur prêt. Il s'agissait du taux d'usure imposé par la loi.

Lorsque la somme des souscriptions d'actions, des intérêts, des escomptes et des droits divers moins les frais d'exploitation égale la valeur nominale des actions souscrites, la société s'éteint. Les emprunteurs sont alors libérés de leur dette et les parts des autres actionnaires, remboursées au pair.

L'incapacité de déterminer le taux d'intérêt effectif, que ce soit pour les prêts accordés ou pour les revenus des sociétés, constituait une des principales difficultés rencontrées par les investisseurs et les journalistes. La valeur future de l'action remboursée, la valeur actuelle de l'avance nette à même le prêt, et le montant du versement mensuel étaient connus. Toutefois, il était impossible de déterminer la durée de la société ou le taux d'intérêt effectif sans connaître l'autre variable. C'est alors que l'on a vu l'apparition de nombreux modèles indiquant la durée de vie d'une société type, donnant aux gestionnaires et aux investisseurs un moyen de mesurer le degré de certitude. Ces modèles, toutefois, ne sont apparus qu'après une longue correspondance mal informée et injurieuse dans les journaux contemporains. Il semblerait qu'en raison de cette incertitude concernant le taux d'intérêt effectif, certaines sociétés aient, au milieu de leur terme, pris de mauvaises décisions en matière d'investissement.

L'escompte est la différence entre le taux d'intérêt déterminé, 6%, et le taux d'intérêt effectif. Les sociétés ont fait de cet escompte un revenu pour la période durant laquelle le prêt a été accordé. Comme nous l'avons déjà mentionné, il était impossible d'amortir, de façon certaine, l'escompte pendant la durée du prêt en question. Mais, comme l'escompte représentait une somme d'argent recue en espèces, les sociétés pouvaient justifier la constatation des produits. Au fur et à mesure que l'extinction des sociétés approchait, entre le début et le milieu des années 1850, les actionnaires se rendaient compte qu'ils aimaient les services offerts par ces sociétés; seule leur éphémérité constituait un inconvénient. C'est alors qu'est née la société permanente. Les premières sociétés permanentes n'étaient vraiment que la succession d'une série de sociétés temporaires. La loi a finalement été modifiée afin de permettre l'incorporation de la société permanente.

**THE INCREMENTAL INFORMATION OF SUPPLEMENTARY FINANCIAL
DISCLOSURES IN PREDICTING BUSINESS FAILURE:**

SOME EMPIRICAL EVIDENCE
Ibrahim Aly, Concordia University
Jeong Kim, Concordia University

This study examines the incremental information of the general price level (GPL), and the current cost (CC) as compared to that of historical cost information in classifying and predicting business failure. The study also examines the usefulness of CC information versus GPL when each is used as a supplement to HC information. Two multivariate statistical techniques, multiple discriminant analysis (MDA) and logistic regression analysis (LRA) are used to derive the ex-post classification results. Five functions are developed based on ratios computed with HC, GPL, CC, and combined HC/GPL and the combined HC/CC model.

The main results of the various analyses indicate that the combined HC/CC model has more discriminant power than does the HC, the GPL, the CC, or the combined HC/GPL models in each of the three years before bankruptcy. The results of this study support the FASB's decision in SFAS No. 82 to change the minimum disclosure requirement from both CC and constant dollar information to CC information alone. Based on the usefulness of CC data alone (without considering the cost of gathering such data), the decision in SFAS No. 89, eliminating the requirement for CC information, appears regrettable for bankruptcy studies. Perhaps other research can determine whether CC information has usefulness for other areas of analysis. The results also indicate that LRA has a better classification rate than MDA for the selected sample.

**THE INCREMENTAL INFORMATION OF SUPPLEMENTARY FINANCIAL
DISCLOSURES IN PREDICTING BUSINESS FAILURE:**

SOME EMPIRICAL EVIDENCE

La présente étude examine l'information différentielle du niveau général des prix et du coût actuel comparativement à celle du coût historique en matière de classification et de prédiction de faillites. Elle aborde également l'utilité de l'information fournie par le coût actuel par rapport au niveau général des prix lorsque chacun est utilisé comme supplément à l'information fournie par le coût historique. Dans le but de déduire les résultats de classification ex-post, nous utilisons deux techniques statistiques multivariées, soit l'analyse discriminante multiple et l'analyse de régression logistique. Nous élaborons cinq fonctions fondées sur des ratios calculés avec le coût historique, le niveau général des prix, le coût actuel, et des ratios obtenus d'une combinaison du coût historique et du niveau général des prix ainsi que des ratios issus du modèle combiné du coût historique et du coût actuel.

Pour chacune des trois années précédant la faillite, les principaux résultats des diverses analyses indiquent que le modèle combiné du coût historique et du coût actuel possède un pouvoir discriminant plus élevé que le coût historique, le niveau général des prix, le coût actuel ou les modèles combinés du coût historique et du niveau général des prix. Ces résultats appuient d'ailleurs la décision du FASB, à l'égard de la norme SFAS n° 82, de changer les obligations d'information minimales l'utilisation de l'information du coût actuel seulement au lieu du coût actuel et des dollars constants. D'après l'utilité de l'information fournie par le seul coût actuel (sans considérer le coût de collecte de telles données), la décision concernant la norme SFAS n° 89, éliminant l'exigence d'information au coût actuel, semble regrettable dans le contexte d'études sur les faillites. Peut-être d'autres recherches pourront-elles déterminer s'il est possible d'utiliser le coût actuel pour d'autres champs d'analyses. Enfin, les résultats indiquent aussi que, pour l'échantillon choisi, l'analyse logistique possède un meilleur taux de classification que l'analyse discriminante multiple.

**CLASSIFICATION TECHNIQUES IN ACCOUNTING RESEARCH:
EMPIRICAL EVIDENCE OF COMPARATIVE PERFORMANCE**

Duane Kennedy, University of Waterloo

Many accounting research problems involve classification of observations into discrete categories. A number of statistical techniques have been used in accounting research involving discrete categories. This study examines the performance of seven techniques that can be used when there are more than two discrete categories. The techniques are linear discriminant analysis, quadratic discriminant analysis, McKelvey and Zavoina n-chotomous probit, Walker and Duncan ordinal logit, Nerlove and Press polytomous logit, ordered classification trees, and unordered classification trees. Technique performance is measured using classification accuracy. The study finds that the Walker and Duncan ordinal logit, Nerlove and Press polytomous logit, and linear discriminant analysis techniques have the highest performance when the discrete categories are ordered. When the categories are unordered, the Nerlove and Press polytomous logit and linear discriminant analysis techniques have the highest performance.

**CLASSIFICATION TECHNIQUES IN ACCOUNTING RESEARCH:
EMPIRICAL EVIDENCE OF COMPARATIVE PERFORMANCE**

Beaucoup de problèmes en recherche comptable nécessitent la classification d'observations dans des catégories discrètes. Un certains nombre de techniques statistiques utilisées en recherche comptable se servent de ce type de catégorie. La présente étude examine la performance de sept techniques pouvant être utilisées en présence de plus de deux catégories discrètes. Il s'agit de l'analyse discriminante linéaire, de l'analyse discriminante quadratique, du "probit n-chotomique" de McKelvey et de Zavoina, du "logit" ordinal de Walker et de Duncan, du "logit polytomique" de Nerlove et de Press, des arbres de classification ordonnés et des arbres de classification non ordonnés. Nous mesurons la performance des techniques selon le niveau de précision de la classification. Notre étude montre que la technique de Walker et de Duncan, celle de Nerlove et de Press et l'analyse discriminante linéaire sont hautement performantes quand les catégories discrètes sont ordonnées. Lorsque les catégories ne sont pas ordonnées, la technique de Nerlove et de Press et l'analyse discriminante linéaire s'avèrent les meilleures techniques.

**RELATED PARTY TRANSACTIONS:
A CASE STUDY OF INTERACTIONS BETWEEN GOVERNMENT AND THE
THE 'DEVELOPMENT' OF DISCLOSURE RULES**

Ross Walker, University of New South Wales
Peter Robinson, University of Western Australia

Regulatory arrangements adopted in most western countries involve the participation of both private-sector (professional) bodies and public-sector agencies in the formulation and administration of accounting rules. The political processes associated with the efforts of interest groups to secure favoured outcomes may involve disputes over regulatory arrangements as well as the content of specific rules.

This case study reviews interactions during the 1980s between government regulatory bodies and the accounting profession, as they handled proposals for the introduction of disclosure rules concerning related party transactions (RPTs). Evidence was obtained from publicly-available documents and copies of correspondence made available by interest-groups, and from interviews with some key participants.

The case study illustrates how debates about the content and drafting of rules on RPTs took place in a complex organizational setting; how the activities of the profession's standard-setting bodies were hardly consistent with the pluralist ideal; but that when considered in the context of complex interactions between different agencies, the notion of "pluralism" is of limited value to describe the underlying political processes involved in the development of accounting rules; and how simple models of "corporatism" fail to describe the dynamics of political processes surrounding particular issues. It is suggested that identifying the "domains" of major participants in the standard setting process, and analyzing threats to these domains, may provide fuller descriptions of regulatory processes than have been presented previously.

**RELATED PARTY TRANSACTIONS:
A CASE STUDY OF INTERACTIONS BETWEEN GOVERNMENT AND THE
'DEVELOPMENT' OF DISCLOSURE RULES**

Dans la plupart des pays occidentaux, l'appareil réglementaire chargé de formuler et de régir les règles comptables est composé à la fois de membres du secteur privé (des professionnels) et d'organismes du secteur public. Les enjeux politiques liés aux efforts déployés par des groupes d'intérêt en vue d'obtenir les résultats désirés peuvent se traduire par des dissensions concernant aussi bien le dispositif réglementaire que le contenu de certaines règles.

La présente étude de cas fait la revue des interactions, pendant les années 1980, entre les organismes gouvernementaux et la profession comptable, au moment où ils traitaient des propositions pour l'introduction des obligations d'information sur les transactions entre personnes apparentées. Nous avons pu obtenir des informations par le biais de documents publiquement disponibles et des copies de la correspondance divulguée par des groupes d'intérêt et d'entrevues avec quelques participants clés.

L'étude illustre la façon dont se sont tenus, dans un environnement organisationnel complexe, divers débats à propos du contenu et de l'ébauche de règlements sur les transactions entre personnes apparentées. Elle montre aussi comment les activités des organismes de normalisation de la profession correspondent à peine à l'idéal pluraliste, mais que, lorsqu'elle est considérée dans un contexte d'interactions complexes entre les différents organismes, la notion de "pluralisme" porte une valeur limitée dans la description des enjeux politiques faisant partie de l'élaboration de règles comptables. Enfin, elle indique la façon dont des modèles simples de "corporatisme" ne parviennent pas à décrire la dynamique des enjeux politiques entourant certaines questions précises. Les résultats suggèrent que la détermination des "domaines" des principaux participants au procédé de normalisation et l'analyse des éléments menaçant ces domaines peuvent fournir de plus amples descriptions des procédés de réglementation que celles que nous avons connues jusqu'à présent.

RANGES TO SUPPLEMENT POINT ESTIMATES IN FOFI

Marc Swartz, Ernst and Young
Gordon Richardson, University of Waterloo
Peter Clarkson Simon Fraser University

The disclosure of ranges to supplement point estimates in future-oriented financial information ("FOFI") is a topic of considerable interest to both practitioners and academics. Two companies with the same point estimate can have quite different risks of forecast error.

The study used the term "range" in a manner consistent with practitioner and academic literature to imply the interval within which management is reasonably confident that the actual results will lie. A range can be provided for either a forecast or a projection.

Academic literature generally provides strong support for the inclusion of ranges in FOFI. Arguments in favour of range inclusion in FOFI suggest that ranges will help to distinguish between firms operating in environments with different degrees of risk, that ranges will help to quantify risk, that they will emphasize the imprecision inherent in FOFI and that the presentation of only a single point estimate may lead users to attach an unwarranted degree of precision to the forecast.

Arguments opposing range inclusion are primarily technical in nature. They include the suggestion that the assessment of probabilities associated with assumptions is difficult and that unless the probability distribution is known, the selection of a range is arbitrary. Further, there is a suggestion that range inclusion will increase legal exposure for both the preparers and the reviewers and that there would be difficulty in providing a reasonable level of assurance. The survey asked three groups of respondents (preparers, accountants and users) whether they agreed or disagreed with favourable and unfavourable arguments towards ranges. The arguments were based on statements in the literature. The results indicated that respondents generally agreed to strongly agree with the statements presented.

The results of the survey suggest that all three groups believe there is merit in including ranges in FOFI and that a range would provide valuable information in addition to that provided by the point estimate. Further, there is strong support for the position that it is technically feasible to develop ranges. However, the general feeling among members of all three groups is that the task of developing range estimates is a difficult one. All three groups indicate that the decision to include a range should be voluntary and that the form the range takes should be left to the discretion of the preparer. These latter positions seem to stem primarily from technical concerns associated with the actual range development. All three groups also expressed some concern about whether inclusion of the range in FOFI would change either the preparer's or the accountant's/auditor's legal risk exposure.

Based on these results, and the following, the arguments advanced in both the academic and practitioner literature, we believe that it is important for regulatory bodies (eg. the Ontario Securities Commission and the Canadian Institute of Chartered Accountants) to require, at least as a first step, some attempt on the part of preparers to quantify the "what if" statements underlying forecasts. In this sense, we agree with the argument that presentation of only a single point estimate provides insufficient information for the users to assess either the sensitivity of forecasted performance to future uncertainties or the potential impact of these uncertainties on company performance. At the same time, we also recognize the practical realities associated with the preparation and the presentation of ranges in FOFI. While most preparers have the technical capability to identify the quantitative impact of the future uncertainties on forecasted performance given the current state and accessibility of computer technology, few are likely to have the knowledge or experience to develop the probability distributions necessary for the construction of sophisticated range estimates such as confidence intervals. We also believe that with increased exposure to FOFI, preparers and reviewers will acquire this knowledge and experience. Thus, standard setters can consider the possibility of mandated range disclosure in the future, as FOFI matures. In addition, Canadian regulatory bodies should institute a "safe-harbour" rule, similar to the one the SEC in the United States uses. The safe-harbour rule would protect preparers and reviewers from legal risk if the ranges were prepared in good faith.

RANGES TO SUPPLEMENT POINT ESTIMATE IN FOFI

Marc Swartz, Ernst and Young
 Gordon Richardson, University of Waterloo
 Peter Clarkson, Simon Fraser

La présentation d'intervalles en vue de compléter l'information financière prospective s'avère un sujet de grand intérêt tant pour les praticiens que pour les universitaires. Il est possible que deux firmes ayant le même estimateur ponctuel aient des risques d'erreur de prévision très différents.

La présente étude utilise le terme "intervalle" dans le même sens que la littérature pratique et théorique pour signifier l'intervalle à l'intérieur duquel la direction peut s'attendre, avec une certaine confiance, à voir les résultats réels. On peut fournir un intervalle que ce soit pour les prévisions ou pour les projections.

En général, la littérature théorique appuie fortement l'inclusion d'intervalles en matière d'information financière prospective. D'une part, les arguments en faveur de cette pratique suggèrent que les intervalles permettront d'établir une distinction entre les firmes opérant dans des environnements comportant des degrés de risque variés, qu'ils aident à quantifier le risque, qu'ils mettent en évidence l'imprécision propre à l'information prospective et que la présentation d'un seul estimateur ponctuel peut induire les utilisateurs à accorder indûment un degré de précision à la prévision. D'autre part, les arguments à l'encontre de l'inclusion d'intervalles sont principalement de nature technique. Ils suggèrent que l'évaluation de probabilités liées à des hypothèses est difficile et, qu'à moins que la distribution des probabilités soit connue, la sélection d'un intervalle est arbitraire. De plus, ils proposent que l'utilisation d'un intervalle augmentera le risque de poursuites judiciaires tant pour les préparateurs que pour les réviseurs et qu'il serait difficile de fournir un degré satisfaisant d'assurance. Le questionnaire demandait à trois groupes de répondants (préparateurs, comptables et utilisateurs) s'ils étaient en accord ou en désaccord avec des arguments favorables et des arguments défavorables quant aux intervalles. Ces arguments étaient fondés sur des énoncés tirés de la littérature. Les résultats ont montré que, de façon générale, les répondants s'entendaient pour donner leur accord entier aux énoncés présentés. Les résultats du sondage suggèrent que les groupes croient tous au mérite de l'inclusion d'intervalles dans la préparation d'information financière prospective et qu'un intervalle ajouterait de l'information de valeur à celle fournie par l'estimateur ponctuel. De plus, la position voulant qu'il soit techniquement faisable d'élaborer des intervalles reçoit un appui solide. Cependant, les trois groupes estiment que l'élaboration d'intervalles représente une tâche difficile. Ils soulignent que la décision d'inclure un intervalle devrait être volontaire et que la forme que prendra cet intervalle devrait être laissée à la discrétion du préparateur. Leurs positions semblent découler principalement des soucis techniques associés à l'élaboration de l'intervalle comme tel. Les trois groupes ont aussi exprimé une certaine préoccupation concernant un changement possible de l'exposition au risque juridique du préparateur du comptable ou du vérificateur à la suite de l'inclusion d'un intervalle en matière d'information financière prospective.

À la lumière de ces résultats et des arguments avancés dans la littérature théorique et pratique, nous croyons qu'il est important pour les organismes de réglementation (comme l'Ontario Securities Commission et l'Institut Canadien des Comptables Agréés) d'exiger, au moins comme première étape, un certain effort de la part des préparateurs pour tenter de quantifier les énoncés hypothétiques sous-tendant les prévisions. De même, nous sommes d'accord avec l'argument stipulant que la présentation d'un seul estimateur ponctuel ne fournit pas suffisamment d'information afin de permettre à l'utilisateur d'évaluer la sensibilité du rendement prévu aux incertitudes futures ou aux répercussions qu'elles peuvent avoir sur le rendement de la firme. En même temps, nous reconnaissons les difficultés liées à la préparation et à la présentation des intervalles quant à l'information financière prospective. Bien que la plupart des préparateurs aient, étant donné l'état actuel de l'informatique et sa facilité d'accès, les moyens techniques de déterminer les répercussions quantitatives des incertitudes futures sur le rendement prévu, peu ont les connaissances ou l'expérience requises pour développer les distributions de probabilités nécessaires à la construction d'intervalles sophistiqués comme les intervalles de confiance. Nous croyons également que les préparateurs et les réviseurs acquerront connaissances et expérience à force d'être en contact avec l'information financière prospective. Par conséquent, les organismes de normalisation peuvent, tandis que l'information financière prospective s'établit, envisager la possibilité d'exiger, à l'avenir, la présentation d'intervalles. En outre, les organismes canadiens de réglementation devraient instituer une règle refuge, semblable à celle utilisée par la SEC aux États-Unis. Cette règle protégerait les préparateurs et les réviseurs contre les risques juridiques dans le cas où les intervalles étaient préparés de bonne foi.

Ethics and Accounting Education

A Presentation by
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Before

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Ethics and Accounting Education

It is a very special privilege to have been invited to address this plenary session of the annual conference of the Canadian Academic Accounting Association. The invitation is especially gratifying since it presumes that despite my alien status, there is something in my experience which might be relevant for you; I hope this turns out to be something more than an ego trip.

The title theme for today's address is "Ethics and Accounting Education." As I have previously advised your chair, Professor Alan Richardson, the text for this morning's address is that which served for my presentation in mid-April before the Northeast regional meeting of the American Accounting Association. That the subject of Ethics is not uniquely a matter for U.S. deliberation may be evidenced by a February 17 BBC broadcast, of which a transcript is attached to this prepared text. So it is that because of your geographic propinquity with the U.S., and traditional bonding with the U.K., I am confident that the subject of "Ethics and Accounting Education" should also be relevant for the Canadian experience.

By my opting for this theme, I want to convey my deeply-held view that in the teaching of accountancy and taxation, we are regularly in a position to challenge the students to come to grips with some very critical, fundamental areas of ethics and ethical conduct. In the fulfillment of our responsibilities for the personal and professional development of our students we should be continuously alert to any ethical aspects, the question of the "should" vs. the "is" so as to permit the consideration of the problem at hand beyond the mathematical or technical solution which may be called for by the text, the FASB, the Internal Revenue Code, etc. This demands that we, the teachers, must be sensitized to these ethical ramifications, and prepared to present them for full and open deliberation.

In the pursuit of this transcendent objective I am not suggesting that we set aside periods of time to discuss ethics, per se. Nor am I oriented towards separate courses captioned Ethics for Accountants. Instead, I am devoted to the pursuit of our objective as an incident to, and a direct aspect of, the actual, practical subject comprising our accounting curriculum. And this phenomenon, I submit, must be pervasive, involving our offerings at the introductory level and on through our graduate offerings. And, if you will forgive my presumptuousness, we should also be mindful of the ethical ramifications in our own interpersonal relationships with our students and colleagues. In short, all this and more, is what I deem to be subsumed in the theme "Ethics and Accounting Education."

Thus endeth the prologue, I turn to sharing with you a nexus of areas of accounting education which have major ethical implications.

The Challenge to the Novitiate:

For the first of these themes I go back to the years when I regularly taught Introductory Accounting, before I was elevated to the exalted status of "Emeritus." My opening gambit was to inquire of my undergraduate scholars as to just what they thought accounting was about. The responses, not unexpectedly, revolved around the maintenance of records, development of tax returns, and corresponding mechanistic aspects. When pressed as to the objective of all of this debiting and crediting it was agreed that accounting, accountancy and accountants were committed to the accumulation of significant data and their communication to those who require the data for better decision making. The key concept for which I was probing was "Communications."

Communications, in turn, provided the lead to the qualities essential for effective communication; especially "truth," "language" (general as well as the special language of a learned study), fairness, "objectivity" and the like.

Proceeding with this communication stream of consciousness, turning to the "to whom," it became clear that in our complex economic society, characterized by giant multinational corporations, the "whom" represents the entire universe of citizens and their governments.

So it is that at the very moment when the students are compelled to lose their innocence regarding the discipline they will be studying over the semester and the ensuing years, they will be confronted with its essential ethical ramifications. This, in turn, led to a consideration of the role of the certified public accountant in this communications process. No longer should he be viewed in the "green eye-shade," "celluloid cuff" Dickensian Stereotype; instead, he should now be seen as society's surrogate, pursuing the challenge set out for him some three-score years ago by Colonel Robert Montgomery, a founder of Coopers & Lybrand, nee Lybrand, Ross Brothers & Montgomery, thus: "It is [the auditor's] duty, after fighting the figures and finding the facts, to assemble the figures and to tell the truth about them, with clarity, conciseness and intelligence so that he who runs may read . . ."

In short, while much of the semester will be devoted to "numbers crunching" I expected my scholars to understand why numbers were being thus processed and, especially, the ethical standards which need to be possessed by those committed to accountancy at the core of accountability.

This leads me to consider with you in some depth the qualities of the CPA -- those that might be required as an essential condition precedent to his assuming his professional role, and some constraints and compromises which we may find in the "real world."

Defining the Practice of Public Accountancy:

What is the practice of public accountancy? I believe it to have been effectively enshrined in the New York statutes which established the special

license or franchise of Certified Public Accountant, and thereupon defined the profession of public accountancy as follows (Section §7401):

The practice of the profession of public accountancy is defined as holding one's self out to the public, in consideration of compensation received or to be received, offering to perform or performing for other persons, services which involve signing, delivering or issuing or causing to be signed, delivered or issued any financial, accounting or related statement or any opinion on, report on, or certificate to such statement if, by reason of the signature, or the stationery or wording employed, or otherwise, it is indicated or implied that the practitioner has acted or is acting, in relation to said financial, accounting or related statement, or reporting as an independent accountant or auditor or as an individual having or purporting to have expert knowledge in accounting or auditing.

Note carefully, our professional license extends to nothing other than "signing, delivering or issuing . . . any financial accounting or related statement or any opinion on, report on, or certificate to such statements." So it is that from its very origins, going back for over a century, society, through its legislative representatives, determined that a profession responsible to the world of third parties for the certification of financial statements was essential. In our formative years, in a far more bucolic era, the universe of third parties was reasonably discernible -- it extended to creditors, potential creditors and, to the limited extent to which ownership was alienated from management, to such owners and potential owners.

However important the independent audit may have been in our traditional days, the role has expanded literally exponentially to the present. That this is not mere rhetoric becomes self evident when we recognize the enormity of the growth of corporate enterprise characterized by multinationality dispersion of share ownership in quantitative terms of course, but then we have the expanding institutionalization of share ownership.

So it is that this enormous delegation of power to corporate managements

demands a full and equal measure of accountability to all those who may be affected by the managerial prerogatives - of such ownership in pension, annuity, insurance, endowment, mutual, etc., funds -- a phenomenon which has induced the so-called "Power Without Property" syndrome identified by Professors Berle and Means more than a half century ago, but which has accelerated most dramatically over the intervening years.

It is to assure that the record of this accountability is produced objectively, fully and timely that the profession of public accountancy was created by statutory edict. The role of the independent CPA was pointed up especially cogently by the then Chief Justice Burger in his celebrated decision in U.S. v. Arthur Young, thus:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

To further emphasize the standard of independence the Chief Justice included the following in a footnote:

The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. It is, therefore, not enough that the Financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. Endowing the workpapers of an independent auditor with a work-product immunity would destroy the appearance of auditor's independence by creating the impression that the auditor is an advocate for the client. If investors were to view the auditor as advocate for the corporate client, the value of the audit function itself might well be lost.

"Independence" - The Professional's Sine Qua Non:

This leads to the subject of auditor's independence, a subject which I have been probing for over a quarter of a century -- with increased and increasing concern.

At the outset, I maintain that our colleagues are guilty of the sin of hubris, of arrogance. When we reflect on the judiciary, legislators (remember the "Keating Five"), journalists, historians, government officials, scientific researchers (especially those with third-party responsibility, e.g., drug testing); we insist that all those committed to these callings be free from conflicts of interest -- we insist that they be virginal not only in fact but also in appearance. But for our profession, we arrogate to ourselves the right to determine unilaterally whether we have "crossed the line."

That our colleagues are all - too - frequently oblivious of the "line" they have crossed can be painfully demonstrated in cause célèbre after cause célèbre, for example:

- o Loans under special circumstances to partners of Peat Marwick and Arthur Young by Penn Square Bank and Republic Bank Corporation, a major Texas S&L which went "belly up", while they were actively engaged in the independent (sic!) audits; of the lending institutions. In both instances the firms deny that they had violated our profession's rules of professional conduct.
- o Partners of Touche Ross and Arthur Young, in charge of the audits of First Executive (Executive Life Insurance) and Lincoln S&L, respectively, moved from their firm associations to richly-endowed positions as chief financial officers of their respective clients -- all the while their erstwhile firms continued to serve as the independent (sic!) auditors for the institutions.

The Lincoln circumstance elicited the following commentary from Judge Sporkin in his August, 1990, opinion (to be considered in some detail

presently):

Atchison, who was in charge of the Arthur Young audit of Lincoln, left Arthur Young to assume a high paying position with Lincoln. This certainly raises questions about Arthur Young's independence. Here a person in charge of the Lincoln audit resigned from the accounting firm and immediately became an employee of Lincoln. This practice of "changing sides" should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence. It would seem that some "cooling off period" perhaps, one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.

In any event despite the fact that study after study, including those undertaken under the aegis of the AICPA or POB disclose that the public, the world of statement users, looks with disfavor on our spreading our areas of involvement to a proliferation of peripheral services we bend our book of rules governing our conduct so as to rationalize this expansiveness.

I turn briefly next to the determination on the part of many in our profession's hierarchy to deprofessionalize our pursuit. I am, essentially, here referring to the pall mall pursuit of activities generally subsumed under the rubric Management Advisory Services (MAS). Aside from my traditional lament that such services compromise the primary commitment of our CPA certificate, namely, the independent audit responsibility for the benefit of third parties, this development brings a nexus of perversity including:

- o Admission to partnership in CPA firms of persons who do not have that degree.
- o Infusion into the firm's professional environment of that intensely aggressive, competitive proclivities of the MAS cohorts.
- o The denigration of the independent audit responsibilities of the firm, and those engaged in that activity,
- o This accelerating "race for the bottom" has also had an inimical effect on those responsible for framing and implementing our standards of professional conduct. Here, I am alluding to the Anderson Committee responsible for the restructuring of our code of professional conduct, the Public Oversight Board and the Peer Review process.

This "headless horseman" phenomenon of running off in all directions at once is discernible also in the profession's relaxation of its rules against contingent fees and commissions. This will encourage those who have an aggressive bent for self-aggrandisement to enter into pursuits which, judged by traditional standards, would be deemed to be incompatible with professional stature -- and especially with our much-cherished independence.

The ultimate tragedy of this development is that it has been pursued by the most-affluent sector of our profession, rather than by those who require the additional revenues for their economic survival. It is those in our profession's hierarchy who are presumed to set the standards for excellence who are principally responsible for the debasement of our professionalism. Or is it time to remind us once again of Oliver Goldsmith's lament, "Ill fares the land [profession], to hastening ills a prey, where wealth accumulates and men decay."*

The Auditor as Historian:

On frequent occasion I have analogized the role of the independent auditor with that of the historian; I suggested that the former serves as the historian for the economic microcosm, as does the latter for the political macrocosm. Both, I have noted focus on the dynamics of their respective centers of interest within a particular time frame. That this analogy was for me anything but a platitude is evidenced by the extensive chapter"; the special meaning of 'What is History'?" in my The Effectiveness of Accounting Communication (1967). Taking Professor Hans Meyerhoff's The Philosophy of History in Our Time (1959) as my frame of reference, I noted the following qualities or characteristics which I deemed to be common to that profession's

* N.B. See my attached letter of May 20 commenting on the AICPA exposure draft relating to this issue.

discipline and ours, including (elipses omitted):

- o The subject matter of history presents a problem. It is so vast and complex that it can hardly be subsumed under a single concept. What, then, is history?
- o The facts of history are peculiar, as historicism has insisted all along . . . the inexhaustible multitude of historical facts are unique events of the past that are accessible to us, not through direct experience or experimental repetition (as the facts in the sciences), but only through memory or through the indirect evidence of physical remains, verbal reports, and written documents.
- o The primary aim of a historical narrative is to reconstruct these events in their unique individuality.
- o The language of history is different. Again, a historical narrative reads much more like a novel than a scientific text - unless it be a dull history which reads like a tract in sociology . . .
- o Fact, theory, and interpretation form a closely knit complex in a historical narrative . . . The facts of history invariably appear in a context of interpretation. There is no narration without interpretation; and there is no interpretation without theory.
- o The methods of history are often dubious and suspect. Some, to be sure, follow ordinary scientific procedures of evidence and inference; others, however, are quite extraordinary - whether they be called insight, introspection, empathy, imagination, or "understanding"
- o Freedom is a special problem for history. There may not be any historical necessity; but, no doubt, there is a necessity of nature, environment, heredity, conditioned reflex, social pressure, legal restrictions, and perhaps even unconscious motivations. Yet there must also be a sense of freedom . . .
- o Values, emotive meanings, and ideological concepts invariably enter into the study of history. They are, in turn, as historicism has shown, subject to change and social climate . . .
- o Meaning has receded, or vanished, from history in the sense of the philosophical theories discussed above. Instead of a single theoretical law or a universal rational principle, the modern historian operates with

a plurality of laws and principles, the logical status of which is often very obscure . . . Instead of a single linear direction, he discovers multiple and incompatible directions in history - or no direction at all.

After discussing in some detail the correspondence of the dilemmas facing the historian with those confronting the independent auditor, I proceeded to point up the critical distinctions between the education and training leading to the two pursuits, thus:

The parallel ends and a distinction needs to be made, a distinction which will be shown to be invidious to the accountant. So it is that for the historian, generation's of scholars have wrestled with these pervasive and gnawing problems, both in the abstract and in their implications for specific subject matter. Through their scholarship the historian has been made to see the nature and impact of the problems and has been made to answer to his colleagues for his performance by reference to these pervasive currents. This kind of exegesis is essentially absent in accountancy; the practitioners thereof are denied effective standards for measuring performance, and correspondingly are free to pursue their practice relatively unfettered.

The Implications of the Foregoing for the Accountant's Education

I will digress briefly from Accounting Education to the Education of the Accountant; the distinction may be subtle, but there is a difference.

This self-analysis would, for example, give added emphasis to the demands for an intensification of the student's exposure to the liberal arts and the humanities in the schools of business.

In brief, such a liberalizing education, furnishing the infrastructure for the self-analysis referred to above, would help to balance the technical emphasis of the education of the accountant (and business leaders generally). It is only through a shift in the central interest of accounting education within the university from the accountant's "doing" to his "being and becoming" that we will develop accountants in good numbers who have "a clear and compelling vision of [their] profession and of its relation to American

life." It is only when we teach accounting with a "liberating and liberalizing effect" that we will be able to overcome the crisis in communications, the crisis in integrity, crisis in confidence, which presently confronts our profession.

As an incident to the more deliberate emphasis on the liberating arts and sciences our students should recognize that our discipline of accountancy does not exist independently of other areas of knowledge. To the contrary, they would recognize that our area of intellectual pursuit may involve a body of special knowledge, frequently technical, sometimes exotic, nonetheless, our pursuit while it is impacted by law, mathematics, economics, philosophy, all of the physical and behavioral sciences. Reciprocally, our special area of professional responsibility impacts critically on economics, both micro and macro, political science and government, as well as all of the behavioral sciences. In sum, our students sense the dignity and high intellectual quality of our undertaking.

And if you will forgive a note of nostalgia, again to go back a quarter of a century, I remember most felicitously the exciting inter-disciplinary discourse on my campus, and at schools of business throughout the nation, revolving around two 1959 seminal studies the one, Pierson's "The Education of the American Businessman," the other, the Gordon-Howell "Higher Education for Business." From all appearances this subject is not even remotely of interest for our American Assembly of Collegiate Schools of Business.

Alan Bloom's The Closing of the American Mind might well have afforded us the opportunity for just such an intensive dialogue, reappraisal and response. In that controversial work, Professor Bloom singled out our Schools of Business for special criticism, branding them as essentially "trade schools." He was especially caustic in his commentary on our MBA candidates.

I do not know what went on at your campuses but at my home base there certainly was no big bang, in fact, hardly a whimper.

Fair vs. GAAP - Fair:

Reverting to the central theme of Communication, I turn to the very special idiom of our discipline -- the very language we use to present our findings to those entitled to know, i.e., the world of statement users. Let us consider the hallmark of our professional pursuit, the "certificate," the independent auditor's report with which we grace our client's financial statements, we there opine that the financial statements present fairly in all material respects the financial condition and results from operations in accordance with generally accepted accounting principles. The phraseology is simple enough, but the meaning is elusive.

Thus, the accounting profession has never meaningfully responded to the catechism, i.e., does the phrase mean:

- o That the statements are inherently fair; or
- o The statements are fair because GAAP has been applied; or
- o That GAAP has been applied fairly so as to produce statements which are fair; or
- o The statements are fair only to the extent GAAP is fair; or
- o The statements are fair because the rules applied to the accountings were culled from the book of rules dubbed GAAP?*

* Mirabile dictu! As of May 31, 1991, the AICPA promulgated an Exposure Draft reflecting a proposed statement "The meaning of present fairly in accordance with generally accepted accounting principles included in the independent Auditor's report."

Alas! All that was contemplated by that draft was some reconfiguration of the hierarchy of the sources of substantial authoritative support for the GAAP. For me, given the issues involved, the proposal is something like rearranging the deck chairs on the Titanic.

In short, I have, in all too many instances, exemplified in articles, books, lectures, testimonies and in other contexts that statements which are consistent with GAAP, may, nonetheless, be inherently unfair.

And then there is another category of financial statements which I deem to be inherently unfair, and not even GAAP-Fair, when judged by the usual FASB/APB book of rules; nonetheless, they carry the imprimatur, the nihil obstat, from Higher Authority, namely, the staff of the Securities and Exchange Commission.

Thus, I have identified some \$72 million of income unfairly dumped into Waste Management's 1989 income resulting from the sale by its subsidiary, Chemical Waste Management, of some newly-minted shares. The dispensation, it turns out, was in an SEC Staff Accounting Bulletin No. 51 ("Accounting for Sales of Stock by Subsidiary," March, 1983)).

And then, in April, 1990, Sanifill, Inc. was allowed to apply the pooling-of-interests mystique when it acquired a nexus of dump sites for \$30 million, including about \$10 million in cash. This obvious deviation from the APB 16 rules for pooling notwithstanding, the pooling accounting was sanctioned by the SEC staff, this time citing staff Accounting Bulletin No. 48 ("Transfer of Assets by Promoters and Shareholders," September, 1982). As a consequence, the \$30 million cost was booked by Sanifill as a negative \$8 million - yes, Virginia, at \$8 million less than zero.

Comes now the high-powered, politicized thrust by Supergiant AT&T to obtain the SEC's dispensation for pooling-of-interests accounting as a condition precedent to its acquisition of and merger with NCR. I find this distressing and absurd -- if not obscene. I fail to comprehend the moral justification for a managerial judgment call to be crucially predicated on the way in which the debits and credits would be entered into the books of

history. The litmus test should be whether the resultant economic and social attributes are expected to prove salutary for the enterprise and those to whom it relates.

In fact, it may well be that neither the SEC nor even the entity's independent auditor should be called upon, or even permitted to, render an anticipatory, declaratory judgment regarding the accounting treatment to be accorded to any contemplated transaction. Instead, management should be constrained to make the critical decision predicated on its calculations of the anticipated flows of revenues and cash leaving it to the independent historian to determine the most appropriate precepts culled from GAAP which most appropriately reflect the economic realities inherent in the transaction.

All this ambiguity induces the Myth-Reality dichotomy. The public, as we know, presumes that the independent auditor has "fought the figures and found the facts and told the truth about them" very much like the gallant knight envisaged by Colonel Montgomery. The public, as we know, presumes that it is the independent auditor who determine which of the principles from our Good Book of GAAP are to be applied to a particular enterprise, to a particular nexus of transactions.

We know the truth diverges about 180° from that perception. We know that it is the enterprise's management which determines the accounting alternatives for which it has opted in the particular circumstances; we know that the client may well have contrived transactions so that a particular accounting precept could be made operative. We may well be aware that the accounting presentation is not inherently fair; viscerally we may believe that the statements are, in fact, inherently unfair. This sensitivity notwithstanding, if the client's management can demonstrate that the precepts applied can, somehow, be "shoehorned" into GAAP, the auditor, however independent, has

little alternative but to "shut his eyes," "hold his nose," "plug his ears" and sign up to the "clean certificate." This condition leads to what our profession prefers to call the "expectations gap"; I refer to it as the "credibility gap," inducing a "crisis in confidence."

I have in some contexts suggested that the auditor's certificate should be accompanied by a skull and bones logo -- to make clear that swallowing or inhaling the reported data could be injurious to the reader's financial health.

Fair, GAAP - Fair and the S&Ls

The distinction between Fair and GAAP - Fair is demonstrated most dramatically by the Tale of Two S&L Judicial Determinations -- both involved suits brought by the owners to recover the institutions from the conservators appointed by the Office of Thrift Supervision ("OTS") ; one involved the Lincoln S&L, the other the Franklin S&L.

The former opinion, rendered last August by U.S. District Judge Stanley Sporkin analyzed in great detail a nexus of transactions structured by Lincoln -- all presumed to have been booked in accordance with GAAP, and then proceeded to cut through them to get to the substance, and determined that they were nought but ploys contrived to divert resources from the S&L to its parent, Charles Keating's, American Continental Corp. ("ACC").

Central to the scheming was a 1986 tax-sharing agreement entered into between Lincoln and ACC whereby the former agreed to pass up to its parent the tax (40%) on its income. This is, as far as it goes, a relatively common arrangement between affiliates. But, and this is a most critical "but," the basis for the upstreaming was Lincoln's income determined by its GAAP calculus, rather than on its "stand-alone" tax books. You see, under the latter reckoning Lincoln would owe nothing to ACC; on the GAAP basis \$94 million was siphoned out of Lincoln by its predatory parent. And then, to

exacerbate matters, the 1986 agreement was made retroactive to 1984.

With that contrived arrangement in hand, Keating's fun and games began.

Judge Sporkin then set out a series of concocted transactions oriented towards increasing Lincoln's GAAP income, all to the glory of ACC, especially the 40 percent upstreaming. For example, Lincoln contrived a \$14 million land sale, with an \$11 million bookkeeping profit, with \$4.4 million moving upstream as the tax. The terms of the sale were \$3.5 million cash and a non-recourse note of \$10.5 million. Clearly, the numbers do add. But again, as it happened, the purchaser, Wescon, was a corporation of "straw"; the \$3.5 million in cash was, in fact, generated by Lincoln in the form of a much larger loan to Wescon's alter ego, someone called Garcia.

There were other such incestuous transactions; there were so-called "parking" transactions to provide intermediaries required to sanitize transactions and thereby legitimize them under GAAP. Judge Sporkin's lament:

Based upon the facts, the Bank Board was absolutely correct in its conclusion that the Wescon transaction amounted to an unsafe and unsound practice and resulted in the dissipation of a substantial amount of Lincoln's assets. This finding is so despite the position taken by Arthur Young and the testimony of the ACC's accounting experts. The court was quite surprised by these experts' rationalization which supported plaintiffs' position as to the appropriate accounting for this transaction. To be generous to the position expounded by plaintiffs' experts, the Court will attribute the position they took to the abstract application of accounting principles.

What it is hoped the accounting profession will learn from this case is that an accountant must not blindly apply accounting conventions without reviewing the transaction to determine whether it makes any economic sense and without first finding that the transaction is realistic and has economic substance that would justify the booking of the transaction that occurred. Moreover, they should be particularly skeptical of any transaction where the audit trail is woefully lacking and the audited entity has failed to

comply with the record keeping requirements established by a federal regulatory body. Of course, the accountants might say they did not have access to the facts that either the Bank Board or the Court had, and it is thus unfair to criticize them for any mistakes they may have made. The fact is the accountants have been aware of the true facts for many months now and have taken no steps to disassociate themselves from the transaction, and indeed have attempted to rationalize before this Court the propriety of the actions they took in allowing the transaction to be booked as it was.

Judge Sporkin then provided the following as a footnote: "Accountants must be particularly skeptical where a transaction has little or no economic substance. This is so despite the fact that the transaction might technically meet GAAP standards."

As a consequence, Judge Sporkin denied Keating's plea that his ravished Lincoln be returned to him; gone now are Keating's lectures regarding the incompetence of the regulators by this failure to see how his fiefdom was as clean as a hound's tooth, and would have been prospering were it not for the bureaucrats.

Any course in auditing should have as something of a textbook case study the savings and loan fiasco and the role and responsibility of our profession for that dismal antisocial phenomenon. For this purpose the Lincoln S&L and Judge Sporkin's opinion might well serve as a remarkable case study.

The Franklin S&L circumstances were different. There were no allegations of skullduggery. Instead, there was a most unique institution; it hardly engaged in a traditional savings and loan operation. Instead, it took in brokered deposits and invested them in mortgage-backed securities and proceeded to engage in a broad spectrum of so-called financial futures hedging transactions - in which Franklin sustained hundreds of millions of dollars in losses. Because of these losses, the OTS determined the institution to be

insolvent and appointed a conservator. Franklin's owners brought suit, asserting that under GAAP it was not insolvent.

The key factor: Pursuant to FASB Statement 80 the enormous losses, assuming that they could be proved to be hedging losses, are permitted to be spread over a seven-year span. If then, these losses were permitted to be thus booked as accounting assets, well, then, Franklin was solvent.

The threshold question confronting Judge Saffels was whether the transactions were, in fact, hedging rather than speculative. This involved some intriguing probes into the esoteric correlations which would determine the nature of the transactions. At the end Judge Saffels upheld the sanctity of GAAP and ordered the institution returned to its owners. (The judgement was put on hold; the OTS is appealing.)

With all due deference to the wisdom of the judge, while I can see SFAS 80 as a nice income-smoothing device, I find it difficult to see how the OTS could be expected to pay off Franklin's obligations with the deferred hedging losses. In fact, I can see a Polish joke coming on: the one about the embezzler who made off with Franklin's assets; -- he stole Franklin's deferred hedging losses.

The S&L Numbers Game

Before leaving the S&L quagmire, permit me to share some considered views on that traumatic debacle. I have asserted that while the accounting profession did not produce that quagmire, it could not have occurred if the profession had fulfilled its responsibilities. Essentially, the record of these failed institutions regularly discloses the complete disintegration to the point of nonexistence, of a system of internal controls. The Lincoln and Silverado cases, for example, are typical. An essential condition precedent to the fulfillment of the audit responsibility is to develop confidence in the

system of internal control, of checks and balances. Instead, loans of enormous sums were passed out without meaningful analysis, presumed collateral turned out to be nonexistent or at the least undocumented.

And then there was the fakery of the numbers which our colleagues permitted to be entered into the books as assets, even beyond the Franklin situation. What is the consequence of that orgy? True, it is traumatic for all of us. Nonetheless, our generation is not being made to pay the cost of that provision. Instead, we are passing the ultimate burden to our children and posterity. Taking the immediate swamp at but \$250 billion, the most recent estimate, we are "zero-couponing" or "PIK-ing" the debt; the \$250 billion, then, swells to \$3.3 trillion after 30 years, applying a 9 percent compound interest rate. (It would be "only" \$3 trillion if an 8 percent rate were applied.)

An Angry and Frustrated Cassandra:

On occasion I have concluded this polemic on the following note:

I know I have thus spoken as a Cassandra -- frustrated and angry; nonetheless, I believe I am entitled to react in that fashion. Back in November, 1985, I testified before the Subcommittee on Oversight and Investigations of the U.S. House of Representatives Committee on Energy and Commerce. The Title theme of the prepared presentation read "Accounting Controversy in the Savings and Loan Industry (Accounting Alchemy -- Creating Assets out of Nothing)."

In the course of the statement I said the tragic consequence of this glorious entertainment is that the savings and loan or thrift industry can be seen to be floating on a sea of watered accounting numbers dubbed assets. Possibly even more tragic, is that the industry's life jacket, the 'FSLIC', may be wholly inadequate to keep the industry afloat. My statement concluded, "I sense an endeavor on the part of the Bank Board to induce a series of accounting practices to help to obfuscate or 'paper over' the problems confronting the savings and loan and thrift industry. And if the past be prologue, absent strong countervailing pressures, the Board will find willing allies among the Accounting Establishment."

But now I want to go on, again speaking as Cassandra, and predict that the past is but prologue to an even "worster" future. Thus, the saga of the savings and loan disaster is being replicated in the realm of our commercial banks; we find a corresponding manipulation of data to make things appear to be less dismal than the underlying conditions warrant; when the institution cannot hurdle the barriers set by the regulators, the bars are lowered so that they can then be hurdled -- until even these standards cannot be met -- leading to further lowering. And in all this the accounting profession will oblige the regulators and banks, and pretend that so long as we are proceeding in accordance with the revised promulgations we are fulfilling our appointed rounds.

Sadly, this "Blue Smoke and Mirrors Syndrome" is not restricted to banks, S&Ls, or even business enterprises generally. It engulfs and permeates our entire environment -- reaching to its very apex, the United States Government. The off-balance sheet liabilities proliferate and at ever - increasing, mind-boggling sums. And where expenditures threaten to violate Graham - Rudman they are moved off budget.

And while these increased levels of expenditures may serve to improve and multiply the potential for destruction in our armormentarium, the essence of our civilization, its people, institutions, communities and their infrastructure are allowed to decay. Oliver Goldsmith's lament is again brought to mind.

The savings and loan cesspool is a tragic reminder of the observation by the late distinguished Circuit Judge Henry Friendly that "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."

The "Big Wheels" Rediscover the Wheel:

March brought forth a report on Internal Control promulgated under the sponsorship of those at the very highest levels of our profession's hierarchy -- those in practice as well as academe. The publication brought forth inquiries from representatives of the financial media; my response was that the promulgation was nought but unmitigated PR. (I could not bring myself to apply more colorful epithets - those which are now common in our literature and student argot.)

I reminded the inquirers of the Foreign Corrupt Practices Act of 1977. That post-Watergate enactment required that all entities registered with the SEC develop and maintain an effective system of internal control; the provision followed the prevalent auditing standards. Consistent with the covenant taken by the Commission when the legislation was working its way through the Congress, the SEC proposed that the independent CPA be required to review, and overtly express an opinion on, the client's system of controls.

Oh what a torrent of protest came forth from our colleagues. I remember well how that proposal was derided by the AICPA, Vice President - Auditing (now a distinguished colleague in academe) during the course of a distinguished lecture at my distinguished institution. Needless to say, that proposal was withdrawn "for further study."

That was more than a dozen years ago. Since then we have seen the corruption of system after system in our S&Ls, banks, brokerage firms (e.g. Hutton and Drysdale), as well as just plain ordinary business enterprises. What makes the situation even more distressing is that our profession's much touted professional disciplinary process appears to be entirely oblivious of these developments; I have not heard of any meaningful sanctions imposed by the POB nor by the various state licensing bodies.

But, those reports do serve a most vital function - our colleagues in academe have something new with which to regale their students. Not inconceivably, the AICPA might even find some kernel hidden away in the promulgation to serve as the basis for a question on the CPA examination.

LBOs, MBOs and the Evils Which Live After Them

A discourse on "Ethics and Accountancy" cannot avoid a significant commentary on the LBO/MBO/Takeover Mania of the Decade of the '80s. My agonizing concerns regarding the phenomenon have been spread on the record in, for example, "Cannibalizing the Transcendent Margin" (Financial Analysts Journal, May/June, 1989), "LBOs and MBOs in the Takeover Alphabet Soup," (University of Iowa Journal of Corporation Law, Winter, 1990). For present purposes I want to review, however briefly, the evils which will live long after the catatonic decade of the '80s.

To begin with we have the watered balance sheets, the enormous deficits in tangible net worth, resulting from the issuance of billions upon billions of high-risk, junk bonds, offset only by what we accountants graciously dub "Goodwill." Mind you, if the good in the goodwill represented the true discounted value of demonstrated excess rates of profit, the asset might be rationalizable. Instead, it is in the first instance the overplus of the amounts the acquirers were able to borrow for the takeover over the net identifiable assets -- regularly the historic carrying numbers. To which is added all of the costs incidental to the takeover -- fees for the underwriters, lawyers, accountants, proxy solicitors, as well as the costs involved up to the date of the closing of the transaction. And that intangible remains as the goodwill even after the market place has settled down from its psychedelic high -- subject, of course, to the straight - line 40-year writeoff, which, in turn, Henry Kravis of KKR, the acquirer of RJR

Nabisco tells you to ignore since it is only bookkeeping and not a cash cost. (In this connection I suggest you note my "Shame on you, Henry Kravis" essay in Barron's, March 6, 1989).

Mr. Kravis would most certainly want to divert your attention from the accounting numbers -- even beyond the intangibles - amortization item. Clearly, the devastating interest cost burden stemming from the new debt spills enormous amounts of red ink on the bottom line. To confirm this you are urged to ignore the accountant's income calculus and, instead, emphasize cash flow - counsel which the accounting profession accepts with hardly a whimper.

By his counsel, Mr. Kravis, for example, hopes to obfuscate the cost of PIKs and zero-coupon obligations.

But even more grievously the takeovers with their emphasis on immediate cash flows, concentrate on the short-range, near-term results -- thereby impacting inimically on research and development, capital asset maintenance and expansion. Adding to the deterioration of the American economy is the disposition of segments of the acquired entities -- frequently to newly-created leveraged entities and foreign conglomerates.

Further, the cash-flow devotees should be reminded that the South Sea Bubble, Ponzi Scheme, Pyramid Games and the S&Ls, each in its own day, was wallowing in positive cash flows -- only to collapse at the moment of truth. Sometimes the phenomenon survived that "moment" for a time -- the wise counsellors refused to accept the fact that they had been deluded by the mirage.

Nor should we overlook the serious erosion in our corporate tax structure resulting from these takeovers. For example, during the year prior to the KKR acquisition, RJR Nabisco contributed \$350 million to the U.S. Treasury --

thereby contributing a modicum of the costs which the company is imposing on society by its encouragement of tobacco addiction. Henceforth RJR Nabisco will not be called upon to contribute to making the world safe for its multinational nefarious activities, or to the subsidization of the growers of the agricultural products, e.g., tobacco and foodstuffs, which it thereby acquires at less than fair value. In fact, an RJR Holdings prospectus promulgated after the takeover indicates that there may be some possibility of claiming refunds by reference to carrybacks. In sum, the tax subsidizations and subventions provided to the decapitalized entities is anything but a free lunch for society.

My Considered Response:

I will here pause to provide my considered response to this critical socio-economic-legal-philosophic dilemma. In this context as in most others, I extend the "public watchdog" function to all aspects of the accounting profession's presumptive responsibility to society, hence, to assume full, fair, open and timely disclosure regarding the governance and accountability of the corporate enterprise which so vitally and materially impact on our society.

To this end, I regularly urge that we "clean up our act" insofar as our accounting precepts are concerned, especially, in this context, the accounting for goodwill. (And while they are studying misapplication of purchase accounting, the FASB should probe the pooling - of - interests alternative for business combinations accounting and proceed forthwith to the exorcism of that misbegotten Dybbuk.)

I urge that the potential acquirer be required to spell out with reasonable specificity what is contemplated to be done with the acquired resources, and by whom these pools would be administered. I maintain that it

is utter nonsense to assume that KKR, for example, would be committing more than \$25 billion in funds to acquire an enormous undefined pot of net assets. Nor is it logical that the game plan has not been meticulously spelled out to the financial institutions which are providing the bridge and "mezzanine" financing. If KKR et al., were ignorant of their program when proceeding with their tender offer, that in and of itself should preclude their proceeding with the transaction. In sum, I insist that the acquirer owes to all those who may have an important stake in the proceedings a "punctilio of an honor the most sensitive," i.e., the standard which Judge Benjamin N. Cardozo articulated for relationships between parties in a simple real estate deal (Meinhard vs. Salmon). If that is the rule relating to a mere inanimate parcel of property, how much more relevant must it be where the "fealty" should run to hundreds of thousands of shareholders, employees, potential bondholders, as well as to hundreds of communities which may be affected by the heaving and hawing in the wake of the takeover.

Ethics and the Groves of Academe:

And now I move to the impeachment of that which goes on within our Groves of Academe. There we find teachers, not always fully familiar with the profession serving as clerics to impart the facts and techniques contained in the text books. Because of pressures of time (or less than adequate comprehension) there is little time devoted to conceptual discourse; and the normative and ethical challenges referred to in the foregoing critique are given even shorter shrift. And, in view of the Institute's determination to deemphasize essays and concentrate the CPA exams on "objective tests" the condition will undoubtedly deteriorate even further.

And then, when the action moves to the doctoral realm the Brahmins and their faculty mentors become obsessed with the publish or perish syndrome.

This means trying to identify a theme which could be pursued in some esoteric fashion so that an exotic quasi-scientific presentation might evolve. The resultant article, if published, is destined to have little, if any, relevance -- and will be useful only to other monastics who will then replicate the research in order to confirm, refute or extend the earlier irrelevancy.

I lament this condition by observing that at this exalted level presumptive first-rate accounting scholars are constrained to demonstrate their competence as second-rate financial analysts, applying a third-rate mathematical methodology, predicated on fourth-rate data, compiled by fifth-rate drones.

And then, I add: All this meets with unqualified acclaim and support from the practice sector of our profession -- it keeps the putative scholars out of where the problems are really festering.

Whither Academe?

What should be the scholarly, intellectual pursuit? In good measure the critical commentaries contained in the foregoing should provide the direction. Thus, I might expect the scholars to undertake a truly independent Peer Review initiative -- one that would probe prevailing accounting and auditing practices with the academic independence to which we are presumed to be dedicated. With that same intrepid independence I suggest that we pursue the major LBO/MBOs along the stream of their subsequent deployments and redeployments -- in order to determine their social and economic consequences.

Further, the putative scholars might study in depth the environment in our major accounting firms to judge the impact of current developments, e.g., disclosures of audit failures, the accelerated proliferation of nonaudit services, firm mergers and reorganizations.

And then, I urge that greater and more intensive scrutiny be given to the

activities of the principal institutionalized organizations in our profession, including: The FASB and its EITF, the Public Oversight Board and its Special Investigations Committee, the AICPA ethics - enforcement activities. A similar probe might be undertaken of the SEC's and Congressional effectiveness (or lack thereof) in the implementation of the Securities Acts.

Further, our colleagues in academe should recognize their responsibility for the shaping and evolution of our special body of knowledge. At present, that responsibility has been abdicated by us and ceded to the Financial Accounting Standards Board for the most part, and to a lesser extent to the SEC. I believe it is fair to assert that this is a most extraordinary phenomenon; about the only exceptions I can conjure up might be the hierarchy of a dogmatic, fundamentalist religious persuasion and, possibly L'Academie Francaise for its role in assuring the purity of the French language -- unless its "the truths" disseminated by an Orwellian ministry of information. Otherwise, the development of the underlying concepts, paradigms, parameters and the like are presumed to be within the domain of the universities. We see this for example, in the fields of law, medicine and even theology (with the exception noted)

On frequent occasion I lament the passing of the Accounting Principles Board. Those of us who are of the generation when that board was in existence remember that about one third of the places were occupied by colleagues in academe. Their voices were heard; their views importantly considered. Their positions provided such visibility and were of sufficient responsibility, for the members and their institutions so that our colleagues wrote and lectured to give vent to their views -- thereby advancing academic controversy regarding the issues confronting our profession in practice. Those of us who are even older recall most vividly the excitement with which the APB was

launched during our Post-Sputnik trauma. We remember that there was created a Research Division headed by Professor Maurice Moonitz; and that process led to successive Accounting Research Studies under the aegis of recognized academics. Oh what a "golden age" that was; I compare it invidiously to the prevailing state of relative sterility -- where seminar after seminar are devoted more to mathematical manipulation than a meaningful probe of the real issues that confront us. This condition produces the euphoria described by Professor George Foster. He referred to a colleague at Stanford who enjoyed processing enormous quantities of data through the university's supercomputer "the way in which a pig enjoys wallowing in mud."

In short, there is a most exciting world on the horizon -- if only we would set our sights on it. Granted, to move into these areas will invite criticism and sometimes recrimination; but if those of us who are securely ensconced in academe do not manifest the appropriate intrepidity, who will?

There is yet another major area where academe should play a more direct, a more aggressive role; I am alluding to Continuing Professional Education ("CPE"). At present, offerings are heavily loaded with courses in the mechanistic aspects of accounting and auditing, and aspects of the conduct or our expansion of practice. I believe such continuing education would be pursued as a matter of course by those who wish to maintain their credentials "green"; any short-fall in these areas would soon become discernible by clients and would, shortly thereafter, be reflected by the CPA's bottom line. Thus, they do not require the pressures from the AICPA or the licensing bodies to goad the practitioner or his firm to pursue those studies.

Instead, in my view, the continuing education of the professional person should be oriented towards his ongoing recognition of the responsibilities vested in us as professional persons and especially as such persons heavily

charged with our third-party responsibilities. I am, of course, proposing the professional's ongoing education in the liberal and liberating arts.

Then too, I would proscribe, or severely limit, the extent to which accreditation would be allowed for courses offered "in house." The reasons for this view include:

- oo The disciplining of the offerings and certification of credits is, at the very least, open to question. I doubt the ability of an instructor to deny credit to a principal partner even though he has had a more vicarious association with the proceedings.

- oo Such offerings are "incestuous" to the extent that persons within the firm are involved in a dialogue with persons of corresponding backgrounds, interests and biases.

Thus, the participants in these "in-house" programs, generally within the major firms, are not made aware of challenges confronting local practitioners, or those in competitive firms.

Further an instructor in such an in-house offering might be especially sensitive, and correspondingly guarded, when presenting critical case studies reflecting the firm in a less than ideal light. And even if the instructor were possessed of the ultimate intrepidity, it is likely that the participants would manifest their sensitivity and circumspection when raising or responding to questions.

So it is that the optimal place for the kinds of offerings which could advance our profession's stature and responsibility should be within an university forum.

But now I must move to the what might be dubbed the "defining challenge," namely, for each of us to respond to the Socratic mandate, "know thyself." Thus, I have considered with you the ethical precepts which might be

integrated into our offerings in accountancy, auditing and taxation, and at all levels from introductory accounting at the undergraduate level to the terminal responsibilities of our scholars in our doctoral programs. But what about ourselves, our own personal ethical roots? Clearly, that which I have been suggesting as the precepts to be appropriate for our scholars might well serve to guide our own conduct and our ethical and moral code; that code manifests itself in many ways.

To begin with, the very way in which we present the material, the issues we raise, and our responses to questions from students, all testify to our own frame of reference. The way in which we respond to academic challenges during committee, departmental or institutional deliberations similarly reflect on the totality of our values.

And then, when we turn to the publishing of articles, books and treatises, are we manifesting the ethical and moral standards which we believe to be consistent with our notions of Transcendence, to bring us, and society to higher levels of consciousness and conscience?

Finally, when we are called upon to provide testimony before legislative, judicial or professional bodies, do we respond with the Independence, Integrity, and Intrepidity required of us for those sometimes awesome responsibilities? Or do we, instead, provide "the best testimony money can buy?"

Reverting to the theme implicit in the opening gambit for my undergraduate students, namely: The very essence of the accounting pursuit is communication and the very essence of communication is measured by studies of ethics and morals. This recognition will not come from the repeated recitation of rules in a code of professional conduct, nor by repeated Clicheistic platitudes. No, the objective can be attained only by the ongoing continuous dialogue among

teachers and students who are committed to understand themselves and where and on what they stand in relation to their professional undertaking.

In brief, you must search for the answer to the ethical challenges in our discipline of accountancy and then to determine the extent to which, and how, you will be exposing your students and colleagues to the totality of your values.

A Side Bar For Our Teachers Of Taxation:

Those of us responsible for offering courses in the area of Taxation have some very special challenges and responsibilities relating to ethics and ethical behavior. This follows from the fact that the practice of taxation involves the accountant in a number of roles, sometimes at odds one with the other. Thus, he is on the one hand an advocate, on the other the independent professional responsible for guiding his clients through the complexities of the law, towards determinations which are consistent with the law. And then, he is required to be like Shiva possessed of a proliferation of limbs, called upon as an especially knowledgeable and responsible citizen to participate in the evaluation of the tax laws towards a "just tax" as he conceives of it -- even if such an involvement would be inimical to his clients -- and even if, as an incident to his current practice, he may be applying the unjust precepts as an incident to his advocacy.

All this calls for the professor to challenge his students to probe for a philosophy of taxation in our democratic society, and then to develop for himself a philosophy of practice as a professional -- a philosophy which is rooted in Independence. Also, to be reconciled is this role and responsibility as an advocate in the realm of taxation if it is being pursued concurrently in the same client situation with that as the independent auditor. Clearly, this area of practice calls upon the practitioners to have

a well developed, solidly based ethical compass.

Our academic brethren might also direct their scholarly endeavors towards unbundling the income tax mystique of our major corporate enterprises. They could then disclose to the public that which is not readily discernible, namely, the amount of tax actually and really being paid to our Federal and State governments.

Those who may have a propensity for relevant empirical research might test the validity of the prevalent politically correct gospel which holds that the current recession would be plunged into a severe depression if the marginal tax rate were increased from 31 percent to say, 40 or 50 percent. Just as our most highly-regarded accounting scholars regularly join with their finance colleagues, our tax researchers might associate themselves with their cohorts in economics to develop models to determine the ways in which increased taxes might work their way through the Keynesian dynamics.

My experience informs me, a priori and anecdotal, of course, that such increased revenues directed towards the rebuilding of our infrastructure in bridges, airports, education, the arts, libraries, parks and public amenities could have a most salutary dramatic impact on our employment statistics, and nation's morale.

That same experience informs me that the taxes avoided by those of us who have had our marginal brackets reduced from 70 to 50 to 28 percents over the past decade, have not generally dedicated the taxes thus avoided to the advancement of our industrial enterprise. Instead, we have been plowing those surplus funds into money-market accounts, U.S. Treasury securities and to the swapping of what still remains in the supply of equity securities.

Again, this very same experience reminds me that we enjoyed extraordinary periods of prosperity, with almost full employment, when we felt good about

our commitment to advancing the political and economic societies around the globe, when the marginal tax rates were, as noted, as high as 70 percent.

To all this the critical challenge is, "Why not now?"

Coda:

The critical thrust of this presentation might well be exemplified by a morality play retold in the Sunday, March 24, New York Times. The front-page article, complete with a full-length picture, captioned "A Straight Arrow's Inexplicable Fall" told of the legal quagmire in which Mrs. Patricia Ostrander finds herself. The lady, a competent bond-fund manager, appears to have had her ethical compass disoriented by Michael Milken. Like so many others who were associated with the Drexel Beverly Hills "bordello" Mrs. Ostrander was admitted to at least one of the Milken "insider partnerships," the sweetheart deals he used to compensate those who were helpful to him in hustling his junk bonds. (For example, my "Drexel's Greediest Deal," Barron's, December 5, 1988). The lady was most accommodating; she loaded up her bond funds with Milken junk. What makes the situation "inexplicable" is that Mrs. Ostrander is not of the yuppie generation, and from all indications, not especially identified with high and fast living. What I find especially relevant were a couple of commentaries included the Times article, to wit:

As sociologists and historians begin to pick through the remains of the fever-ridden 80's, many are struggling to understand what caused so many people of professional standing to leave the straight and narrow, either through lapses in judgment or outright breaches of ethical and legal standards. Mrs. Ostrander's story is far more unsettling than that of the stereotypical 26 year old yuppie longing for a new Ferrari and discovering how to bend the rules to get it. By contrast, Mrs. Ostrander had a lifetime of achievement to protect; her apparent willingness to jeopardize both her career and her reputation underscores just how seductive - and treacherous - the 80's were.

"They set up their own culture," said Samuel L. Hayes 3d, a Harvard Business School professor, speaking of those who lived in the high-yield world of Michael Milken. And in that culture, "I can imagine people saying, 'It's perfectly legitimate, you deserve it, we're all doing it.'"

How Mrs. Ostrander ultimately fares in the suit and whether she is even indicted remains to be seen. What is clear is that in the 80's, many individuals were forced to make ethical choices in the face of extraordinary financial opportunities. At the time, it often seemed as if there were no downside risk. But in many cases, the true cost of those decisions is only beginning to be measured.

This last point demands special emphasis. The students for whom all of the foregoing is nought but sermonizing from the ivory tower, or from the State of Limbo to which professors emeriti are assigned, should be made to respond to the following acid test when confronted with a judgment call involving their ethics, their values, thus:

Assuming that you are prepared to thus compromise, expecting that the matter would not be detected, or that you would otherwise avoid adverse consequences, are you prepared to take the consequences if the future does not work out consistent with your scenario? Remember, those involved in the Watergate, Iran-Contra, Drexel-Boseky - Milken imbroglios undoubtedly assumed that the perfidious conduct would go undetected or, in any event, they would be able to quash any adverse consequences. This fateful flaw appears to have been inherent in the sad sagas involving the late Justice Abe Fortas and Senator Harrison Williams and, more recently, Nobel Laureate David Baltimore, the Stanford University administration and the distinguished advisor to American Presidents, Clark Clifford.

Then, too, where the Faustian challenge occurs in a client-related circumstance, e.g., attest or tax, the CPA should be aware that he and his client are not playing on a level-playing field. For the client the tens or hundreds of millions of dollars which might result from the perversity, and

stashed away in various funds possibly beyond detection, might be adequate compensation for a brief period spent in involuntary confinement.

For the professional person the material benefits would undoubtedly be little more than crumbs, relatively speaking. More importantly, for him the fall from grace would be particularly severe. He risks not only the overt sanctions of the law, but his professional license, and the prestige which that affords will all be put into jeopardy.

So it is that while this presentation has been concentrating on the "good life" because of the rewards that it offers for society, the professional and his profession, we must not be oblivious of the other side of the coin, the punishment contingency.

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NB: THIS TRANSCRIPT WAS TYPED FROM A TRANSCRIPTION UNIT RECORDING AND NOT COPIED FROM AN ORIGINAL SCRIPT. BECAUSE OF THE POSSIBILITY OF MISHEARING AND THE DIFFICULTY IN SOME CASES OF IDENTIFYING INDIVIDUAL SPEAKERS, THE BBC CANNOT VOUCH FOR ITS ACCURACY.

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VOICE OVER INTRODUCTION:
accounts that can mislead.

Tonight, auditors under pressure over

PETER WILLIAMS: Accounting standards have been pushed right to the limit in the last few years and the auditors really haven't been strong enough to stand up and do something about that.

MRS ROBIN HILLYARD: The auditors' report has really misled the shareholders very much because it just seems to bear no relation to fact at all.

VOICE OVER: Then the crisis at Jaguar, with production now part-time, is the firm running out of road?

And in Notebook, the broader recession, how real is talk of a 1930's style depression?

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(ACTUALITY)

IAIN CARSON: This is the ultimate in gambling, but at least it's fair. In roulette you bet on the numbers and you take your chance. You know what the odds are and as gambling in Britain is regulated there is an inspector up here in the chair to enforce the rules. But in business and in that other casino, the City, the odds and the numbers are not always what they seem and the inspectors in that case, company auditors, often seem to let the punters down.

In the last couple of years, an auditor's seal of approval for a company's account has not been the guarantee of underlying health that investors once believed, even with accounts that are technically correct.

August 1989, Sock Shop reported profits of nearly four and half million pounds.

QUOTATION: "In our opinion these accounts give a

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true and fair view of the state of affairs of the group. Stoy Hayward Chartered Accountants".

CARSON: Six months later Sock Shop collapsed, after over-extending itself in America. Administrators were called in. May 1989, the financial services group; British and Commonwealth reported profits of one hundred and sixty five million pounds.

QUOTATION: "In our opinion the financial statements give a true and fair view. Deloitte Haskins and Sells Chartered Accountants."

CARSON: A year later B&C crashed owing nearly one and a half million pounds, after the discovery of hidden liabilities in the subsidiary audited by another firm.

In May 1989, the home furnishings group Coloroll reported profits of fifty five point six million pounds.

QUOTATION: "In our opinion the financial statements give a true and fair view. Binder Hamlyn Chartered Accountants."

CARSON: A year later Coloroll was in receivership with debts of one hundred and eighty million pounds, after a disastrous acquisition just as its markets were declining.

But the crash of the Polly Peck Group was the most spectacular of all. From fruit growing and packing in Northern Cyprus it became a two billion pound empire, including electronics and hotels.

(MUSIC)

It was the fastest rising share of the 1980s. Then last Autumn after a summer of damaging rumours, Chairman Asil Nadir failed to repay its nervous bankers. Soon police were raiding the London head office, Mr Nadir was arrested on a number of charges including theft. He's currently on bail awaiting trial. His company's in administration, its shares virtually worthless.

(MUSIC)

Inside the head office, fine Eighteenth Century English furniture collected at shareholders' expense is up for auction this Tuesday. The administrators are hoping it will raise three million pounds, a small contribution towards the billion Polly Peck owes its creditors. But it won't help the shareholders.

Mrs Robin Hillyard was one of Polly Peck's eighteen thousand small investors attracted by one of Britain's best performing shares. Her pride and joy is her herd of pedigree English cattle, but the declining proceeds from selling beef are now her only income. Her plans to retire in comfort thanks to her Polly Peck shares are in ruins.

MRS ROBIN HILLYARD: I read the accounts carefully and they all seemed very good, perfectly okay and very buoyant and they always gave good dividends or shares in lieu of dividends which I built up my holding that way.

CARSON: Mrs Hillyard cannot understand how the company's auditors, Stoy Hayward, could give their approval to a set of accounts that proved to be so poor a guide to the company's finances.

HILLYARD: I think there's no doubt at all that the

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auditors' report has really misled the shareholders very much because it seems to bear no relation to fact at all. I mean, if this is a professional company who audits companies, I mean it's a terrifying prospect.

CARSON: Gottfried Hoffman is a different kind of investor. He works for a Swiss bank in Zurich and has his own portfolio of mainly British and American shares. He bought seven hundred thousand Polly shares in 1984, in six years they doubled in value. But Mr Hoffman began to suspect that Polly Peck was overstating its profits.

GOTTFRIED HOFFMAN: I complained first at the annual meetings, and didn't get the proper response because the finance director would say well we have to adhere to the accounting standard and we are observing it. So, we can't do anything about it, and then I thought well, in that case the rules should be changed and that's why I wrote to the Institute of Chartered Accountants.

CARSON: What concerned Mr Hoffman was that most of Polly Peck's profits were earned in Turkish Lira, in the company's fruit business in Northern Cyprus, and in Turkey in its electronics factory. That local currency was devaluing heavily against the Pound. The losses caused by this were tucked away in a footnote to the accounts. Had they been deducted from profits they would over the five years to 1989 have wiped out three quarters of Polly Peck's reported profit.

In his letter to the Institute of Chartered Accountants, Mr Hoffman complained the accounts were misleading.

HOFFMAN: The accounts didn't reflect the reality really. The profits were really vastly overstated.

CARSON: Hoffman's letter came to the Keeper of the Accountancy Ark here in the City, but the Secretary of the English Institute of Chartered Accountants wrote back to Switzerland with the same response as Polly Peck's finance director. The accounting rules had been adhered to, no investigation was necessary.

MICHAEL LICKISS: If an investor makes a complaint to us and we are able to see that that is not complying with accounting standards then, of course, we would look into it, but at the time that that inquiry was made and that complaint, if you like, was made, then indeed the company was complying with accounting standards.

HOFFMAN: One wonders how the accounting profession and the auditing profession takes the interest of shareholders to their heart. Not much I believe...

CARSON: Mrs Hillyard too finds the legalisitic approach of the profession hard to understand.

HILLYARD: Surely it is the accountant's job oversee the real state of a company, and that is what is, that is what counts, not the glossy brochure of the annual report, but the real nuts and bolts behind it.

CARSON: That voice finds an echo in the heart of the City.

(ACTUALITY)

Unease in the Bank of England about the

deteriorating standard of company accounts led it to back the creation of this new body; the Financial Reporting Council. Here at its second meeting it is getting down to its job, to sanction tighter accounting rules and stamp out abuses by companies.

Professor David Tweedie is the man who heads the new Accounting Standards Board, the frontline body for improving the quality of company accounts.

PROFESSOR DAVID TWEEDIE: What we have to do is to ensure that accounts are prepared under a framework which makes sense to management, which makes sense to the user particularly. Does it show him exactly what's happening to a company in terms of its profitability, in terms of the amount of cash flowing into the company? Does it show him how strong the company is financially? At the moment I don't think they do and we are going to try and work on that.

CARSON: But, it's one thing to set down rules in black and white, it's quite another to enforce them in the real world.

PETER WILLIAMS: The commercial pressure means that a strong board or a strong finance director really can get very much his own way. Accounting standards have been pushed right to the limit in the last few years and the auditors really haven't been strong enough to stand up and do something about that.

(ACTUALITY)

CARSON: No matter how tightly the new accounting rules are drawn, unlike gambling, there will always be grey areas where an auditor will have to use judgement. But some critics say auditors are biased by the conflicts of interest that the profession has brought upon itself.

(ACTUALITY)

Accounting in Britain is a two billion pound business, dominated these days by six big firms. These firms are auditors to most companies in the Stock Exchange.

(MUSIC)

The firms trawl the universities every year to recruit new talent. Tonight, Coopers Deloitte are at Cambridge where they hope to find the cream of the one in ten British graduates who choose accountancy as a career.

(MUSIC)

The potential recruits soon learn that here is more to accountancy than the auditor's job of approving company accounts.

(ACTUALITY)

Accountants started selling other services in addition to auditing in the late seventies. This has prompted fears that the integrity of auditors is undermined by the desire to win other business from audit clients.

Labour MP, Austin Mitchell has been campaigning to make auditors subject to statutory regulation to prevent them

coming under pressure from clients.

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AUSTIN MITCHELL MP:

The chief executive wants the highest rate of return and the maximum salary for himself. They want to sell services to a company; whether it's advice on balance sheet accounting, whether it's advice on management selection and it's all the other services that they offer. So, this is an incestuous relationship which is no good for anybody.

CARSON:

Even senior figures in the profession concede there are growing and damaging conflicts of interest.

CHRIS SWINSON:

During the 1980s, the conflicts grew because the profitability of auditing declined under the effects of competition and it became more important for us to sell parallel ancillary services to our clients.

CARSON:

So, has this affected the quality of audits?

SWINSON:

It has meant that the independence and objectivity of decisions has come under greater strain than heretofore.

CARSON:

Queen's latest release should do well for the music division of Thorn/EMI. Auditors have to use judgment in a number of grey areas and handling this property is one for Thorn.

(ACTUALITY)

Thorn has started putting copyright into its balance sheet as an asset but without making the usual charge against profits for decline in value of the asset. At a stroke of the pen, it boosts its stated worth without hurting its profits.

(ACTUALITY)

It falls to this man to approve such accounting treatment which would be banned in America. Richard Findlater, a partner in the firm of Ernst and Young is in charge of the Thorn audit. Here, he and colleagues plan the job of completing the audit after Thorn's year-end in March. He wouldn't be drawn on the copyright issue.

(ACTUALITY)

RICHARD FINDLATER:

The company and the management are the ones primarily responsible for preparing the accounts and for the accounting principles underpinning those accounts. The auditor's role is to take an objective view as to whether those accounts give a true and fair picture. You basically are looking at the risks which could mean that the financial statements could be misstated. Those risks are not fixed for all time and recession is clearly a risk which is on the agenda today.

CARSON:

Getting to know a client's business is part of an auditor's job. Theoretically, Findlater's clients are the shareholders who own Thorn/EMI; in practice, it's the management that Findlater deals with. It's also they who give his firm extra business.

FINDLATER:

We obviously provide other services to a company like Thorn and, frankly, there are relatively few major companies where we don't also provide some other services. We are involved in tax services to Thorn and we also get actively involved when they make an acquisition, if they wish us to, and other advisory services.

WILLIAMS:

Audit partners over the last few years have been encouraged to go out and find new business. They're really encouraged to become in some ways the marketing arm of the firms themselves. They do get an awful lot of kudos. They may even increase their profit shares, if they go out and they win new business.

FINDLATER:

The amount of business we do with a client is not unimportant to the progress that I or others like me would make but it isn't by any means the be-all and end-all. However, I don't believe our objectivity in auditing is affected by providing other services. We would be very foolish if in the thirst for other work, we ignored our role and duty as auditors.

CARSON:

The big firms are opposed to changes that would prevent them selling other services to their audit clients and force companies to change their auditors periodically. That's what Austin Mitchell wants.

MITCHELL:

I think it's actually good for the company that a new set of eyes comes in at a periodic interval, that this is known, that this has got to happen because it makes them more doubtful about embarking on dubious practices and it makes them aware that somebody else is going to take another look at things in a fairly short period.

CARSON:

Many of the issues now being discussed have been brought into public focus by events around one firm - Stoy Hayward. The West End firm which grew rapidly in the Eighties audited several high-profile companies which collapsed. Sock Shop was typical of Stoy's clients - fast-growing children of the entrepreneurial Eighties. Sock Shop's founder, Sophie Merman, and her husband, Richard Ross, a former Stoy's accountant, were nursed by Stoy's all the way to flotation on the unlisted securities market.

RICHARD ROSS:

When the company floated on the unlisted securities market, it helped to raise the credibility of the company and it helped us raise finance for future acquisitions.

CARSON:

But after a disastrous expansion into America. Sock Shop, worth seventy million pounds at its peak, collapsed. Esther Kaposi was involved in marketing Stoy Hayward at a time when business was booming.

ESTHER KAPOSI:

Stoy Hayward has an entrepreneurial approach to its business. It likes to work with small, fast-growing businesses that are perhaps run by one or two entrepreneurs and those types of people really do appreciate a lot of hands-on advice when they're growing their business, when they're thinking about ways to expand and so on and a medium-sized firm, such as Stoy's, can actually allocate younger partners to that sort of business and they can spend a lot of time nurturing the businessman, giving him advice about the types of activities that he ought to be doing and helping him to find finance to expand.

CARSON:

Another Stoy's client to run into trouble was, for a brief time, the biggest casino owner in London. Leisure Investments borrowed heavily to buy up a major competitor but, as interest rates rose and the casino business lost customers in the late Eighties, the founders, the Forsyth Brothers, sold out. The company ended in a receivership. Then, last autumn, administrators, followed by the police, moved into Polly Peck, Stoy's largest client. This time the accounts as well as the company came under scrutiny.

KAPOSI:

I think any firm that has specialised in helping entrepreneurial businesses will find that, in a period of difficulty for those types of businesses, it finds itself in the limelight. I think that there's always a danger that what happens to your clients will rub off on you.

MITCHELL:

It is rather unfortunate, isn't it, that that particular firm is auditing the affairs of so many firms which suddenly, unfortunately and totally unexpectedly, collapse. Now that would have me worried if I was working for Stoy Hayward, I would be saying why is this happening?, and I think the public has a right to ask that question too.

CARSON:

A select road in North London, the boss of another Stoy Hayward client, Roger Levitt (phon) lives here. He's on half-a-million pounds bail on charges alleging theft from clients of his investment business, Levitt Group, which collapsed in early December. In the House of Commons, Labour's City spokesperson, Miss Marjorie Mowlem (phon), set down an early-day motion that claimed:

VOICEOVER:

"The auditors, Stoy Hayward, who were the accountants for Polly Peck, were aware of the irregularities and have some link to the management of the Levitt Group, including the possibility that individuals received payments from the Levitt Group for introducing clients to them".

CARSON:

Stoy's declined our invitation to take part in this programme but they have previously firmly denied the allegations made in the House of Commons. Yet this letter, written to "Whom it may Concern" on January 27th 1988 and leaked to the "Mail on Sunday", shows that Stoy Hayward helped Levitt secure business by vouching for him.

VOICEOVER:

"We can confirm that we have acted for Mr. Levitt and the Levitt Group for a number of years and have an extremely high regard for the professionalism, business approach and integrity of the Group and its directors".

CARSON:

This kind of business recommendation for an audit client is considered unusual in professional circles.

WILLIAMS:

Stoy Hayward of course do all the services that you'd expect of an accountancy firm, they do the audit, they do accounting, they do tax, they do consultancy but I think something in the Levitt affair has demonstrated that maybe they also go further and they also actively at times help. All the allegation is that at times they actively do help their clients go out and get new business and are prepared to recommend some clients in what I think other firms would see to be quite an extraordinary way.

LICKISS:

I think it would be very inappropriate for the President of the Institute to speak about any particular firm. The reason for that is very simple: the President is not permitted to become part of disciplinary processes of this Institute and, secondly, it is still subjudice and investigations are going on.

CARSON:

Is that an indication that there might be disciplinary proceedings?

LICKISS:

I think it's too early to tell.

CARSON:

Are you looking at disciplinary proceedings?

LICKISS:

We are looking at investigating the situations which have been drawn to our attention, either by articles in the press or by comments which have been made to us by interested parties and those investigations are going on.

CARSON:

For investors like Mrs. Hillyard, the damage has been done and hints of investigations and promises of reform do little to restore her faith in investing in companies on the Stock Market.

HILLYARD:

Owning shares now is a whole different ball-game, it's much more a thing for the gambler - unfortunately, because I think we should invest in industry, I think industry needs our money and it's a good thing for the country but, in this current climate, it's an impossible thing for a small investor.

CARSON:

Will these accountants really do anything to make investing safer? They can't take away the risks but they could make them more apparent. The profession is taking tiny steps to open itself up to public scrutiny like bringing lay-members onto key committees. This and tougher rules from the new Standards Board are the profession's last-ditch attempt to regulate itself but some, even inside the profession, think such self-regulation won't be up to the task.

JAMES CARTY:

We still don't have sufficient backing from the government in my view and the Accounting Standards Board will still come under pressure from companies to produce inadequate standards. I think we've got to go the American route and have some form of government body overseeing accounting so that the person who is ultimately responsible can take a totally detached view of accounting and really act in the public interest.

CARSON:

That's not the view of the accounting profession at large but the profession is becoming increasingly aware that time is not on its side.

WILLIAMS:

I think definitely if they don't get their own house in order, either the European Commission or maybe a future Labour government will step in and impose something which will be far, far worse for the profession.

CARSON:

It took a succession of casino scandals before a statutory gaming board was set up to regulate gambling and establishments like this. Likewise, each round of company collapses and financial scandals has added to pressure for accountancy reforms. The government and the profession are now staking all on self-regulation to solve problems but this could be their last chance.



May 20, 1991

AICPA
Monroe S. Kuttner, Director
Management Advisory Services Division
1211 Avenue of the Americas
New York, NY 10036

Dear Mr. Kuttner:

As my commentary on the April 1, 1991, "Exposure Draft of a Proposed Statement on Standards for Consulting Services - Definitions and Standards," I am submitting several pages extracted from a recent presentation at a convention of the American Accounting Association; this material will be included as part of my forthcoming address before the Canadian Academic Accounting Association.

In my view the exposure draft fully affirms my indictment of our profession's arrogance in this most critical and controversial area. Thus, paragraph 9 captioned "Consultation Services for Attest Clients" begins with an entirely platitudinous sentence and then asserts "Thus, certain consulting services for attest clients may be prohibited; however, in general the performance of consulting services for an attest client does not, in and of itself, impair independence."

That self-serving judgment is not, in my view, supported by the research studies, including those sponsored by the AICPA and the POB. Most certainly, the performance of consulting services for an attest client would, in and of itself, impair the public's perception of the auditor's independence. This perception or appearance aspect was especially vital in the opinion of Chief Justice Burger in his celebrated Arthur Young opinion, thus:

The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. It is, therefore, not enough that the financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent

professional. Endowing the workpapers of an independent auditor with a work-product immunity would destroy the appearance of auditor's independence by creating the impression that the auditor is an advocate for the client. If investors were to view the auditor as advocate for the corporate client, the value of the audit function itself might well be lost.

I respectfully urge that the committee responsible for the drafting of standards for certified public accountants who engage in the performance of management advisory and consultative services go back to the drawing board to develop standards which would, to the extent relevant, fully reflect the overarching responsibility of CPAs, i.e., to the independent attest function for the benefit of third parties. It may well be that such standards should be the responsibility, of a committee comprised of members, who through their firm responsibilities and their curriculum vitae otherwise have demonstrated their commitment to such independent attest function. I note with misgiving that the sole academic member of the drafting committee has not, according to the AICPA library, written anything at any time indicating his awareness of the independence controversy; in fact, his only two listings in the Institute's index go back a decade or more -- neither bearing on this critical issue.

Please include this commentary in the record of the committee's deliberations; I am prepared to appear at any hearings scheduled to consider this promulgation.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Abraham J. Briloff', with a stylized, flowing script.

Abraham J. Briloff
Emanuel Saxe Distinguished Professor
Emeritus

"Independence" - The Professional's Sine Qua Non:

This leads to the subject of auditor's independence, a subject which I have been probing for over a quarter of a century -- with increased and increasing concern.

At the outset, I maintain that our colleagues are guilty of the sin of hubris, of arrogance. When we reflect on the judiciary, legislators (remember the "Keating Five"), journalists, historians, government officials, scientific researchers (especially those with third-party responsibility, e.g., drug testing); we insist that all those committed to these callings be free from conflicts of interest -- we insist that they be virginal not only in fact but also in appearance. But for our profession, we arrogate to ourselves the right to determine unilaterally whether we have "crossed the line."

That our colleagues are all - too - frequently oblivious of the "line" they have crossed can be painfully demonstrated in cause célèbre after cause célèbre, for example:

- o Loans under special circumstances to partners of Peat Marwick and Arthur Young by Penn Square Bank and Republic Bank Corporation, a major Texas S&L which went "belly up", while they were actively engaged in the independent (sic!) audits; of the lending institutions. In both instances the firms deny that they had violated our profession's rules of professional conduct.
- o Partners of Touche Ross and Arthur Young, in charge of the audits of First Executive (Executive Life Insurance) and Lincoln S&L, respectively, moved from their firm associations to richly-endowed positions as chief financial officers of their respective clients -- all the while their erstwhile firms continued to serve as the independent (sic!) auditors for the institutions.

The Lincoln circumstance elicited the following commentary from Judge

Sporkin in his August, 1990, opinion (to be considered in some detail presently):

Atchison, who was in charge of the Arthur Young audit of Lincoln, left Arthur Young to assume a high paying position with Lincoln. This certainly raises questions about Arthur Young's independence. Here a person in charge of the Lincoln audit resigned from the accounting firm and immediately became an employee of Lincoln. This practice of "changing sides" should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence. It would seem that some "cooling off period" perhaps, one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.

In any event despite the fact that study after study, including those undertaken under the aegis of the AICPA or POB disclose that the public, the world of statement users, looks with disfavor on our spreading our areas of involvement to a proliferation of peripheral services we bend our book of rules governing our conduct so as to rationalize this expansiveness.

I turn briefly next to the determination on the part of many in our profession's hierarchy to deprofessionalize our pursuit. I am, essentially, here referring to the pall mall pursuit of activities generally subsumed under the rubric Management Advisory Services (MAS). Aside from my traditional lament that such services compromise the primary commitment of our CPA certificate, namely, the independent audit responsibility for the benefit of third parties, this development brings a nexus of perversity including:

- o Admission to partnership in CPA firms of persons who do not have that degree.
- o Infusion into the firm's professional environment of that intensely aggressive, competitive proclivities of the MAS cohorts.
- o The denigration of the independent audit responsibilities of the firm, and those engaged in that activity,

- o This accelerating "race for the bottom" has also had an inimical effect on those responsible for framing and implementing our standards of professional conduct. Here, I am alluding to the Anderson Committee responsible for the restructuring of our code of professional conduct, the Public Oversight Board and the Peer Review process.

This "headless horseman" phenomenon of running off in all directions at once is discernible also in the profession's relaxation of its rules against contingent fees and commissions. This will encourage those who have an aggressive bent for self-aggrandisement to enter into pursuits which, judged by traditional standards, would be deemed to be incompatible with professional stature -- and especially with our much-cherished independence.

The ultimate tragedy of this development is that it has been pursued by the most-affluent sector of our profession, rather than by those who require the additional revenues for their economic survival. It is those in our profession's hierarchy who are presumed to set the standards for excellence who are principally responsible for the debasement of our professionalism. Or is it time to remind us once again of Oliver Goldsmith's lament, "Ill fares the land [profession], to hastening ills a prey, where wealth accumulates and men decay."

Ross M. Skinner
University of Toronto

Discussant's Comments on "Ethics and Accounting Education,"
(A Paper presented by Professor A. J. Briloff
At the CAAA Conference, Kingston Ontario, June 7, 1991)

INTRODUCTION

Today is a red letter day for me. Ever since I first became aware of Professor Briloff's articles in Barron's Weekly, I have hoped to meet him in person. But not until today have I had that pleasure. And I want to say to him that I am more than pleased to meet the living embodiment of the fact that we should take the semi-strong version of the EMH with a large dose of salt.

Prof B is a stern critic of the accounting discipline and the accounting profession. Today, he has excoriated accounting teachers and practising public accountants alike. As one who has made his career in public accounting, I take it I am expected to concentrate on that part of Prof. B's paper, leaving the defense of Academe to Morley Lemon.

AREAS OF AGREEMENT

Let me begin my commentary by saying that there are four fundamental positions stated by B. with which I am in agreement:

- I have often said that no-one should adopt a career as an auditor who is not an idealist. That is another way (and probably less satisfactory way) of saying what B. says -- namely, that a strong ethical sense should be ingrained in public accountants.
- Second, I agree that financial reporting is intended as communication. The goal of any communication must be truthful communication. Even though we recognize that absolute truth is unattainable, the goal must nevertheless remain the truth and the whole truth.
- Third, I agree that public accountants, by holding out that they are the possessors of special skills, undertake duties to the public, just as any

professional does. I do not go as far as B. in claiming that a public accountant becomes "society's surrogate," merely by the fact of licensing. If there were time I would argue that opinion and whether it is justified based on historical evidence. However, I do in substance agree with B's major thesis in relation to an auditor of a public company. I hold this opinion on the simple grounds that if an audit report is intended to add credibility to an accounting communication, and if the distribution of that communication by its nature cannot be restricted to a limited class of persons, sooner or later society will demand that the auditor's reporting responsibility extend to everyone who may read that report.

- Finally, I agree with B's assertion that education for a professional accountant should include, indeed be founded upon, a solid exposure to subjects known as "liberal." I suggest only a certain degree of scepticism as to assertions about what is "liberal." In my observation the claim to be liberal and liberating is often asserted as a support for academic one-upmanship, designed to keep professional and other subject disciplines in their proper place below the salt.

Perhaps today's discussion can benefit from what we have learned in our liberal studies. B. has emphasized the ethical need for each of us to observe the Socratic precept "Know thyself." Once again I agree. I may be among the few persons in this room to have been exposed to the study of ancient Greek in my high school days. In my studies I learned the inscription on the temple of Apollo at Delphi -- $\gamma\omega\omega\ \delta\iota\ \pi\alpha\lambda\epsilon\sigma\tau\epsilon\upsilon$ -- which Socrates emphasized in his teachings. I also learned another inscription -- $\mu\eta\delta\epsilon\upsilon\ \pi\epsilon\upsilon\sigma\epsilon\iota\varsigma$ -- which means "nothing in excess."

These two prescriptions together have always seemed to me the wisest of guides to a fulfilling and ethical life. And I believe the second one ought to be applicable to our discussion today as well as the first. Applying it to a critical paper, such as B.'s, I suggest it means that criticism ought to be balanced. A critic ought to realize that there are only a few matters in human affairs that can be interpreted fairly as a struggle between good and evil, or a choice between black and white. The vast majority of decisions have a mixture of motives; the vast majority of events a variety of causes. There is almost always something to be said on the other side of the question.

So, if there is single criticism that I would make of B's paper, it is that his criticism is unbalanced. Although there is much truth in what he has to say, he does not adequately express the whole truth. In the brief time available to me, therefore, I shall try to suggest facts and interpretations that add balance to the observations made in that principal paper.

ETHICS AND GAAP

B. has two main complaints relating to accounting as it is practiced.

First, he doesn't know for sure what our double-barrelled audit report means with its reference to both fair presentation and GAAP. Is the emphasis on the first or the second? He has good reason. The question what is fair presentation, or "true and correct" is the core financial reporting question, with which accountants have struggled for at least one and one-half centuries. What has "general acceptance" to do with that?

In recent correspondence with Steve Zeff on the historical background of the "two-opinion" audit report, I experienced what I thought was a flash of insight as to a cultural difference between Canada and the United States. In the context of today's discussion it may be interesting:

- As you know, the term GAAP originated in the U.S. in the 1930s. It is apparent that U.S. accountants, in their search for the Holy Grail of fairness thought it natural -- as indeed it is -- to look at the way most people resolved particular accounting issues. However, they went beyond that, suggesting a belief that if a practice is widely used it is probably as good as you can get. This comes pretty close to saying that general acceptance determines fairness.
- In contrast, in Canada a reference to GAAP was not imported till 1959. Until that time we used statutory wording in audit reports to shareholders with a simple reference to "true and correct" or, later, to "fair presentation." I had just become a member of the CICA Research Committee when a vote was taken on addition of the reference to GAAP to the standard audit report. We did not believe

that the new words changed the meaning of the audit report -- and we said so in the Bulletin. The objective was still fair presentation. We only wanted to indicate to auditors that they should make sure their idea of fairness was not way out in left field. Individual judgment should not ignore solid collective judgment to the contrary. But if still satisfied with the fairness of his judgment, the auditor should feel free to go ahead. In effect, we were saying that if the auditor was satisfied that the client's position was fair, some other position couldn't be "generally (ie exclusively) accepted."

Since then, of course, matters have been muddled by the transformation of professional accounting recommendations into accounting standards and by calling the book of rules GAAP when some of them are far from generally accepted in the ordinary meaning of those words. Probably the position in the U.S. and Canada today is similar. That is, the audit report means that the financial statements are fair because they follow a book of rules drawn up (with due process) with fair presentation as an objective. Obviously, if the rules fail to achieve that objective the statement presentation may be unfair. In view of this, both countries allow a little scope for deviation from the book of rules when the auditor is convinced that their literal application in a particular case would lead to materially misleading results.

In my opinion, so long as present day standards are as well devised as is humanly possible, the concept that the auditor should be strongly guided by the standards but should nevertheless retain responsibility for independent judgment in individual cases is as good as we are likely to achieve. I believe, however, the present reference to GAAP should be dropped because it invites the auditor to rely on the dubious guidance provided by apparent acceptance in practice when standards do not cover a particular situation. I also believe it would be better if the audit report referred only to fairness, the primary objective. Management's representations on the financial statements would be the logical place to refer to the reliance on accounting standards promulgated by the acknowledged authority, with specific description of deviations therefrom (if any) and the effect thereof. (Unfortunately, since the reference to GAAP is so deeply entrenched in statutes

and regulatory practice, such a simple clarification of the primacy of the fairness objective would be practically very difficult to achieve today.)

B's second and more serious complaint is that the application of our book of rules often has unfair results, and public accountants, whether wilfully or not, often ignore that. Over the years B has earned a solid reputation for digging out examples of dubious accounting. In particular, he was the first to bring to our attention cases where GAAP for revenue recognition permitted abuses.

He was right to do so. It is worth pointing out, however, that the idea of revenue recognition at a single point of time is an artificial concept. It is small wonder, then, that it gives trouble, especially as we move from a manufacturing economy where physical shipment of goods sold provided a reasonable trigger for revenue recognition to a service economy where there is no such visible trigger. B's identification of the problem was good service to the profession. His service would be redoubled if he took the lead in suggesting workable criteria for revenue and income recognition in the wide variety of situations we encounter in our ever more complex world.

In today's paper B mentions only one generalized example of bad GAAP as opposed to bad applications of GAAP. The example cited is that of accounting for goodwill. The paper is not entirely clear on the essence of B's complaint or what improvements he would make in accounting standards for intangibles, so I will comment no further. I hope to hear a fuller exposition on this subject another time.

ETHICS AND AUDITING

Auditor independence

B has three comments on the auditing side. First, he asserts that auditors are losing their independence. The support he specifically cites for this consists of studies that he says show that the public or world of statement users looks with disfavor on spreading

involvement with peripheral services. Since I am not aware of these studies, and they are not individually named it is hard to comment on this.

I will only comment that submissions to the Macdonald Commission did include some references to this, but they were not a major issue. Also, to the best of my recollection more than one study, including the Macdonald Commission, has reported no evidence of auditor performance damaged by management services. To that I might add one isolated piece of anecdotal evidence. I sat in on a meeting last Monday and heard the Superintendent of Financial Institutions say that his Office had encountered no problems attributable to audit firms performing management services for institutions regulated by the Office. In fact, their general impression was that the quality of the audit was better by firms also performing such services than by those who were retained only for the audit.

The auditor and internal controls

A second auditing point made by B. concerns internal controls. He points out that most of the S&L disasters in the U.S. have been marked by a complete disintegration of internal controls. As examples, he cites loans issued without meaningful analysis and presumed collateral that turns out to be nonexistent or undocumented. If true, clearly such lack of control over collateral documentation is a weakness that should be an audit concern in view of its significance to the financial position. Lack of meaningful loan analysis, in contrast, is a weakness in the management of credit risk. However, this too should be a concern of an aware auditor. For one thing, it might well suggest more audit work on the loan portfolio. Perhaps even more important for a prudent auditor, it might suggest he should resign as soon as possible. For weaknesses in risk management by a financial institution cannot be overcome by audit, and auditors ignore that at their peril.

Although I have no direct knowledge of the current situation, I know the Macdonald Commission heard some suggestions (but not hard evidence) that auditors had cut back their examination of internal controls under competitive fee pressures in the '80s, and that this was felt to be too risky. I suspect, therefore, that the problem B raises is a

real one. Although not directly stated in the paper, I understand that B's solution to this would be to require the expression of a public audit opinion on the adequacy of the internal control system.

The Macdonald Commission saw two problems with this idea. First, there could be no certainty that an internal control system that seemed satisfactory at the time of the audit, would remain so for any extended period of time. (You will recall our real-life example of this a few years ago, when Crown Trust company, which had operated over 100 years, was taken over by new interests who overrode the controls, and effectively gutted it in three months.) Second, It is difficult to frame an audit opinion that effectively conveys the state of an internal control system. A system may be strong in one area, weak in another but tolerable because of the low exposure to material risk, and of medium quality in another. Putting these two facts together, along with the public's tendency to read an audit opinion as a guarantee, almost regardless of what it says, the danger is that public reporting would be productive of little but litigation.

The Macdonald Commission accordingly considered that a more effective step would be the encouragement of reporting on internal controls by auditors to regulators -- initially the regulators of financial institutions as the most urgent case. There has, of course been communication between auditors and some regulators for some time, but work is proceeding on more formal reporting under the sponsorship of the CICA and with the blessing and assistance of the regulators. I believe this to be potentially a more effective course of action than requiring public reporting. But I think it will only be effective if it gets into the specifics of controls in considerable detail. A blanket overall opinion on whether controls are, say, "adequate" will accomplish little in the typical case.

The auditor and MAS

The final point made by B overlaps the first. He says that the conduct of management advisory services (MAS) "deprofessionalizes" the public accounting pursuit. There is much that could be argued on this, but time permits only a few comments:

- The basic question being raised here concerns the impartiality of auditors and the objectivity of their judgments. Concern about MAS performed by auditors is only one of a number of concerns about conditions that might tend to make an auditor less than fully objective. Other such concerns range from ownership by auditors or members of their families of shares in client companies all the way to an overly close involvement in clients' affairs.
- It is often asserted that the appearance of independence is as important as actual independence. Insofar as an auditor's credibility depends upon appearances, that is true. But I think the universality of the statement is suspect. The appearance of conflict is usually charged by cynics and the suspicious, and not all people are cynics or suspicious. What is far more important than appearances is that the auditor be objective in fact.
- As we all know, in today's world the audit appointment, although nominally made by the shareholders, is usually heavily influenced by management, the very people whose financial representations the auditor must report on. Of all the possible pressures on the auditor's objectivity, this one must head the list. In a personal submission to the Macdonald Commission, I said that the system of appointment is a thoroughly bad one. The difficulty, however, is to think of a replacement that is not impractical or have even more serious objections.
- To date, our legislators and regulators have relied upon auditors' integrity to withstand the potential pressures inherent in the manner of their appointment. This being so, one wonders about the attention paid to much less important possible pressures. It almost seems a case of swallowing the camel and straining at the gnat.
- The theory may be that, given the basic weakness in an auditor's position, any additional pressures that can be removed, should be. Perhaps so. But two things should be borne in mind. It's not worth worrying about something unless it represents a significant addition to the pressure implicit in the manner of audit appointment. And any proposed cure should not carry disadvantages that far outweigh the advantages claimed for it. I recently came across an apposite quotation of H. L. Mencken: "To every complex question there is an answer that is

clear simple, and wrong." Many suggestions for changes in the regulation of audits are of this character.

- Let me now turn specifically to the subject of advisory work by auditors. Our thinking about this subject will be sharpened if we consider separately two categories of advice (1) advice for which the audit partner takes direct and personal responsibility and (2) advice given by some other organizational unit in the firm in a consulting assignment.
- I shall deal with the first of these only briefly. It is just not realistic to think that auditors can or should refrain from giving opinions when asked by clients or when possessed of ideas worth putting to clients. An auditor is likely to have a much better knowledge of a client's business and thereby do a more effective audit if its management finds it worthwhile to keep him or her fully informed, and that requires a good working relationship. This is particularly true of auditor/client relationships in smaller companies.
- I do not deny the possibility that a relationship with management of a client can become too cosy. But the answer to this is not a complete cut-off of constructive work and advice for a client. That would be seriously damaging to the welfare of the economy at large, particularly the small business sector. Rather, the answer to the danger must lie in awareness by auditors of the dangers of going too far.
- In particular, an auditor should never advise a transaction or arrangement whose acceptability for tax or other reasons depends upon financial reporting that contravenes the spirit of accounting standards or does not reflect the substance of the action taken. Participation in "creative accounting" betrays the very essence of the public accountant's mission -- to see to it that financial reports are fair. That ethic needs to be emphasized throughout our education and ingrained in the culture of every audit firm. If that is done we need have little concern about auditors' personal role in advising clients.
- I take it, however, that it is the second type of advisory service that is B's main concern -- that is, the provision by a public accounting firm of consulting assignments for audit clients that are unconnected with the audit engagement.
- Recent decades have seen a great expansion of consulting service departments within public accounting firms. There are no indicators that this trend is coming

to an end. It is certainly legitimate to consider whether this situation poses any threat to the integrity of the audit services performance.

- Let me say, at once, that I do not share B's dark view of management consultants in accounting firms. Their opinions, to be useful, must be objective, just as an auditor's. They can, and normally do, conduct their engagements in a highly professional manner. I have seen no evidence that they "denigrate" the audit responsibilities of a firm. In my own firm, and I presume in others as well, the management consultants were required to adhere to the code of ethics of our Institute. In addition, the associations of management consultants have developed their own codes of ethics. I do join with B in deploring the aggressive competitive attitude infiltrating firms today, but I attribute this more to the times we live in than the influence of management consulting. Indeed, it is ironic that pressures on the profession to remove advertising restrictions in the name of stimulating competition have emanated principally from governments. So much for society's concern for the effective functioning of its "surrogate."
- So how do I see the threat to audit integrity caused by MAS performance? And what are the disadvantages to his proposal to prohibit the performance of MAS by public accounting firms.
- As to the first question, I am unaware of any independence problem caused by MAS performed by the firm, either during the time I was a direct client handling partner, or subsequently when I was involved in difficult auditing issues firm-wide in my capacity as National Director of Accounting & Auditing. Of course, my experience is by now somewhat out of date. However, I have not heard of situations anywhere where such a problem has been proved to exist.
- Possibly the concern about MAS rests upon speculation that an audit firm may underprice its audit services in order to gain access to supposedly lucrative consulting opportunities. Then, there would be an incentive to downgrade the quality of the audit to meet the price. This suggestion deserves consideration, given known examples of low-ball audit proposals. However, it seems to me some questions should be asked before the thesis is uncritically accepted. For example: Can one be sure that low-ball audit proposals are motivated by the desire for consulting access? Might they not be simply be a way to obtain the

audit franchise in the present more competitive environment? Is it true that consulting work is more lucrative than audit work? It wasn't in my day. Also, if management is aggressively seeking to hold down audit costs these days, as seems to be the case, why would they be such easy marks as to give consulting assignments more or less automatically to their auditors? The possible answer that knowledge gained in the audit gives the audit firm a cost advantage in the consulting work may be true in a small minority of cases, but I am positive it is not sufficiently pervasive as to explain the phenomenon.

- In the result, I am far from convinced that the problem seen by B and others exists. I am sure it did not exist in my time, and I note that the same concerns were raised then, though less vociferously. If the problem does exist in some measure, B's solution would appear to be to prohibit accounting firms from performing any MAS. Let us now consider the disadvantages to this proposal.
- First, the prohibition would be most unwise in the case of smaller clients. The fact is that for organizations up to, say, several hundred employees in size, the auditor can usually provide consulting advice more efficiently and cheaply than any outside firm. Where that is not so, he or she should have the common sense to recommend outside help rather than run the risk of losing the client through a botched assignment. There would be significant costs to society and damage to small business from a prohibition of MAS in these situations.
- Second, since the bulk of consulting revenue comes from larger companies we must also consider the social cost of cutting off public accounting firms from this sort of work. There, would, at least temporarily, be a reduction of competition in this field. In some cases, also, there could be some reduction in audit efficiency.
- Third, auditing can require special skills not within the portfolio of the training of the typical auditor. There are times when you need actuaries, mathematicians or statisticians, valuers, etc. It is useful to have these skills in house, because you cannot always buy them in time to meet audit deadlines or audit emergencies. But the normal auditing demands may not be sufficient to warrant full-time employment of such specialists. There can, therefore be synergy between MAS and auditing.

- Finally, one should consider the long-run impact of a prohibition of MAS on the attraction of auditing as a career. When I began a career as an auditor in 1945, the term MAS had not been invented. However, in those years every firm performed "special work" as well as regular audit work. Today, much has changed. As the economy has grown, it has become more economic for greater specialization to occur in advisory services. Consequently, I suspect the variety of work available to the auditing specialist has shrunk. Even tax work of any complexity is hived off in specialist departments. For the health of the profession we should be sure the work that is left to our auditors is fulfilling if we want good people to embrace that career.

- Over my lifetime great development has taken place in auditing theory and technique. Adjusting to that change is stimulating, of course, but it is only realistic to recognize that the really exciting development work is largely confined to a few researchers in each firm and in the universities. For the ordinary line auditor, satisfaction must be found in the clients. The young, recently-qualified auditor will find interest in the exposure to a continually widening variety of business situations. For a more mature auditor, it can be harder. The repetitive cycle of planning the audit, performing the laid-down procedures and assessing the results can become routine, especially when the output is simply one more unqualified audit report. There are, from time to time, occasions of high drama when the auditor must say "no" to a determined client. But these occur only infrequently, and even then few people are aware of the auditor's excellent work. There is a danger in this that the creative juices may dry up -- essential though the work may be.

- As specialization grows, therefore, audit firms need to cling to activities that staff will find interesting and rewarding. As already discussed, building a good and constructive relationship with clients provides one form of reward. Association with a diversified MAS department provides another possible source of interest and variety. If staff have the opportunity to spend part of their careers in MAS activities, or even to work on a few MAS assignments, their career will be enriched, their abilities enhanced, and their horizons widened. To

my mind, it is essential to the health of the accounting profession that it continue to be able to provide the widest possible range of challenges to its people.

- For all these reasons, I see enormous disadvantages in a policy of prohibiting the association of MAS and public accounting. On the other side of the scale, so far as I can see evidence for the need for such a step is largely lacking.

CONCLUSION

Time has permitted only the most superficial of responses to Professor Briloff's paper. In sum, he has made serious criticisms of the accounting profession and, incidentally, of accounting teachers. He is on unquestionably solid ground when he asserts that a strong ethical base and a dedication to truthful financial reporting is essential to the survival of the public accounting profession. He attributes some notorious financial failures to the profession's falling away from these high purposes. That is a debatable diagnosis, and I don't think he really attempts to substantiate it in this paper. I also think his prescriptions for reform are too simplistic and, in some cases, ill-advised. But there can be no doubt that the changing environment of public accounting, and particularly the pressures created by growth, warrant the most thoughtful examination of ways to maintain its integrity and goals.

W. MORLEY LEMON

DISCUSSANT'S COMMENTS

with respect to

ETHICS AND ACCOUNTING EDUCATION

by

ABRAHAM J. BRILOFF

JUNE 7, 1991

CAAA

KINGSTON, ONTARIO

Professor Elias, Professor Briloff, Colleagues.

It gives me great pleasure to be invited to discuss Professor Briloff's interesting paper "Ethics and Accounting Education." My co-discussant and I, taking the view that we each had a comparative advantage in examining the paper from each of its two perspectives, has dealt with the paper as it applies to the world of public accounting and business; I propose to consider Professor Briloff's comments about the world with which I am more familiar - the academic world.

Much has been written about ethics in the last few years. Some like Professor Briloff have been raising issues from a fairness for ethical perspective for a number of years - as a matter of fact more years than I have been in the academic world. That is not to say the Professor Briloff has been at it for a long time; my academic life dates from 1972.

The academic world has made sporadic attempts to consider how ethics might be brought into the classroom over the past few years - the CAAA Education Committee of which I was Chair sponsored a session at the 1986 CAAA Annual meeting considering who (a philosopher or an accounting professor) should teach ethics to accounting students - but until very recently there has not been a systematic attempt to consider the issues. I think this plenary session is particularly appropriate.

My limited exposure to the subject of ethics and the teaching of ethics has lead to my belief that there are really two issues involved:

1. There are rules and laws which must be obeyed in accounting as in life. For example, Rule of Professional Conduct 209 promulgated by the Institute of Chartered Accountants of Ontario states that "A member or student shall not take any action, such as acquiring any interest, property, or benefit, in connection with which he or she makes improper use of confidential knowledge of a client's affairs obtained in the course of his or her duties."

It seems to me that the rule is straight forward and a member or student either follows the rule or

does not. If the rule is not followed, the person so acting is guilty of wrong-doing and should be censured.

It further seems to me that a rule such as 209 should not pose a problem for professor or student. The rule exists and is or is not followed.

2. The second issue is where the difficulty lies. The second issue deals with what I understand is commonly known as "an ethical dilemma." An ethical dilemma exists when there is either no rule or law to follow or when there is a rule or law but its interpretation or applicability to the facts of the situation are not clear. Or an ethical dilemma could exist when there are competing rules or precepts and a choice must be made between two courses of action.

Let me illustrate what I mean by reference to another ICAO Rule of Conduct. Rule 204.1 requires the member to "hold himself or herself free of any influence, interest or relationship .. which [might impair his or her] professional judgment or objectivity..." There is additional material appended to the rules which defines financial and other relationships which could be presumed to impair objectivity. But there are no rules, nor do I think there should be, which provide guidance to the auditor when he or she is engaged in a dispute with a client over a disclosure issue and where said client pays a big chunk of the auditor's fees be the auditor a sole practitioner or a partner in a large firm.

The auditor has to decide whether the client's position is defensible and in making that decision must attempt not to let the potential loss of the client be a factor. The ethical dilemma in this situation I believe is in making the decision without taking the client into account.

In my mind, it is the second issue that we as academics, to

paraphrase Professor Briloff, "[with the responsibility] for the personal and professional development of our students" must focus on. The rules and laws speak for themselves; we must inculcate in our students a recognition of what an ethical dilemma is and how they might deal with an ethical dilemma when confronted by one.

The issue as to how ethics should be incorporated into a student's educational experience is much debated. One approach is to have an introduction to the subject early in the student's academic career and then incorporate ethical issues into succeeding courses. A second method is to focus on ethical issues in a separate course like the course "Ethics for Accountants" mentioned and rejected by Professor Briloff in his paper. The third approach is like the first except that the initial ethics course is omitted. Professor Jim Gaa who has the advantage of doctoral training in both philosophy and accounting is studying the issue at the present time.

At any rate, no matter how we do it, I think we would all agree with Professor Briloff that the study of ethics within the accounting program is important.

We would also agree with Professor Briloff that we must be like Caesar's wife; "we must be aware of the ethical ramifications in our own interpersonal relationships with our students and colleagues."

Professor Briloff refers to the "liberating arts and sciences" and suggests that we must ensure that our students "recognize that our discipline of accountancy does not exist independently of other areas of knowledge." He is concerned as are others such as Bloom, who wrote The Closing of the American Mind, that accounting education is becoming "too mechanistic."

At another point he decries the tendency for (especially) fledgling academics to research and publish articles that "have little, if any relevance." He describes the process as "first-rate accounting scholars ... constrained to demonstrate their competence as second-rate financial analysts, applying a third-rate mathematical methodology, predicted on fourth-rate data, compiled by fifth-rate drones." I am not willing to agree with

his characterization which I realize is stated to reinforce his point about relevance but I do agree that soft research, and I would include ethics in this category, is undertaken at the untenured professor's peril.

I attended, as did many here, the Ethics Symposium sponsored by the Centre for the Advancement of Professional Accounting Education at the University of Alberta in early May. I was quite perturbed to hear Professor Roger Shiner, a philosophy professor at the host University and Professor Mike McDonald, Maurice Young Chair in Applied Ethics and Director of the Centre for Applied Ethics at the University of British Columbia, explaining how their colleagues in philosophy belittled the notion of and their research efforts in applied ethics. Their colleagues seemed to feel that applied ethics was not a relevant subject for consideration by an academic philosopher.

Obviously accountants aren't the only academics who worry more about angels on the head of a pin than in saving peoples' souls.

Professor Briloff pays special attention to "Teachers of Taxation." I could not resist the chance to make a comment since my tax colleagues at Waterloo consider my area, auditing, to be fair game. It bothers me that some of our students who have an interest in tax see tax practice as a matching of wits with Revenue Canada where the object is to concoct schemes that find loopholes which will reduce a particular taxpayer's tax. While this, in and of itself, is not wrong, we have major fiascos like the fabled Scientific Tax Credit Scam that cost the people of Canada billions of dollars and made some less-than-honest non-taxpayers wealthy; most of them are now living in Brazil I understand. It also made ordinary taxpayers who had to pay for the fiasco quite cynical I believe.

I agree that we should teach our students to realize that tax schemes may be unethical if their only goal is to bend the law to save a client money. I do not regard bending the law to be equivalent to taking advantage of opportunities to reduce taxes on income.

A final topic dealt with by Professor Briloff is Continuing Professional Education. He suggests academic involvement could aid a firm which relies exclusively on in-house courses for CPE

of partners and staff. Such academic involvement could bring exposure to the "liberal and liberating arts" and force the participants to examine their own actions. Otherwise he suggests such offerings are "incestuous."

In summary, I agree that we must do more to make our students aware of the ethical dilemmas they will face after they graduate and provide them with a framework or process to deal with those dilemmas. And I agree that we must labour to make teaching and research in the area of ethics a more legitimate calling in the eyes of the universities and our colleagues.

I thank Professor Briloff for his timely message and insightful ideas on this important topic.

END

AUDIT QUALITY AND CLIENT SATISFACTION:
AN EXPLORATORY STUDY

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AUDIT QUALITY AND CLIENT SATISFACTION:
AN EXPLORATORY STUDY

SYNOPSIS

The purpose of this paper is to investigate the determinants of audit quality and client satisfaction by means of a client questionnaire, which was developed and circulated to 175 companies. Client satisfaction is expected to be a function of service saliency, expectation confirmation, perceived quality and cost. Perceived quality is expected to consist of two components: (1) technical quality, a combination of the auditor's competence and integrity, which is consistent with DeAngelo's (1981) definition of audit quality, and (2) functional quality which encompasses the customer service dimensions of how the audit firm deals with the client. Through examination of the literature and discussions with audit partners eight aspects of functional quality were identified: reliability, responsiveness, courtesy, access, communications, security, understanding and caring.

The questionnaire consisted of 34 structured questions with a 7-point response scale and an unstructured part that allowed the client to relate incidents that left him/her feeling either satisfied or dissatisfied with the audit firm's services, and to make further comments. The 69 responses that were received form a sample that is spread across six client types and a wide size range. The responses are analyzed both descriptively and statistically.

In general, the responses indicate a high level of client satisfaction with auditor services. In particular, the scores on questions about competence, courtesy and integrity are high. Despite the negative press coverage the auditing profession has received lately, the management of these firms express no concern about the technical quality of the audits performed for them. In fact, they perceive the quality of the audit services they receive to be higher than the quality of the tax services they receive from the same firm. In terms of customer service, the data suggest one area that could be improved is the auditor's propensity to act in an anticipatory manner.

Of the 10 quality dimensions investigated in this study, the factors that contribute most to the clients' satisfaction with auditor services are competence and effective communications. They account for 65% of the variability in the overall satisfaction score. Apart from quality, there are no other detectable differences in the way clients view tax services versus audit services, despite the fact that audit services may be purchased for very different reasons than are tax services. Despite the fact that a number of clients mentioned how high they felt their fees were, no statistically significant relationship is detected between cost and overall client satisfaction.

This study should be viewed as exploratory in nature. The small sample size and the fact that all the surveyed clients are audited by one firm limit the generalizations that can be drawn from the results presented here. The issues of audit quality and client satisfaction are important ones to the auditing profession. It is hoped that this paper, despite its limitations, will help to motivate future research in this area.

1. Introduction

The concept of consumer satisfaction occupies a central position in marketing thought and practice. Audit practitioners recognize that it directly affects their firm's profitability. Despite its importance, however, research aimed specifically at client satisfaction in the audit industry is scarce. Research dealing with services in general has suggested that satisfaction plays an important role in customer retention (Congram 1986, Maisters 1989)¹, and that service quality is one of many factors that contributes to customer satisfaction (DeSouza 1989). Audit quality, however, is a topic of research interest not only because it plays a role in the client satisfaction/auditor retention process, however. The quality of audits has received widespread and concerned attention from a variety of sources in recent years, following the spectacular failures of public firms.²

The purpose of this study is to investigate the determinants of audit quality and client satisfaction by means of a client questionnaire, which was developed and circulated to 175 companies. The 69 responses were analyzed and the findings are presented here. Because of the small number of surveyed clients, this paper should be viewed as providing preliminary data only. A more extensive survey is planned, so that the results of this analysis can be corroborated with a larger and more diverse sample.

The paper is organized as follows: Section 2 reviews the literature on service quality, audit quality and client satisfaction and provides the rationale for the development of the questionnaire; Section 3 describes the questionnaire in more detail, Section 4 presents the results and Section 5 provides a conclusion.

2. Background

2.1 Customer Satisfaction and Professional Services

¹ Although the auditor selection decision is an interesting topic in and of itself, the focus in this paper is that of client retention once an auditor has been engaged. The recurring nature of many services offered by a public accounting firm to a client makes a stable client base extremely valuable. The literature on "low-balling" would also suggest the returns to auditing firms are greater in the years subsequent to the initial engagement.

² The series of articles in the Financial Post on "Auditing in Crisis" (1989) provides evidence of this concern about the issue of audit quality.

Since the early 1970's, the volume of consumer satisfaction research has been impressive. The bulk of this research, however, has focused on the consumption of goods rather than of services, and client satisfaction with professional accounting services, in particular, has received little attention in the academic literature³. A review of the literature⁴ indicates that whether or not a client is satisfied with a particular service depends on at least four factors:

- a) Service saliency - how important the service is perceived to be. Someone may perform a service brilliantly, but if the service itself is held in low esteem by the consumer, customer satisfaction is likely to be low. External audit services, to the degree that they are mandated by entities external to the organization, may be less salient than tax services performed by the same audit firm, for instance, where the payoff may be more visible to the client.
- b) Expectancy confirmation - the degree to which expectations about the service are confirmed when the service is performed. Someone with a low expectation can be satisfied with a mediocre performance, while someone expecting more may be dissatisfied with the same level of performance. A client's expectations set the stage for satisfaction by providing an anchor for later assessments.
- c) Performance/quality- how well the job is done. The higher the quality, the more satisfied the customer, all other things being equal. This concept is further discussed below.
- d) Cost - how much the job costs. Satisfaction is higher when someone feels they have received value for money, a concept that links quality directly with cost. Someone may be just as satisfied with a low-cost, medium-quality audit as they are with a medium-cost, high-quality audit. A good return on each dollar spent is what contributes to satisfaction.

³ In Quelch and Ash's study (1981) of 17 professional services in Canada, for example, accountants were not included.

⁴ The main sources used to develop the theoretical foundation for the following discussion are articles by Oliver (1980), Churchill and Suprenant (1982), Bearden and Teel (1983) and Oliver and DeSarbo (1988), as well as the collection of readings provided by Donnelly and George in The Marketing of Services (1981).

2.2 The Quality of Professional Services

Quality is an elusive and indistinct construct. The concept of quality, according to the Japanese, is "zero defects - doing it right the first time", and the search for quality may be the most important consumer trend of the 1980's and beyond (Leonard and Sasser 1982). For the goods industry, quality control has been a subject of extensive research. Until recently, however, much less attention has been given to service quality. To understand service quality fully, three well-documented characteristics of services must be acknowledged:

1. Intangibility

Unlike goods, precise manufacturing specifications cannot easily be set. Most services cannot be measured, counted, or tested before sale to ensure quality. As a result, service firms must rely on users' perceptions of quality to know how they are doing. Unfortunately, consumers also find it difficult to measure service quality, even after the service has been "consumed" by them.

2. Heterogeneity

The high labour content of services makes performance variable. Consistency in performance and consistency in how the performance is viewed across time, across producers, and across users is generally low.

3. Inseparability

The production and consumption functions are not separable in the service industry the way they are in a goods industry. There is considerable interaction between the producer and the consumer as the service is being performed, adding another element that is extremely difficult to control.

These three characteristics have an important impact on how we define and study service quality. In a service industry, the focus shifts from an engineering approach (meeting the specifications set by management) to a marketing approach (the customer's opinion is the only one that counts). Since attributes of the product cannot objectively be measured, quality is very much in the eye of the beholder, and quality is measured by consumers' opinions.

In the accounting academic literature, it is common to use DeAngelo's (1980) definition of audit quality, that is, the jointly-assessed probability that both a) the auditor will find a breach in reporting if one occurs, and b) the auditor will report the breach. These two variables can be captured by the concepts of auditor competence and integrity, which, in this paper, are jointly referred to as technical quality. Although other attempts have been made to

improve on this definition of audit quality (Davidson and Felix, 1988), the DeAngelo approach to technical quality is used here.

Technical quality, a combination of competence and integrity, is what the shareholders (or the audit committee) demand when exercising their right to appoint an auditor. But the shareholders seldom deal directly with the auditor. Company management has the direct contact with the audit staff and it is not only the technical quality of the service that is important to them. The manner in which the service is delivered is also important: the courtesy of the audit staff, the way communications are handled, etc. These elements are referred to as functional quality in this paper. They are not the service dimensions the outside investment community cares about necessarily, but they are important to those who deal directly with the providers of the service. Since the clients contacted in this study are members of management, and not of the audit committee, this aspect of quality is likely to play an important role in satisfaction.

Through examination of the literature and discussions with audit partners, the questionnaire was designed to elicit feedback on the two aspects of technical quality (competence and integrity) and on eight aspects of functional quality - reliability, responsiveness, courtesy, access, communications, security, understanding and caring.

3. Questionnaire Design

The above discussion provides the foundation for the structure of the questionnaire, which was designed to acquire feedback on the four elements hypothesized as being important to a client's satisfaction: quality, cost, saliency and expectancy confirmation. Further, questions about two aspects of technical quality and eight aspects of functional quality were included.⁵

⁵ The dimensions that this study seeks to examine are qualitative. Construct validity is always a concern when attempts are made to assign quantitative measures to qualitative factors. Without reliable and valid measures of the variables of interest, examining the structural relationships among these variables is fruitless. While acknowledging these real concerns, this study defends its use of these questions and scalar measures to code responses by referring to the frequency with which this methodology is found in published research of this nature.

The questionnaire consisted of a number of parts. Part 1 contained 25 statements. Respondents were instructed to comment on these statements by circling one of seven (7) possible answers as follows:⁶

| | | | | | | |
|------------|----------|----------|------------|-------|----------|------------|
| Absolutely | Somewhat | | Neutral/ | | Somewhat | Absolutely |
| Disagree | Disagree | Disagree | No opinion | Agree | Agree | Agree |
| o | o | o | o | o | o | o |

These 25 statements were aimed at obtaining clients' opinions on the ten (10) dimensions hypothesized to affect service quality:

- competence (possession of the required skills and knowledge) Q1 to Q5;
- integrity (trustworthiness, honesty, reputation) Q19,20;
- reliability (dependability and consistency of performance) Q8 to Q10;
- responsiveness (willingness and readiness to perform) Q12,13;
- courtesy (politeness, respect) Q6,7;
- access (approachability and ease of contact) Q11;
- communications (listening and keeping clients informed) Q14 to 18;
- security (freedom from risk) Q21,22;
- understanding (knowing the client's needs) Q23;
- caring (making the client feel valued) Q24,25.

The first two dimensions, competence and integrity, capture technical audit quality. The other eight dimensions capture the functional aspects of service quality, how the audit firm deals with its clients.

Part 2 contained nine (9) additional statements, similarly structured, dealing with the four hypothesized determinants of client satisfaction, specifically the perceived value of the service to the organization (service saliency), the degree to which their expectations about the service were met (expectancy confirmation), and their perceptions on the overall quality and cost of the services. These four questions were asked for both external audit and tax services, since most clients used both services and it would not be surprising to find that they perceive these as distinct services. The ninth statement asked for an overall assessment of client satisfaction with the services offered by the

⁶ When selecting an appropriate scale, consideration is given to the consumer's ability to discriminate among possible responses. A scale should be broad enough to capture different client perceptions without being so broad that the responses cannot be differentiated from each other by the respondent. The most commonly-used point scales are 5-points and 7-points and both are equally defensible (Cox 1980).

audit firm and used by the client and was used as the overall satisfaction score (SAT) in the analysis described below.

Part 3 was unstructured, allowing the client to relate incidents that left him/her feeling either satisfied or dissatisfied with the audit firm's services, and to make further comments.

The steps followed in the questionnaire development were:

- a preliminary questionnaire was designed, discussed with an audit partner and revised;
- the revised questionnaire was pre-tested with three auditees, with the author present to observe length of time to complete and to ask questions related to understandability, etc. Some minor modifications were made as a result of this pre-test.

The survey was circulated to 175 companies⁷. Of these, 69 returned completed surveys, for a response rate of 40 percent. These responses form the basis for the following analysis of results.

The main objectives of this research are twofold: to investigate the determinants of client satisfaction and to investigate the determinants of audit quality. Specifically, the hypotheses being tested by this study, in their null forms, are:

- H₁: A client's satisfaction is not related to the quality, cost, or saliency of the audit, nor to his/her expectancy confirmation.
- H₂: The auditee's perception of audit quality is not related to the ten service dimensions examined in this research.

4. Analysis of Results

4.1 Sample Statistics

Selected firm-specific data on the auditees included in the sample were examined. Specifically, the sampled firms were broken down by size (measured by total assets and total revenues), client type (public, owner-managed, non-profit, etc.) and by length of relationship with the audit firm. Summary data on fees were also compiled. The data suggest that there is a fairly broad representation of clients in the sample across all dimensions. Client size ranges from very

⁷ The companies were randomly selected from the audit client list of one audit firm. The next stage of the research should expand the sample to include other audit firms and more geographical areas.

small (total assets < \$4,000) to very large (total assets > \$270 million). There are six major client types represented, with two client types (public and owner-managed) accounting for 75% of the observations. There is a fairly even spread of relationship lengths, ranging from eight new clients to eleven firms with well-established (more than twenty years) relationships.

4.2 Analysis of Responses

Descriptive statistics on responses

Descriptive statistics (mean, standard deviation and frequencies) for the responses to the 25 statements in Part 1 on the ten service dimensions of audit services and the overall satisfaction statement were compiled and are presented in Table 1. As evident from the Table, the surveyed clients made generally positive comments. Overall, there were only 94 negative responses (approx. 5%) in the entire sample, ranging from slightly dissatisfied (frequency=63) to extremely dissatisfied (frequency=4).

INSERT TABLE 1

A number of questions stand out as those having the most consistent positive response (high mean, low standard deviation). The highest scores were on aspects of competence (Q1 & Q2) courtesy (Q6 & Q7), responsiveness (Q13), integrity (Q19) and security (Q21 & 22). The lowest score was obtained on the comment: "The auditor doesn't wait for us to initiate everything: they anticipate".

Clients were neutral (had no opinion) on a fairly large number of questions (6%). The most common response across all questions was, by far, a +2 (54%), indicating, that, in general, most clients are satisfied with the auditor's services. The wide spread in the responses across the six non-zero points in the scale suggests that clients can distinguish various degrees of satisfaction and dissatisfaction and that a 7-point scale is appropriate for a survey such as this. Only five clients were, in general, somewhat dissatisfied with the services provided to them by the auditor.

The non-normality of a 7-point scale and the non-symmetric pattern of responses evident in Table 1 suggest that a non-parametric approach to analyzing the data in the following sections is appropriate.

Comparisons across groups

The consistency of the responses taken as a whole across client type and length of relationship with the auditor was investigated by the use of the Kruskal-Wallis test. A cumulative score for each client was constructed by summing a client's responses to questions 1 to 25 inclusive. These cumulative scores were ranked and the mean rankings for the subgroups were analyzed.

Table 2 reports the size of each subgroup, the mean rank of the cumulative scores in the subgroup and the results of the Kruskal-Wallis test. It also reports the mean rank for the overall satisfaction question (SAT) for each subgroup. Although there appear to be differences across the mean ranks of the subgroups, the Chi-Square suggests that these differences are not statistically significant. In other words, taking questions 1 to 25 as a whole and taking the SAT score alone, there are no statistical differences in the response patterns across client types or length of relationship.⁸

INSERT TABLE 2

Technical vs. functional quality

Whether or not the scores for technical quality (competence and integrity) were statistically different from those for functional quality (reliability, responsibility, courtesy, access, communications, security, understanding, caring) was investigated by a Wilcoxon matched-pairs test. The mean rank for the 27 cases with technical quality scores greater than functional quality scores was 40.1, while the mean rank for the 42 cases in the other group was 31.7. The Z-statistic of $-.75$ suggests they are not significantly different from each other. With this sample, the auditor's services are equally satisfactory in aspects of functional and technical quality.

Audit vs. tax services

Descriptive statistics (mean, standard deviation and frequencies) for the eight questions in Part 2 of the questionnaire covering the aspects of service

⁸ The sample was broken down into 3 groups by length of relationship: 1 to 5 years, 5 to 10 years, and over 10 years. Since this split is essentially arbitrary, other splits were examined. The results reported in Table 2 remain essentially unchanged. No statistical differences by length of relationship are detected.

saliency, expectation confirmation, quality and cost, broken down by audit and tax services, were compiled (Table 3A). All but one firm in the sample used the auditor's external audit services; 36 firms appear to have used tax services as well.⁹

INSERT TABLE 3

As is evident from the Table, many clients did not express a definite opinion on these issues. Even the questions about quality and cost were frequently left blank or answered with a "no opinion".¹⁰ The largest difference is between the means for the quality questions. Table 3B examines whether there are significant statistical differences between the responses for tax and audit services. The responses to the four questions on external audit services were compared to the responses to the corresponding four questions for tax services, again using the Wilcoxon matched-pairs test. The Z-statistics suggest that the surveyed clients view audit services as being of significantly higher quality than tax services.¹¹

Because of the mandated nature of audit services, clients might value them less and/or be more inclined to view them as relatively more costly than tax services. A lower score on the audit saliency question and/or on the reasonableness of cost audit question would be evidence of this. The Table 3B means for saliency and cost are not consistent with this interpretation. Thus, the fact that audit services may be mandated by factors external to the firm does not appear to affect the way clients view these services.

⁹ If the total auditor fees for a particular client exceed the total audit fees for that client, this is interpreted to mean that tax services are provided.

¹⁰ A non-response (blank) was coded as a -0 in the data base, so that they are treated as no opinions in the statistics.

¹¹ In responses to the unstructured part of the questionnaire, a number of comments were made about errors committed by the auditor in the calculations of the client's taxes. The fact that these clients perceive their tax services to be of lower quality is therefore not surprising. We must keep in mind, however, that since, unlike errors in taxes, clients rarely receive feedback about possible deficiencies in audit procedures, the client's perception of quality differences may be inaccurate.

Determinants of satisfaction

The responses were used to examine the determinants of satisfaction, as stated in H₁. To combat its skewness, the SAT score was transformed as follows:

$$SAT* = \ln \{SAT + 4\}.$$

This transformed variable, SAT*, was used as the dependent variable and the scores for service saliency, expectation confirmation, quality and cost were used as the independent variables in a multiple regression analysis.

The results presented in Table 4A do not confirm the hypothetical expectations. There is no detectable relationship between clients' overall satisfaction with their auditor's services and how important they view that service, whether or not their expectations about the service were confirmed or their perceptions about service quality and cost.

INSERT TABLE 4

Determinants of quality

H₂, which investigates the factors that affect a client's assessment of quality, was also examined by the use of a multiple regression model. The scores on the first 25 questions were combined to form average scores for the ten dimensions of service quality the questions were designed to capture, which were used as the independent variables. An average score for both audit and tax service quality was compiled and transformed to

$$QUAL* = \ln ((Q29+Q33)/2+4),$$

which was used as the dependent variable. Table 4B presents the results of this analysis.

There are a number of statistically significant relationships detected here. The data suggest that the factors that contribute most to a client's assessment of quality service are competence, courtesy and communications. These variables account for approximately 20% of the variability in the client's quality assessment.

Determinants of satisfaction revisited

The original analysis of this data took a two-step approach, as depicted below:

$$\text{Sat} = f\{\text{Saliency, Confirmation, Quality, Cost}\}$$



$$\text{Quality} = f\{2 \text{ Technical} + 8 \text{ Functional dimensions}\}$$

A study by Tse & Wilton (1988) on the determinants of satisfaction found that of the four variables in the first equation, expectancy confirmation is the predominant determinant of satisfaction and that this confirmation is a direct function of perceived service quality. This would suggest that a more direct approach to studying the determinants of satisfaction may be:

$$\text{Sat} = f\{2 \text{ Technical} + 8 \text{ Functional quality dimensions}\}$$

Therefore, a multiple regression of the SAT* score on the ten quality dimensions was conducted. Only the dimensions suggested by the Table 4B regression results as important were used, although running the regression on all ten dimensions did not alter the results.

Table 4C presents the results of the multiple regression of SAT* scores on the three dimensions found to be important in Table 4B. The results confirm the existence of a direct link between the SAT scores and certain dimensions of service quality.

In the Table 4C regression, the importance of competence and communications persist. These two factors can explain 65% of the variability in the SAT* scores. Courtesy, which is significantly related to the quality score, is not significantly related to the satisfaction score.

Cost and satisfaction revisited

Part 2 of the questionnaire included questions on the perceived reasonableness of cost and the relationship between cost and satisfaction was investigated in the Table 4A analysis. Since many of the respondents left the questions on cost blank, the actual audit fees and total auditor fees data were also used to examine whether there is any detectable relationship between service cost and client satisfaction. Simple regressions of the SAT* score on the log of total auditor fees and on the log of audit fees alone were performed to test for a significant relationship. Since research has consistently reported a significant relationship between client size and fees (Anderson and Zéghal 1989), fees are scaled by total assets in the analysis. Since the literature also

suggests some industry effects in pricing decisions by audit firms, an ANOVA analysis was first performed on the scaled fee variable, breaking the sample down by client type to ensure no significant industry effects are confounding the results.¹² The log of the scaled fee variables were then used as the independent variables in two simple regressions of the SAT* score on cost.

Using actual fee data to measure cost instead of client perceptions gives the same result as Table 4A. This data provide no evidence that relatively higher fees significantly affect clients' satisfaction with services. The t-statistic is 1.19 when audit fees are the independent variable and 1.60 when total fees are used. This inability to detect a relationship may be due to the use of a simple linear regression technique to capture the complex relationship that may exist between pricing and satisfaction levels.¹³

Unstructured responses

Part 3 of the questionnaire allowed for unstructured responses. Clients were asked:

- a) to relate an incident that took place in the last two years that left them feeling satisfied with their auditor's services,
- b) to relate an incident that took place in the last two years that left them feeling dissatisfied with their auditor's services,
- c) to comment on whether there is anything they would like done that their auditor is not doing now.

These responses were reviewed and classified, to the extent possible, according to the ten service dimensions covered by the questionnaire.

Of the 69 firms in the sample, 36 related at least one positive incident, 24 at least one negative incident, and 13 provided further comments. The comments corroborate the findings of the multiple regressions in Table 4. The comments are overwhelmingly (68%) about the dimensions of competence and communication,

¹² Client type is used here as a rough surrogate for industry. To the extent that this is an imprecise discriminator, the ANOVA results may be misleading.

¹³ Research has shown that audit pricing, for instance, is related to auditee and auditor size, internal control costs and elements of auditee risk and complexity. Analysis that incorporates these would have a better chance of detecting a relationship between cost and satisfaction if one does indeed exist. A more complete analysis of this issue could not be performed here, as measures of these factors are not available for the firms in this sample.

confirming their importance in the satisfaction assessment. Also worth noting is the number of negative comments made about tax services compared to the many positive ones made about audit services. This also confirms the statistical result provided in Table 3B. These clients are more satisfied with their audit services than they are with their tax services.

Limitations

The results presented here should be viewed with an appreciation for the limitations of the study. There are a number of factors which should be taken into consideration. All observations are from the same office of one audit firm and may not be a representative sample of the larger population of interest. In addition, such a restricted sample may reduce the variability of the responses. Another concern is the small sample size, which limits the degree to which reliable statistical tests can be performed, especially when intersample comparisons (across client type, for example) are made.

As with any questionnaire, non-response bias is also a possibility. In this case, one may assume that dissatisfied clients would be more likely to complete the questionnaire and thus communicate their dissatisfaction than would those with no complaints. If this is the case, the results reported here are likely understating clients' satisfaction. However, such a statement cannot be made with any assurance, and the affect of this potential non-response bias is indeterminable.¹⁴ Related to non-response bias is the bias that results from sampling only current clients. A survey of former clients to assess the reasons for their decision to engage another firm would also be informative.

¹⁴ Descriptive data for the firms not responding to the questionnaire were not available, so that comparisons between respondents and non-respondents were not possible.

Another problem stems from the high intercorrelation that exists among many of the responses to questions in the survey. When the questions are combined to form the ten service dimensions, the variables still exhibit strong interrelationships. This multicollinearity problem may impair the accuracy and stability of the parameter estimates in the multiple regressions. Because of the small sample size, it is difficult to assess the extent to which the multicollinearity apparent in the sample data may be affecting the results. A larger sample may help assess the extent of the problem and permit alternative analysis techniques to circumvent the multicollinearity problem.

5. Summary and Conclusion

A survey designed to examine satisfaction and dimensions of auditor service quality was developed and mailed to 175 auditees. The 69 responses that were received form a sample that is spread across six client types and a wide size range. The responses were analyzed both descriptively and statistically. In general, the responses indicate a high level of client satisfaction with auditor services. In particular, the scores on questions about competence, courtesy and integrity are high. Despite the bad press the auditing profession has received lately, management of these firms has no overwhelming concern about the technical quality of the audits performed for them. In terms of customer service, the area that could be improved is the auditor's propensity to act in an anticipatory manner.

According to the data, the factors that contribute most to a client's satisfaction with services appear to be competence and effective communications. They account for 65% of the variability in the overall satisfaction score. Management of these firms view their audit services as being of higher quality than their tax services. There were no other detectable differences in the way

clients view tax services versus audit services, despite the fact that audit services may be purchased for very different reasons than are tax services.

The 25 quality dimension scores and the satisfaction score taken alone were not statistically different from each other when compared by client type or by length of relationship with the auditee. Despite the fact that a number of clients mentioned how high they felt their fees were, no statistically significant relationship was detected between cost and overall client satisfaction.

The issues of audit quality and client satisfaction are important ones to the auditing profession. It is hoped that, despite its limitations, this study will help to motivate future research in this area.

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Table 1

Response Statistics (Questions 1 to 25 and SAT) (n = 69)

| | | Response Frequency | | | | | | | Mean | Std. Dev. |
|-----------------|-----|--------------------|----|----|-----|-----|-----|-----|------|--------------|
| | | -3 | -2 | -1 | 0 | 1 | 2 | 3 | | |
| Competence: | Q1 | | | 2 | | 4 | 46 | 17 | 2.1 | .75 |
| | Q2 | | | 2 | 3 | 4 | 43 | 17 | 2.0 | .87 |
| | Q3 | | 3 | | 5 | 9 | 40 | 12 | 1.7 | 1.10 |
| | Q4 | | | 4 | 1 | 10 | 45 | 9 | 1.8 | .91 |
| | Q5 | | 4 | 3 | 12 | 13 | 30 | 7 | 1.2 | 1.30 |
| Courtesy: | Q6 | | | 1 | 5 | 3 | 30 | 30 | 2.2 | .93 |
| | Q7 | | | | | 6 | 37 | 26 | 2.3 | .62 |
| Reliability: | Q8 | | 3 | 4 | 5 | 20 | 28 | 9 | 1.3 | 1.24 |
| | Q9 | 1 | 4 | 3 | 4 | 10 | 39 | 8 | 1.4 | 1.37 |
| | Q10 | | 1 | 5 | 7 | 4 | 36 | 16 | 1.7 | 1.23 |
| Access: | Q11 | 1 | | 3 | 1 | 7 | 38 | 19 | 1.9 | 1.10 |
| Responsiveness: | Q12 | | 1 | 2 | | 11 | 40 | 15 | 1.9 | .94 |
| | Q13 | | | 1 | 1 | 6 | 43 | 18 | 2.1 | .73 |
| Communications: | Q14 | | | 2 | 1 | 20 | 39 | 7 | 1.7 | .79 |
| | Q15 | | | 7 | 5 | 23 | 27 | 7 | 1.3 | 1.09 |
| | Q16 | | 2 | 3 | 6 | 16 | 36 | 6 | 1.4 | 1.11 |
| | Q17 | 1 | 3 | 7 | 16 | 19 | 20 | 3 | .8 | 1.30 |
| | Q18 | | 1 | 1 | 10 | 5 | 41 | 11 | 1.7 | 1.05 |
| Integrity: | Q19 | | | | 5 | 2 | 35 | 27 | 2.2 | .82 |
| | Q20 | | 1 | 2 | 11 | 5 | 38 | 12 | 1.6 | 1.12 |
| Security: | Q21 | | | 1 | 3 | 7 | 39 | 19 | 2.0 | .83 |
| | Q22 | 1 | | | | 2 | 31 | 35 | 2.4 | .86 |
| Understanding: | Q23 | | | 4 | 2 | 11 | 35 | 17 | 1.9 | 1.02 |
| Caring/Concern: | Q24 | | | 1 | 2 | 8 | 44 | 14 | 2.1 | 1.11 |
| | Q25 | | 4 | | 8 | 9 | 38 | 10 | 1.6 | 1.21 |
| Satisfaction: | | | | 5 | 1 | 7 | 43 | 13 | 1.8 | .99 |
| | | 4 | 27 | 63 | 114 | 241 | 961 | 384 | | |
| % frequency | | 0% | 2% | 4% | 6% | 13% | 54% | 21% | | |

Table 2
Overall Response Comparisons
Across Groups

| | <u># of Observations</u> | <u>Cumulative Mean Rank (Q1 to Q25)</u> | <u>Satisfaction Mean Rank (SAT)</u> |
|-------------------|------------------------------|---|---|
| A. By Client Type | | | |
| Government | 4 | 23.3 | 28.8 |
| High technology | 5 | 48.8 | 40.6 |
| Not-for-profit | 3 | 38.0 | 44.3 |
| Parapublic | 12 | 34.6 | 34.6 |
| Owner-Managed | 40 | 33.4 | 33.0 |
| Public | 5 | 42.6 | 46.2 |
| | <u>69</u> | | |

Chi-Square = 4.78 Chi-Square = 3.41

B. By Length of Relationship

| | | | |
|--------------|-----------|------|------|
| 1 - 5 years | 29 | 36.1 | 36.7 |
| 6 - 10 years | 16 | 32.9 | 33.3 |
| > 10 years | <u>24</u> | 35.1 | 34.0 |
| | <u>69</u> | | |

Chi-Square = .26 Chi-Square = .38

Table 3
Response Statistics (Audit vs Tax Services)

A. Response Data

| | | <u>Response Frequency</u> | | | | | | | <u>Mean</u> | <u>Std. Dev.</u> |
|------------------------|-----|---------------------------|-----------|-----------|------------|-----------|------------|-----------|-------------|------------------|
| | | <u>-3</u> | <u>-2</u> | <u>-1</u> | <u>0</u> | <u>1</u> | <u>2</u> | <u>3</u> | | |
| <u>External Audit:</u> | | | | | | | | | | |
| Saliency: | Q27 | | | 2 | 16 | 6 | 22 | 23 | 1.7 | 1.24 |
| Expectations: | Q28 | | 1 | 10 | 54 | 2 | 2 | | -.1 | .59 |
| Quality: | Q29 | | | 1 | 18 | 4 | 36 | 10 | 1.5 | 1.08 |
| Cost: | Q30 | | 1 | 14 | 20 | 17 | 15 | 2 | .5 | 1.17 |
| | | <u>0</u> | <u>2</u> | <u>27</u> | <u>108</u> | <u>29</u> | <u>75</u> | <u>35</u> | | |
| <u>Tax Services:</u> | | | | | | | | | | |
| Saliency: | Q31 | | | | 23 | 5 | 27 | 14 | 1.5 | 1.16 |
| Expectations: | Q32 | | 3 | 8 | 54 | 2 | 2 | | -.1 | .65 |
| Quality: | Q33 | | 2 | 3 | 27 | 6 | 27 | 4 | .9 | 1.21 |
| Cost: | Q34 | | 2 | 8 | 37 | 9 | 13 | | .3 | 1.01 |
| | | <u>0</u> | <u>7</u> | <u>19</u> | <u>141</u> | <u>22</u> | <u>144</u> | <u>18</u> | | |

B. Mean Response Comparisons

| | | <u>Mean Rank (Frequency)</u> | | | <u>Z-statistic</u> |
|------------------------|--|----------------------------------|-------------------------------------|-------------------------------------|--------------------|
| | | <u>Tax = Audit Score</u> | <u>Tax > Audit Score</u> | <u>Audit > Tax Score</u> | |
| Q27 vs Q31 | | | | | |
| Service Saliency | | -(23) | 23.1(19) | 23.8(27) | -1.11 |
| Q28 vs Q32 | | | | | |
| Expectations Confirmed | | -(48) | 9.7(11) | 12.4(10) | -.29 |
| Q29 vs Q33 | | | | | |
| Quality | | -(31) | 16.1(11) | 20.9(27) | -2.81* |
| Q30 vs Q34 | | | | | |
| Cost | | -(29) | 23.2(14) | 19.1(26) | -1.15 |

* statistically significant at better than the .005 level of confidence

Table 4
Multiple Regressions

| <u>Dependent Variable(s)</u> | | <u>Independent Variables</u> | | | | | | | | | |
|------------------------------|-----------------------------|------------------------------|-------------------------------------|----------------------------|-------------------------|------------------|------------------|---------------|------------|-----------------|---------|
| A. | Overall Satisfaction (SAT*) | Service Saliency (Q27+31/2) | Expectation Confirmation (Q28+32/2) | Service Quality (Q29+33/2) | Service Cost (Q30+34/2) | | | | | | |
| T-ratio | | .98 | .31 | 1.11 | .64 | | | | | | |
| F-ratio = | 2.8 | | | | | | | | | | |
| R ² = | .09 | | | | | | | | | | |
| B. | Service Quality (QUAL*) | Compe- tence | Courtesy | Relia- bility | Access | Respon- siveness | Communi- cations | Credi- bility | Secu- rity | Under- standing | Caring |
| T-ratio | | (2.31*) | (2.20*) | (.20) | (.51) | (-.57) | (2.43*) | (-.96) | (.55) | (-1.14) | (-1.80) |
| F-ratio = | 3.0 | | | | | | | | | | |
| R ² = | .23 | | | | | | | | | | |
| C. | Overall Satisfaction (SAT*) | Compe- tence | Courtesy | Communi- cations | | | | | | | |
| T-ratio) | | (4.24*) | (.54) | (4.48*) | | | | | | | |
| F-ratio = | 43.1 | | | | | | | | | | |
| R ² = | .65 | | | | | | | | | | |

* statistically significant at better than the .05 level of confidence

**LA CONTINUITÉ D'EXPLOITATION ET LE VÉRIFICATEUR:
Une évaluation comparative des outils diagnostiques**

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LA CONTINUITÉ D'EXPLOITATION ET LE VÉRIFICATEUR: Une évaluation comparative des outils diagnostiques

L'objet général de la présente recherche vise à faciliter le travail du vérificateur par la mise à disposition de procédures de discrimination statistiques efficaces dans le cadre de l'hypothèse de continuité de l'exploitation¹.

La responsabilité du vérificateur se précise de plus en plus lorsque la continuité d'exploitation est remise en question. Aux États-Unis, les vérificateurs sont tenus depuis 1989 d'évaluer si l'entreprise sera en mesure de fonctionner dans un contexte de continuité d'exploitation (SAS n° 59). Au Canada, la Commission MacDonald est d'avis que des normes nouvelles sont nécessaires pour permettre au vérificateur d'exprimer des doutes au sujet de la continuité d'exploitation lorsque cela s'avère nécessaire.

Ce nouveau contexte en matière de responsabilité du vérificateur amènera celui-ci à modifier sa stratégie de vérification pour faire place à des modèles de détection des difficultés financières potentielles de l'entreprise. En s'appuyant sur le modèle d'évaluation du risque inhérent de vérification de l'I.C.C.A., notre étude vise donc à développer des outils statistiques performants afin de faciliter le travail du vérificateur.

Quatre techniques multivariées différentes seront considérées: l'analyse discriminante linéaire, l'analyse logistique, la programmation par objectif et le partitionnement récursif. Ces techniques statistiques nous permettront de discriminer entre une entreprise saine et une entreprise en difficulté financière.

La recherche est présentée comme suit. La section I présente l'objet et la motivation de la présente étude. La section II développe le modèle empirique utilisé dans la présente étude, tout en s'appuyant sur une revue de la littérature des principales recherches sur les modèles de prévision de faillite et celles portant sur la continuité de l'exploitation. La section III expose le design expérimental de l'étude de même que l'échantillon. Enfin, la section IV discute des particularités de l'étude.

I. OBJET ET MOTIVATION

Au cours des dernières années, les vérificateurs ont fait l'objet de critiques sévères de la part des investisseurs suite à certaines faillites retentissantes de sociétés ouvertes (e.g., Norbanque et Canadian Commercial Bank). De plus, le rapport de la Commission Macdonald affirme que les investisseurs se fient au rapport du vérificateur afin d'obtenir de l'information fiable sur la capacité d'une entreprise de poursuivre ses opérations. Il ressort de ces événements que l'hypothèse de continuité de l'exploitation revêt une grande importance pour le vérificateur.

Le Manuel de l'I.C.C.A. définit l'hypothèse de continuité de l'exploitation comme étant l'un des principes fondamentaux soutenant les états financiers. Une dérogation à l'hypothèse ou un doute sérieux quant à sa validité entraînent des répercussions sérieuses sur plusieurs postes des états financiers. Dans ce contexte, le système de

¹ Au chapitre 1000 du Manuel de l'ICCA, intitulé "Fondements conceptuels des états financiers", on entend par l'hypothèse de la continuité d'exploitation qu'une entreprise poursuivra ses activités dans un avenir prévisible et sera en mesure de réaliser ses actifs et de s'acquitter de ses dettes dans le cours normal de ses activités.

valorisation aux coûts historiques n'est donc plus approprié. Toutefois, il n'existe pas de norme comptable relative à l'information financière à publier dans le cas d'une entreprise qui est sur le point de rencontrer des difficultés financières sérieuses, e.g., faillite. Il s'agit pour le vérificateur de déterminer si les états financiers sont présentés selon les principes comptables généralement reconnus. On sous-entend ainsi qu'en vertu des P.C.G.R., les états financiers doivent renseigner explicitement le lecteur de la possibilité que l'entreprise soit dans l'impossibilité de poursuivre ses activités. Ainsi, si le vérificateur considère que les renseignements fournis par l'entreprise sont suffisants, il n'est pas actuellement tenu de mentionner son doute quant à la continuité d'exploitation dans son rapport.

Depuis 1989, les vérificateurs américains sont tenus d'évaluer si l'entreprise sera en mesure de fonctionner dans un contexte de continuité d'exploitation. La période pour laquelle le vérificateur doit s'assurer que la continuité d'exploitation n'est pas menacée n'excède pas un an à compter de la date des états financiers (S.A.S. n° 59).

Même si, à ce jour, les normes canadiennes n'imposent pas cette obligation, plusieurs titres d'entreprises canadiennes sont transigés sur les marchés boursiers américains et plusieurs entreprises canadiennes sont des filiales d'entreprises américaines. De plus, des coûts économiques importants peuvent être encourus par les vérificateurs en cas de non-continuité de l'exploitation. En conséquence, l'évaluation du risque inhérent d'un client par le vérificateur devra considérer expressément la possibilité que l'hypothèse de non-continuité de l'exploitation ne soit pas respectée.

Cependant, même si le Manuel de l'I.C.C.A. et les ouvrages de vérification fournissent des indications sur les éléments à considérer dans l'analyse du risque inhérent, aucune approche systématique n'est fournie. De plus, même si l'analyse des états financiers du client est partie intégrante du processus d'évaluation du risque inhérent, les modèles (qualitatifs et quantitatifs) retrouvés dans la littérature ne sont pas explicites quant à la direction que devra prendre le travail du vérificateur. Par exemple, certains modèles de prédiction de faillite indiquent que la marge d'autofinancement d'une entreprise peut être considérée comme un signal utile pour prédire la faillite prochaine. Cependant, un tel signal donne peu d'indications au vérificateur quant à la démarche de vérification à entreprendre par la suite. De plus, rien ne nous renseigne sur la fiabilité de la méthode d'analyse qui génère ce diagnostic.

Le présent projet de recherche a deux objectifs: premièrement, évaluer la précision de différents outils d'évaluation du risque de non-continuité de l'exploitation d'une entreprise; deuxièmement, fournir au vérificateur des indications quant à la direction que devra prendre son travail de vérification, c'est-à-dire sur quels aspects des états financiers diriger ses efforts.

II. MODELE EMPIRIQUE

2.1. Non-continuité de l'exploitation

L'identification des caractéristiques permettant d'anticiper la faillite d'une entreprise a fait l'objet d'un grand nombre d'articles depuis les études de Beaver [1966] et Altman [1968]. Ces articles ayant été révisés et commentés en détail par Dumontier [1990], Foster [1986] et Zavgren [1983], les résultats des études antérieures seront plutôt cités au besoin.

La plupart des études en vérification (e.g., Koh & Killough [1990], Mutchler [1985] et Kennedy & Shaw [1990]) définissent la non-continuité de l'exploitation comme étant la faillite d'une entreprise (au sens du Chapitre 11 de la loi américaine). Cet usage s'inscrit directement dans la lignée des études de prévision de "faillite" (voir Zavgren

[1983]). La faillite (ou non-faillite) légale d'une entreprise est une variable dichotomique objective facilement identifiable pour le chercheur. Cependant, du point de vue du vérificateur, une entreprise en difficulté financière a d'autres alternatives légales ou économiques que de déclarer faillite. En effet, une entreprise peut être acquise ou elle peut fusionner avec une autre, elle peut tout simplement cesser ses opérations et être liquidée, ou elle peut être réorganisée de manière radicale. De plus, il arrive parfois que certaines entreprises réémergent des procédures de faillite. Chaque alternative peut entraîner un coût économique important pour les parties impliquées, c'est-à-dire, les investisseurs, les employés, la direction et les créanciers. Toutes ces possibilités marquent l'aboutissement des difficultés financières d'une entreprise. Lorsque des difficultés financières sérieuses apparaissent, il est donc difficile de prédire le cours postérieur des événements. De plus, chacune des possibilités constitue en quelque sorte la fin de l'entreprise telle que connue avant les difficultés. Les pertes économiques réelles des investisseurs, qui constituent un indicateur du montant des poursuites éventuelles contre le vérificateur, ont probablement été encourues bien avant.

La présente étude cherche à développer un outil utile à la prédiction des difficultés financières sérieuses d'une entreprise. Un diagnostic de difficultés financières sérieuses potentielles indique au vérificateur que le risque de non-continuité de l'exploitation est sérieux et que des procédés de vérification additionnels seront peut-être nécessaires afin de s'assurer de l'évaluation fidèle de l'actif et du passif. De plus, un diagnostic de difficultés financières potentielles sérieuses pourrait permettre au vérificateur de prendre des mesures afin de réduire leur coût économique, avant que la faillite (ou autre possibilité) ne devienne inévitable.

Aux fins de la présente étude, une entreprise est considérée en difficultés financières sérieuses si son rendement (ajusté pour le marché) boursier annuel est négatif.¹ La valeur au marché d'une entreprise est fonction des flux monétaires futurs actualisés (Ou et Penman [1989]). Une réduction dans la valeur au marché d'une entreprise reflète soit une révision à la baisse des flux monétaires anticipés, soit une augmentation du taux d'actualisation, laquelle serait causée par une augmentation du risque non systématique. Ces deux facteurs nous laissent présager des difficultés financières qui pourraient mettre en péril la continuité d'exploitation. L'entreprise sera présumée avoir un risque de non-continuité si son rendement annuel ajusté pour le marché est inférieur à -50%.¹ Il aurait été plus précis de calculer un rendement annuel en utilisant des données mensuelles, hebdomadaires ou même quotidiennes. Ce travail serait toutefois fastidieux et le résultat serait fort probablement le même, car les bornes sont suffisamment éloignées pour éliminer les écarts. En effectuant une dichotomie sur cette base, nous éliminons le risque d'erreur de classement causé par les mouvements erratiques du cours des actions.

¹ Afin de s'assurer que le modèle est prédictif, les données des variables indépendantes proviendront des états financiers et d'autres sources d'information antérieures à la période de calcul du rendement boursier. Ce rendement sera calculé au 31 mars.

¹ ($R_i - R_m = < -50\%$). Nous n'avons pas ajusté le rendement pour le risque systématique (bêta) car la plupart des entreprises de notre échantillon n'ont pas un historique assez long pour calculer un bêta fiable. De plus, plusieurs études démontrent qu'un rendement ajusté pour le marché donne des résultats comparables (voir Brown et Warner [1980]).

2.2. Modèle d'évaluation du risque inhérent

2.2.1. *L'incidence du risque sur la vérification*

Les différents types de risque ne peuvent être évalués avec précision; aucune norme de vérification ne permet de les déterminer de façon uniforme et précise. C'est alors que le jugement professionnel intervient dans les différentes étapes de l'estimation du risque.¹

La relation entre le modèle de risque en vérification et le concept de la continuité d'exploitation n'est pas évidente. Le modèle de risque vise principalement à évaluer la probabilité que les états financiers contiennent des erreurs matérielles. Le vérificateur a intérêt à contrôler ce facteur, car il peut en résulter des coûts importants (poursuites judiciaires, perte de crédibilité, etc.). Un manquement à la continuité d'exploitation peut, dans certaines circonstances, fausser les états financiers. Le vérificateur aura toutefois rempli ses engagements s'il met en garde le lecteur sur le fait que la continuité d'exploitation est menacée.

Il y a tout de même lieu de croire que le modèle de risque peut s'avérer utile pour prédire la santé financière de l'entreprise et sa capacité à assurer la continuité d'exploitation. C'est la raison pour laquelle nous comptons estimer le risque inhérent de chaque entreprise contenue dans notre échantillon. Notre évaluation du risque comportera deux dimensions: premièrement, une analyse dynamique des états financiers et deuxièmement, une analyse des éléments qualitatifs de risque inhérent.

2.2.2. *Analyse dynamique des états financiers*

La littérature en prévision de faillites et en évaluation de continuité de l'exploitation utilise de nombreux ratios financiers. Les textes en analyse d'états financiers font eux aussi appel à un grand nombre de ratios financiers. La sélection de ces ratios financiers s'appuie sur différentes sources: analyse discriminante pas-à-pas (Koh et Killough [1990]), analyse factorielle (Mensah [1983]), modèles répandus et traditionnels d'analyse d'états financiers (Beaver [1966], Dopuch et al. [1987]), interviews avec analystes financiers ou vérificateurs (Mutchler [1985]), etc.. Il est à noter que la sélection de ratios spécifiques revêt un certain caractère ad hoc dans plusieurs études et est difficilement généralisable.

L'entrée d'une entreprise dans une phase de difficultés financières sérieuses est un phénomène dynamique. En d'autres termes, une entreprise connaît des difficultés parce que ses conditions d'exploitation se sont détériorées par rapport à l'équilibre qui existait auparavant. Dans ce contexte, il devient nécessaire d'évaluer les tendances dans les états financiers afin de faire ressortir les postes pour lesquels les variations sont un signe avant-coureur de difficultés financières. La performance boursière d'une entreprise, ajustée pour la performance du marché, devrait être affectée par des changements survenus dans sa situation financière. Le niveau d'un poste des états financiers ou d'un ratio financier, à un moment donné, est une information statique qui ne devrait pas influencer directement la variation du cours des actions.

L'utilisation d'information dynamique est aussi appropriée compte tenu de la nature multi-industries de l'échantillon considéré. Il a été établi que les niveaux de ratios financiers varient fortement d'une industrie à l'autre (Foster [1986]). L'identification d'un niveau de ratio comme étant précurseur de difficultés financières devient ainsi une information peu pertinente pour le vérificateur car elle lui est présentée hors contexte (e.g., un ratio de fonds de roulement inférieur à 1,5). Une information mieux

¹ Pour une description détaillée du risque en vérification, voir: L'étendue des sondages en vérification, I.C.C.A. (1981).

adaptée à la réalité de l'entreprise est donc nécessaire au vérificateur. C'est cette information dynamique qui devrait jouer un rôle de précurseur des difficultés financières.

Enfin, dans le cadre de sa planification, le vérificateur doit déterminer ses attentes par rapport aux soldes des différents postes aux états financiers et effectuer un examen analytique de la cohérence des chiffres qui lui sont fournis par la direction. L'utilisation d'information comptable dynamique, laquelle est intégrée dans un modèle systématique d'analyse des tendances des états financiers d'une entreprise devient un apport précieux au travail de planification du vérificateur en lui permettant d'identifier les postes "risqués".

La présente étude propose de s'appuyer solidement sur les états financiers disponibles d'une entreprise et d'utiliser une démarche cohérente avec les objectifs du vérificateur. De plus, Beaver [1966] souligne le risque de manipulation des données comptables dans un contexte de difficultés financières, mais aucune étude n'a spécifiquement considéré cette possibilité dans son analyse. L'objectif de la démarche proposée est de s'assurer de la qualité de l'information financière divulguée par une entreprise dans une perspective d'évaluation de la continuité de l'exploitation.

2.2.3. *Évaluation de la qualité des bénéfices*

Un des objectifs primordiaux d'un vérificateur est de s'assurer de la fidélité du montant de bénéfice net présenté aux états financiers. A cet égard, il est intéressant de noter que plusieurs vérificateurs définissent le concept d'importance relative en fonction du bénéfice net (Arens, Lemon & Loebbecke [1987], Leslie [1985]). Les analystes financiers attachent eux aussi beaucoup d'importance au bénéfice net mais cherchent principalement à en établir la "qualité", laquelle est considérée comme un signal de la situation future de l'entreprise en termes de liquidités.⁵ Par exemple, la firme Value Line évalue la qualité du bénéfice d'une entreprise afin de lui attribuer une cote "Safety Index" (Lev et Thiagarajan [1990], p. 6). Enfin, le F.A.S.B. définit le bénéfice comme étant une mesure des flux monétaires à long terme de l'entreprise: toute transaction inhabituelle affectant le bénéfice ne devrait pas affecter ces flux monétaires à long terme et ne devrait donc pas être considérée dans l'évaluation de la liquidité future de l'entreprise. Les études empiriques tendent à supporter cette affirmation (Brown et al. [1987], Ou et Penman [1989]).

En résumé, l'évolution de la "qualité" des bénéfices d'une entreprise est un signal quant à ses perspectives en termes de liquidités et, indirectement, un indice quant au risque de non-continuité de l'exploitation.⁶

⁵ L'énoncé suivant en fait foi: "In an effort to place the discussion of liquidity analysis using financial ratios in proper perspective, this section discusses quality of earnings. Quality of earnings refers to how closely earnings are correlated with cash flows. The higher the correlation, the higher the earnings quality is and the lower is the risk associated with liquidity". (Gallinger and Healey [1987], p. 42)

⁶ De plus, dans le cadre de l'évaluation du risque inhérent, le Manuel de l'ICCA oblige les vérificateurs à considérer les éléments qui pourraient affecter la fidélité des états financiers. Si la direction de l'entreprise prévoit des temps durs et des difficultés financières à moyen terme, elle pourra être tentée de diminuer la qualité de ses bénéfices en réalisant diverses transactions qui gonflent le bénéfice à court terme sans pour autant affecter les tendances à long terme.

Les ajustements nécessaires pour déterminer un bénéfice de meilleure "qualité" sont les suivants:

Bénéfice avant impôts
 Plus (Moins) les ajustements suivants:
 Radiations d'actifs intangibles (ex. frais de développement capitalisés ou
 frais de démarrage capitalisés)
 Radiation d'actif à long terme tangible (ex. immobilisations ou placements)
 Gains ou pertes non récurrents sur cessions d'actifs
 Ajustements d'exercices antérieurs
 Quote-part des bénéfices des filiales non consolidées
 Bénéfice d'activités abandonnées
 Intérêts capitalisés
 Ajustements résultant de devises étrangères
 = Bénéfice ajusté

La résultante de cette transformation est désignée comme bénéfice ajusté avant impôts (BAAI). Ce chiffre est par la suite multiplié par $(1 - \text{taux d'imposition})$ afin d'obtenir le bénéfice net ajusté (BNA). Le taux d'imposition sera estimé comme étant la moyenne du taux d'imposition des deux exercices les plus récents.

Les variables indépendantes suivantes traduiront l'évolution de la qualité des bénéfices d'un exercice à l'autre:

- Variation du BNA par action d'un exercice à l'autre.
- Variation en Ajustements par action d'un exercice à l'autre.

L'analyse antérieure a permis de dégager un chiffre précis indiquant la qualité du bénéfice. Cependant, pour une analyse complète de la qualité du bénéfice, il est nécessaire d'évaluer la cohérence entre l'état des résultats et le bilan. Différents signaux sont émis par les états financiers qui peuvent alerter le vérificateur quant à l'apparition possible de difficultés financières dans le futur. Deux types de signaux sont émis par une entreprise: ceux qui reflètent les décisions d'exploitation de la direction et ceux qui traduisent ses décisions en matière de choix comptables.

Décisions d'exploitation:

- Une augmentation des comptes-clients supérieure à l'augmentation des ventes.
- Une augmentation des stocks supérieure à l'augmentation des ventes.
- Une augmentation des charges d'exploitation supérieure aux ventes.
- Une augmentation des déboursés d'intérêts supérieure aux ventes.
- Des réductions en dépenses d'immobilisations et recherche et développement.
- Une diminution de l'échéance relative des dettes portant intérêt.
- Une diminution des dividendes (et rachats d'actions).⁷

⁷ Les variations relatives sont définies de la manière suivante (l'exemple utilisé reflète les variations de comptes-clients):

(Variation en % des clients) - (Variation en % des Ventes)
 où les variations sont définies de la manière suivante:

$$[\text{Clients}_t - E_{t-1}(\text{Clients}_t) / \text{Clients}_{t-1}]$$

$$E_{t-1}(\text{Clients}_t) = \text{Clients}_{t-1}$$

Décisions comptables:

- . Changement de méthode d'amortissement (1/0).
- . Radiation d'actifs à long terme (suivie de réduction dans les charges d'amortissement) (1/0).

Des variables externes donnant une perspective sur la performance du secteur industriel dans lequel se situe le client permettent d'évaluer la qualité relative des bénéfices de l'entreprise. Il est à noter qu'en pratique le vérificateur aura fort probablement des renseignements légèrement déphasés sur l'industrie par rapport aux résultats du client. Il sera nécessaire de considérer cette contrainte lors de la cueillette des données. Les éléments à considérer sont:

- . Tendance récente des ventes de l'industrie
- . Tendance récente des bénéfices de l'industrie

2.2.4. Indicateurs qualitatifs de risque inhérent

Une analyse du risque inhérent d'une entreprise par le vérificateur ne saurait être complète sans considération des contraintes pouvant affecter le travail et les décisions de la direction. Les indicateurs qualitatifs de risque seront identifiés à partir d'ouvrages de référence en vérification (e.g., Lemon, Arens & Loebbecke) et codés sous forme dichotomique.

- . Investissement dans un secteur industriel différent (1/0) (1 si l'actif de ce nouveau secteur représente 10% ou plus de l'actif total; 0 sinon)
- . Mise en place d'un régime incitatif de rémunération (1/0)
- . Changement dans le contrôle de l'entreprise (1/0)¹
- . Augmentation substantielle dans le volume de transactions avec parties apparentées (pourcentage des ventes plus les charges totales avec parties apparentées par rapport à l'ensemble)
- . Changement dans le nombre d'emplacements (1/0)
- . Changement dans l'actionnariat (variation du pourcentage d'actions détenues par le président)

Il s'agira ensuite d'utiliser des modèles statistiques nous permettant de discriminer entre une entreprise saine et une entreprise en difficulté. Ces modèles constitueront un outil intéressant pour le vérificateur dans la mesure où l'on utilisera des données financières dont il dispose, de même que des données qualitatives sur le risque inhérent. Actuellement, le vérificateur procède déjà à l'estimation du risque inhérent, il lui sera donc facile d'obtenir les données pertinentes, probablement plus que nous d'ailleurs.

¹ Nous définissons une société à grand nombre d'actionnaires comme toute entreprise dans laquelle aucun actionnaire ne détient plus de 20% des actions donnant droit de vote; le contrôle est alors exercé par les gestionnaires. D'ailleurs, le Manuel de l'I.C.C.A. parle d'influence sensible lorsque l'on détient entre 20% et 50% des actions votantes.

III. DESIGN EXPERIMENTAL

3.1. Échantillon et cueillette de données

Notre échantillon de base sera constitué de sociétés ouvertes canadiennes, un groupe dont la continuité d'exploitation semble assurée et un groupe dont la continuité d'exploitation n'est plus assurée. L'échantillon proviendra entre autres sources de la base de données Compustat, des bases de données des Commissions des valeurs mobilières et de Financial Post, et des états financiers.

La prévision des difficultés financières de la firme constitue notre variable dépendante. A cet effet, nous choisirons de définir les difficultés financières comme la perte de valeur boursière du titre que nous traduisons par la différence entre le rendement propre du titre (R_i) moins le rendement du marché (R_m). Par hypothèse, nous considérons que lorsque cette valeur est inférieure à - 50%, l'entreprise est en difficulté. Toutefois, nous définirons une entreprise en bonne santé par une différence ($R_i - R_m$) supérieure ou égale à zéro.

Chaque entreprise sera caractérisée par des indicateurs de santé financière suggérés par une analyse de risque inhérent. Ces indicateurs de risque sont de deux nature:

- 1° Indicateurs financiers et comptables;
- 2° Indicateurs qualitatifs de risque (e.g., nature des activités).

Les indicateurs financiers seront extraits des états financiers des entreprises visées. D'abord, une analyse de corrélation sera effectuée. Les variables fortement corrélées (par exemple 90% ou plus) seront d'abord éliminées. Une analyse factorielle (en composantes principales) servira ensuite à extraire les indicateurs les plus représentatifs de la situation financière des entreprises contenues dans l'échantillon.

Pour chaque entreprise comprise dans notre échantillon, nous utiliserons une représentation du risque inhérent que fixerait normalement le vérificateur pour une mission semblable. Les 6 indicateurs qualitatifs ci-haut mentionnés serviront à cette fin. Ces indices de risque serviront de variables explicatives dans le modèle de prévision de la santé financière de la firme. Le résultat obtenu du modèle de précision de la santé financière pourra d'ailleurs être utilisé par le vérificateur pour réviser ses estimations quant à la composante risque global acceptable pour chaque mission de vérification.

Nous évaluerons le risque de non-continuité en analysant les données pour une période couvrant les trois exercices précédant l'événement, c'est-à-dire un rendement de -50%.

3.2. Outils de diagnostic du risque de non-continuité d'exploitation

D'un point de vue purement conceptuel, l'opinion que devra émettre le vérificateur lors de l'examen annuel des comptes revient à savoir si l'entreprise pourra continuer normalement son activité ou si sa pérennité sera remise en cause durant le prochain exercice. S'il est relativement évident que nous ne pouvons acquérir de certitude en la matière, il devrait être possible d'estimer les différentes alternatives avec leurs probabilités de réalisation.

Si l'on interprète à présent la question d'un point de vue technique, le problème revient à acquérir l'expérience de ce qui est une entreprise saine et de la réalité d'une entreprise en difficulté. Plus formellement, on va rechercher un hyperplan qui sépare au mieux deux (ou plusieurs) ensembles d'individus pour plusieurs critères jugés pertinents. L'hyperplan résultant devrait alors nous servir pour reclasser correctement

tout nouvel individu avec une approximation raisonnable, pour peu que l'échantillon de base soit représentatif de la population.

Pour étudier ce problème, nous nous intéresserons à quatre classes de procédures, dont les unes sont très connues et les autres, plus spécifiques à des domaines connexes de la finance d'entreprise. Les deux premières procédures se rapportent l'une à l'analyse discriminante et l'autre, à l'analyse logistique. En ce qui concerne les deux dernières, il s'agit de la programmation par objectif et du partitionnement récursif.

Très généralement, les trois premières méthodes aboutissent à la définition analytique d'une relation fonctionnelle, la dernière conduisant à une structure arborescente.

Chacune des quatre méthodes s'articule autour de trois questions:

- . quel est l'ensemble des critères discriminants?
- . quelle est la forme de la relation?
- . comment tester la qualité de la relation?

Appelons X_{ij} valeur des critères j pour un individu i avec $i=1....h$ et $j=1....p$;
 \hat{u}_j vecteur des moyennes pour le caractère j , $j=1....p$;
 a_j vecteur des coefficients discriminants;
 σ matrice des variances - covariances totale;

$$\sigma = W + B$$

les deux termes de la sommation traduisant les variances inter-groupe et intra-groupe.

Le problème de l'analyse discriminante au sens de Fisher consiste à maximiser la différence entre les groupes ou à minimiser l'étendue des groupes. Le problème s'écrit alors:

Maximiser $a_j^t B a_j$
 sous-contrainte: $a_j^t \sigma a_j = 1$

Si nous appelons C le vecteur des différences des moyennes des groupes, on écrira:

$$D^2 = C^t \sigma^{-1} C,$$

qui est la distance généralisée de Mahalanobis. Cette dernière relation est importante, car si l'ensemble initial de critères est trop grand, on va procéder à une analyse combinatoire pour l'obtention du meilleur sous-ensemble de critères. A partir du même concept, on peut construire, en suivant Mardia [1970], un test pour vérifier la multinormalité du tableau initial, basé sur les coefficients d'asymétrie et l'aplatissement.

$$b_{1,1} = (1/n^2) \sum \sum ((X_{1j} - \hat{u})^t \sigma^{-1} (X_{1j} - \hat{u}))^3$$

$$b_{2,1} = (1/n) \sum ((X_{1j} - \hat{u})^t \sigma^{-1} (X_{1j} - \hat{u}))^2$$

La seconde approche se rapporte à l'utilisation de la fonction logistique, le problème s'écrit alors:

$$\log L = \sum_{i,1} \log (\exp (a_j X_{1j} + a_0) / (1 + \exp (a_j X_{1j} + a_0)))$$

$$\sum_{i,2} \log (1 / (1 + \exp (a_j X_{1j} + a_0)))$$

où n_1 et n_2 traduisent les individus du groupe 1 et 2, on aura:

Maximiser $\log L$.

En ce qui concerne à présent la sélection des critères pertinents parmi les p possibles, on peut, là encore, procéder à une analyse combinatoire, mais cette fois, faire intervenir le L ratio (likelihood ratio) avec un calcul de pseudo R2 qui s'écrirait:

$$R2 = (L \text{ ratio} / (n + L \text{ ratio}))$$

La troisième méthode évoquée part du principe qu'une analyse discriminante classique n'est qu'un problème de régression au sens des moindres carrés. De fait, rien ne nous empêche de faire de la régression dans une autre norme, en particulier L1, soit une technique de programmation linéaire qui, tout en étant moins complexe que les techniques de discrimination conventionnelles, ne sacrifie pas le pouvoir prédictif. En suivant Fred et Glover [1981], on peut définir tout un ensemble de modèles de discrimination, dont une formulation générale serait:

Maximiser $\sum d_i$

$$\begin{aligned} \text{sc: } & \sum a_{ij} X_{ij} - d_i \geq c \text{ pour } i \in g_1 \text{ (les entreprises saines)} \\ & \sum a_{ij} X_{ij} - d_i \leq c \text{ pour } i \in g_2 \text{ (les entreprises en difficulté financière)} \\ & a_{ij}, d_i \text{ sans restriction de signe} \end{aligned}$$

où c représente une valeur critique et d la distance de chacun des individus au point critique. La définition de c a assez peu d'importance puisque même si elle est choisie arbitrairement et influence l'échelle des résultats, elle permet la comparaison entre les individus, à condition de ne pas la modifier.

Enfin, la dernière procédure s'appuie sur les travaux de Breiman, Friedman, Olshen et Stone [1984], où la règle de classement se traduit par une suite de partitions de l'ensemble des individus. La partition peut être le fait d'un seul critère ou d'une combinaison linéaire de critères. Il s'agit d'une technique non paramétrique qui repose sur la construction d'un arbre de décision.

La construction de l'arbre demande que l'on réponde aux questions suivantes:

- quel est le critère le plus discriminant?
- à quel moment arrêtons-nous la procédure de partitionnement?
- comment va se faire l'assignation d'un noeud terminal à un groupe?

Chaque noeud se définit par son taux d'impureté qui représente le degré de mélange des groupes dans le noeud. Si nous appelons $P(1/t)$ la proportion de sujets du groupe g_1 dans le noeud, et si nous supposons deux groupes initiaux, le taux d'impureté s'écrira:

$$i(t) = 2 * P(1/t) * P(2/t)$$

Puisque à chaque partition nous devons avoir une diminution de l'impureté qui s'écrit:

$$i(d,t) = i(t) - p_g i(t_g) - p_d i(t_d)$$

où p_g et p_d sont les proportions des sujets de (t) allant dans les noeuds inférieurs t_g et t_d . La meilleure division de t entraînant la plus grande réduction d'impureté sera telle que:

Maximiser $d(i(d,t))$

Pour l'ensemble des procédures précédentes, nous nous attacherons à tester la stabilité des classements obtenus. En l'occurrence, pour les trois premières procédures, nous utiliserons la variante .632 bootstrap et pour la dernière méthode, la technique définie par ses auteurs comme une évaluation croisée sur l'échantillon de base.

D'un point de vue purement statistique, seule la quatrième méthode est libre de toute hypothèse, le seul choix pouvant porter sur la règle de classement qui est ici le critère de Gini. La régression au sens des moindres valeurs absolues apparaît aussi comme peu contraignante au plan des hypothèses, mais avec des tests relevant de modèles robustes, donc peu répandus.

L'objectif de la présente recherche est d'évaluer les avantages et inconvénients pour le vérificateur de chacune des procédures statistiques décrites.

IV. PARTICULARITÉS DE L'ÉTUDE

Cette étude se distingue de la littérature antérieure sur plusieurs plans:

- . la définition de non-continuité d'exploitation utilisée nous apparaît appropriée puisqu'elle a une signification économique plutôt que strictement légale;
- . les variables représentatives du risque inhérent, tant qualitatives que quantitatives, sont incorporées au modèle de prévision de non-continuité;
- . notre étude définit la non-continuité de l'exploitation comme étant un phénomène dynamique, ce qui nous amène à considérer les changements intervenus dans la situation de l'entreprise au cours de la période cible;
- . notre modèle d'analyse des états financiers cadre bien avec les objectifs et la stratégie du vérificateur;
- . enfin, nous introduisons de nouveaux outils d'analyse pour le vérificateur et comparons la performance relative de chaque modèle.

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**Classificatory Smoothing of Net Income
Before Extraordinary Items - The Canadian Evidence**

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Classificatory Smoothing of Net Income
Before Extraordinary Items - The Canadian Evidence

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SYNOPSIS

Smoothing of reported income has been operationally defined as the dampening of fluctuations about some level of earnings currently considered to be normal for a firm (Biedleman, 1973), and management of smoothed earnings through choice of accounting techniques has been advocated as a utility maximizing objective of management.

Most empirical tests of the smoothing hypothesis have focused on the smoothing of "bottom line" net income, while it is generally recognized that net income before extraordinary items (NIBEI) is of primary focus to financial analysts and the investment community in general. Thus, the incentive for allocation between 'above the line' income statement accounts and extraordinary items (EI's), i.e. classificatory smoothing, exists. This paper tests the classificatory smoothing hypothesis in the recent Canadian setting.

The paper is particularly relevant to the Canadian institutional environment because, until the recent amendments of Section 3480, Canadian managers had relatively wide discretion in classifying certain items as extraordinary. This is in contrast to the U.S. reporting environment, where APB No. 30 severely restricted such discretion since 1973. The spirit of the pre-amendment Section 3480 implicitly suggested that management had a comparative advantage in identifying transactions that were differentially relevant for firm valuation and that management would report such items consistently, to the benefit of investors. Evidence consistent with rejecting the null hypothesis of no classificatory smoothing would support the recent amendments to Section 3480, on the argument that strategic smoothing activities by management distorted the distinctions of the classifications to investors.

Tests of the smoothing hypothesis are necessarily tests of joint hypothesis, i.e. in the absence of smoothing behaviour by management, the smoothed variable (NIBEI) follows a particular process and management adopts accounting procedures or classifications to reduce the variance of that process. Normal earnings are specified by two models - a linear time trend model and a random walk model - and deviations from normal earnings determined. Utilizing a sample of 170 Canadian firms, correlations between the deviations of NIBEI and reported EI's are used to assess the existence of classificatory smoothing behaviour. The results strongly support behaviour indicative of classificatory smoothing.

Classificatory Smoothing of Net Income Before Extraordinary Items - The Canadian Evidence

I. Introduction

Smoothing of reported earnings has been operationally defined as the dampening of fluctuations about some level of earnings that is currently considered to be normal for a firm (Beidleman 1973). Theory, originally presented by Gordon (1964), advocated that such smoothing behaviour is an appropriate objective of management, given the desire to maximize their utility. Following Gordon's work, several researchers presented empirical tests of the "smoothing hypothesis" (Barefield and Comiskey 1972, Beidleman 1973, for example). With the exception of Barnea, Ronen and Sudan (1976) tests of the smoothing hypothesis have focused exclusively on reported "bottom line" net income, as the hypothesised smoothed variable. However, it is generally recognized that net income before extraordinary items (NIBEI) is the primary focus of the investment community and financial analysts in particular.¹ Recognizing this, Barnea et al., utilizing a sample of 62 U.S. firms over the 1950-70 period, present evidence consistent with managers acting as if they utilize extraordinary revenues and expenses to smooth NIBEI. This particular research question has not been pursued in the U.S. because with the adoption of Accounting Principles Board Opinion No.30 in 1973 it became a non-issue, in that APB No.30 severely restricted management's discretion with respect to extraordinary items classification. Such has not been the case in Canada, where, until the revised provisions of CICA Handbook Section 3480 became effective for fiscal years commencing after December 31, 1990, relatively wide classificatory discretion was available to Canadian managers.

This paper addresses the issue of classificatory smoothing behaviour in the Canadian setting. In the next section the objectives of and dimensions through which smoothing can be achieved will be outlined. In Section 3 the applicability of this question to the Canadian institutional setting will be discussed and the motivation for it's study developed. Section 4 describes the sample and presents the methodology, Section 5 presents results, and the final section outlines limitations of the study and suggests avenues for future research.

¹ Analysts forecasts and mechanical time series forecasting models, which are typically used as proxies for the market's expectations of earnings, are based on NIBEI, for example.

II. Incentives and Techniques for Smoothing

Advocates of income smoothing as a management objective originally rested their arguments on the theory of capital asset values. Traditional asset pricing models accept that firm value is the present value of expected future cash flows, where the discount rate is a function of the uncertainty associated with the expectation. Through dampening the fluctuations about reported earnings, it was argued that management could influence investors' subjective expectations about future cashflow variability and hence firm value. This mechanistic hypothesis is at odds with the academic literature that provides evidence that the market cannot be fooled by paper manipulations, (Watts and Zimmerman 1986) although more recent work has provided evidence to the contrary (Hand 1989). Other advocated motivations for smoothing include linkage to maximization of managerial bonus compensation (Healy 1985) and signalling information useful to investors in assessing the degree of future persistence in an unexpected component of earnings (Miller and Rock 1985). Given these arguments, this paper proceeds on the presumption that management has the incentive to smooth reported income. While the analysis does not purport to discriminate between competing alternatives to the null hypothesis of no smoothing behaviour, evidence consistent with rejecting the null is presented.

Accepting smoothing of reported income as a desirable activity of management, the practice can be carried out on a number of different dimensions, briefly summarized as follows:

1) Real smoothing - Managers can initiate actions such that actual transactions are carried out so as to dampen income fluctuations over time; i.e. effect the timing of payment of dividends from a subsidiary.

2) Allocation (non-classificatory or intertemporal) smoothing - Given that an event has occurred, management has some discretion over the period(s) in which the financial results of the event are allocated. Balance sheet accounts and income statement accounts are involved in the process; e.g. percentage-of-completion vs. completed contract for long term projects.

3) Classificatory smoothing - When income statement items other than bottom line net income are the object of smoothing management can allocate within the income statement to reduce the dispersion of the income statement item in question over time.

This paper addresses type 3). Gibbins (1977) points out that, given high correlations between net income before and after extraordinary items, non-classificatory smoothing (type 2) using extraordinary items will result in a negative correlation between EI's and NIBEI. The analysis that follows hypothesises a positive relationship between EI's and NIBEI, indicative of classificatory smoothing behaviour. This does not rule out, nor suggest, the presence of non-classificatory smoothing behaviour simultaneously.

Management may well have incentives to smooth "bottom line" net income in addition to incentives to smooth NIBEI as advanced here. If intertemporal smoothing exists simultaneously, it would tend to bias against finding evidence of classificatory smoothing.

III. The Canadian Institutional Environment

Since 1969, section 3480 of the CICA Handbook required extraordinary items to be included in the determination of net income for the period and defined them as :

"Gains, losses and provisions for losses which result from occurrence the underlying of which is not typical of the normal business activities of the enterprise, are not expected to occur regularly over a period of years, and are not considered as recurring factors in any evaluation of the ordinary operations of the enterprise".

This provision initiated the all-inclusive earnings concept and mandated that such items could no longer be charged directly to retained earnings. Over the past 20 years some have argued that reporting inconsistencies between firms and over time within firms impeded comparability of financial statement items.

The spirit of the pre-1991 section 3480 suggested that management had a comparative advantage in identifying income statement items which were truly extraordinary in nature and would truthfully and consistently use that advantage to the benefit of the investor. Submissions by management of major Canadian corporations in opposition to the more restrictive provisions of the January 1989 CICA exposure draft indicate that management recognized this implicit assumption underlying section 3480. For example,

" The argument that disclosure of extraordinary items within the context of ongoing or normal operations is sufficient to meet the needs of the readers of financial statements is, in our opinion, inappropriate. Separate disclosure is not an adequate alternative to proper income measurement and classification. The users of financial statements frequently refer to net income and earnings per share as a basis of comparison between periods, companies and in particular, share prices. Any accounting basis that distorts or renders these comparisons invalid or useless must be considered regressive and a disservice to the capital markets." (CICA Public Record, pg.232, Maclean-Hunter Ltd.)

or,

" It should be appreciated that the primary purpose of financial statements is to inform the reader who may not always be as sophisticated as the trained accounting professional. In spite of notations, the reader of financial statements could well be misled through the proposed treatment. In turn, the investment community commonly looks to earnings per share before extraordinary items as a basic measure of profitability and indeed applies multiples to such numbers in arriving at a perceived reasonable market value for the shares of a public company." (CICA Public Record, p.243, Oshawa Group Ltd.)

Whether we believe that management has this comparative advantage in classifying these components of income is not the issue addressed here. The previous quotations are presented to illustrate managements' recognition of NIBEI as a key figure in firm valuation to the extent that they felt that their ability to classify these items should be maintained in practice. Coupled with the previous discussion of the desirability of reduction of earnings variability, classificatory smoothing behaviour is motivated.

IV. Data and Methodology

The sample data includes all firms for which annual earnings per share before and after extraordinary items, net income before and after extraordinary items, and extraordinary items were reported for the 20 year period 1969-1988 on the 1988 version of the Canadian Compustat tape. Selection of a sample period commencing in 1969, and therefore after CICA Handbook Section 3480 was implemented, eliminates the variable reporting practices that existed before 1969 when EI's were sometimes reported in the income statement and sometimes directly to retained earnings. This criteria yielded a sample of 180 firms, representing 97 different four digit SIC code industry categories. Ten firms which reported no extraordinary items in the 20 year period were excluded, reducing the final sample size to 170 firms. To the extent that the usual survivorship bias is present, it should be considered in assessing generalization of the results.

The frequency of reporting extraordinary items by firms is presented in Table 1. One's first impression is that the reporting of extraordinary items is far from extraordinary. Fifty-two firms reported extraordinary items in 10 or more years of the 20 year sample period. On average a sample firm reported an extraordinary item in 8 of the 20 years. The relatively high frequency with which extraordinary items are reported by the sample firms helps alleviate concerns regarding the sensitivity of correlational analysis to data gaps (Gibbins, 1977).

Empirical tests of the smoothing hypothesis are necessarily tests of joint hypotheses; that is, in the absence of smoothing behaviour by management accounting earnings follow a particular process and managers adopt or change accounting procedures or classifications to reduce the variance of that process. Therefore, it is necessary to postulate normal levels of both the smoothed variable (NIBEI).

Table 1 - Number years in which Extraordinary items(EI's) were reported by sample firms during the 1969-88 sample period

| # years with EI's | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|--------------------------|----|----|----|----|----|----|----|----|----|----|
| # firms(total=170) | 8 | 8 | 18 | 11 | 15 | 11 | 14 | 14 | 11 | 8 |
| # years with EI's | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
| # firms(total=170) | 9 | 13 | 7 | 5 | 4 | 4 | 5 | 4 | 1 | 0 |
| Mean = 8 Median = 7 | | | | | | | | | | |

Specification of the "normal" level of NIBEI was first derived by detrending the series of NIBEI for the 20 year period over time as specified by,

$$NIBEI_{it} = \alpha_i + B_{it}t + D_{it}, \quad t=1969, \dots, 1988 \quad (1)$$

where,

$NIBEI_t$ = observed smoothed variable in year t

D_{it} = deviation of NIBEI of firm i from trend in year t

It is recognized that such an ex-post measure of normal income assumes foreknowledge of both the magnitude and distribution of earnings over the twenty year period and may not be applicable to all firms and all industries. However, consistent with previous research, this approach is adopted for its computational convenience, its ability to permit testing across sequential time periods, and to allow comparison to the extant literature.

There is evidence, however, that suggests that annual earnings in general are more appropriately characterized by a random walk (Ball and Watts, 1972). While a random walk earnings generation process may be inconsistent with the joint hypotheses typically advanced in the smoothing literature it is not necessarily inconsistent with smoothing per se (Watts and Zimmerman, 1986, pg,144-5). That is, managers may "smooth" but the underlying time series of reported earnings may not follow a deterministic time trend.

To test the robustness of the results to the specification of the underlying earnings generation process the analysis is repeated using a random walk model, where annual NIBEI deviations are calculated on the basis of their deviation from that of the previous year, i.e.,

$$D_{it} = A_t - A_{t-1} \quad (2)$$

Prior studies have typically detrended the smoothing variable using a time detrending technique similar to that outlined above. This detrending technique does not appear to be applicable to extraordinary items however. Given the nature of classificatory smoothing, it does not make sense to advance normal levels of extraordinary items. In this context, extraordinary items result from classifying gains or losses as required to smooth NIBEI. Thus anything taken out of NIBEI to meet classificatory smoothing objectives creates extraordinary items as a residual result.²

However, Barnea et al (1976), argued that in the absence of deliberate smoothing by management, the incidence of extraordinary items would have resulted in some constant amount reported annually in the financial statements as an EI. Accordingly, they calculate deviations of reported EI's from their constant trend as,

$$EIDEV_{it} = EI_{it} - \frac{\sum_{t=1}^{20} EI_{it}}{20} \quad (3)$$

where,

$EIDEV_{it}$ = deviation of observed EI from constant trend
 EI_{it} = observed EI of firm i in year t

This approach seems somewhat questionable and ad hoc, but its use in the correlational analysis that follows would provide identical results to using actual reported EI's. Therefore, EI's as reported were regressed on the deviations of net income before extraordinary items from 'normal' earnings to assess the relationship that would be indicative of smoothing behaviour, i.e.,

$$D_{it} = \alpha_i + \beta_i EI_{it} + \epsilon_{it} \quad (4)$$

where, D_{it} are the deviations of reported NIBEI from 'normal' as specified by either the time trend or random walk model, EI_{it} is reported extraordinary items, and ϵ_{it} is a white noise. Equation 4 essentially estimates the Pearson correlation coefficients between

² I thank one of the reviewers, whose comments helped clarify my thoughts on this issue.

deviations from normal NIBEI and reported extraordinary items.³ In this instance the correlation coefficient, r , provides a useful descriptive measure of the degree of association between D_{it} and EI_{it} . A statistically significant positive correlation would be indicative of smoothing behaviour in that under that situation if the extraordinary revenues (expenses) were recorded above the line as ordinary revenues (expenses), then the variations in the magnitude of the smoothed variable (NIBEI) would have been observed to be larger in absolute value and identical in sign. In other words, NIBEI would have fluctuated more had these extraordinary items not been present.

V. RESULTS

Tables 2 and 3 provide results for the deterministic time series model and the random walk model respectively. Results are provided for the full sample as well as by general industry SIC code categories to provide an indication of any possible industry smoothing patterns. Positive correlation coefficients indicate that overtrend NIBEI is associated with overtrend extraordinary revenues or undertrend extraordinary expenses, suggesting smoothing behaviour. T-statistics from the 170 regressions of each model were utilized to assess the presence or absence of a relationship between the deviation variables regressed.

The results indicate strong support for the classificatory smoothing hypothesis through the manipulation of extraordinary items. Table 2 and 3 results are very similar indicating that the results are robust to the two normal NIBEI generation processes specified. The results are equally robust across the sample industries with each category exhibiting smoothing behaviour.

As further illustration of the smoothing behaviour suggested by the results, two graphical illustrations are presented. Figure 1 presents a histogram of the frequency of occurrence of correlation coefficients for each of the earnings generation models. A correlation coefficient in excess of positive (negative) .43 indicates a statistically significant positive (negative) correlation at the .05 level of significance (two-tailed test). The number of firms which exhibited a negative association is very small and those reaching a level of statistical significance are negligible.

³ Recall that in the simple linear regression model $\beta_1 = (S_D / S_{EI}) \times r$, where β_1 is as defined in Equation 4, r is the correlation coefficient, and S_D and S_{EI} are the sample standard deviations of D and EI respectively.

Table 2 - Summary of Significance of Regression Coefficients

| DETERMINISTIC TIME TREND MODEL | | | | | | | |
|--|-----|----------|--------|-----|----------|--------|-----|
| Significance of Regression Coefficient * | | | | | | | |
| | N | r > 0 ** | | | r < 0 ** | | |
| | | <.05 | .05-.1 | >.1 | <.05 | .05-.1 | >.1 |
| SIC 1000 | 34 | 20 | 2 | 11 | 0 | 0 | 1 |
| SIC 2000 | 42 | 20 | 2 | 18 | 0 | 0 | 2 |
| SIC 3000 | 38 | 22 | 3 | 10 | 0 | 0 | 3 |
| SIC 4-5000 | 45 | 18 | 3 | 19 | 0 | 1 | 4 |
| SIC 6-8000 | 11 | 8 | 0 | 1 | 1 | 0 | 1 |
| FULL SAMPLE | 170 | 88 | 10 | 59 | 1 | 1 | 11 |

* Based on T-statistic from regression of Equation (2)

** r = Correlation coefficient between the deviations of extraordinary items and deviations of net income before extraordinary items.

Table 3 - Summary of Significance of Regression Coefficients

| RANDOM WALK MODEL | | | | | | | |
|--|-----|----------|--------|-----|----------|--------|-----|
| Significance of Regression Coefficient * | | | | | | | |
| | N | r > 0 ** | | | r < 0 ** | | |
| | | <.05 | .05-.1 | >.1 | <.05 | .05-.1 | >.1 |
| SIC 1000 | 34 | 21 | 1 | 11 | 0 | 0 | 1 |
| SIC 2000 | 42 | 21 | 1 | 16 | 0 | 0 | 4 |
| SIC 3000 | 38 | 20 | 1 | 11 | 0 | 0 | 6 |
| SIC 4-5000 | 45 | 16 | 3 | 21 | 1 | 0 | 5 |
| SIC 6-8000 | 11 | 5 | 2 | 2 | 0 | 0 | 2 |
| FULL SAMPLE | 170 | 82 | 8 | 61 | 1 | 0 | 18 |

* Based on T-statistic from regression of Equation (2)

** r = Correlation coefficient between the deviations of extraordinary items and deviations of net income before extraordinary items.

The results presented illustrate a strong incidence of positive correlation between NIBEI and extraordinary items which is indicative of smoothing behaviour. Figure 2 further illustrates this relationship by plotting total NIBEI and total EI for the 170 firm sample over the 20 year period. In almost all years the total NIBEI and total EI move in same directions.

Figure 1 - Frequency of Correlation Coefficients - Time Trend Model (n=170)

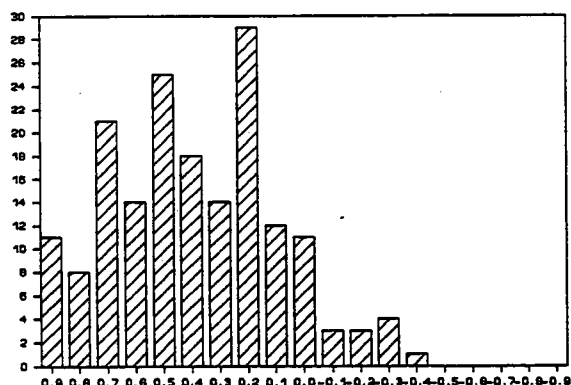
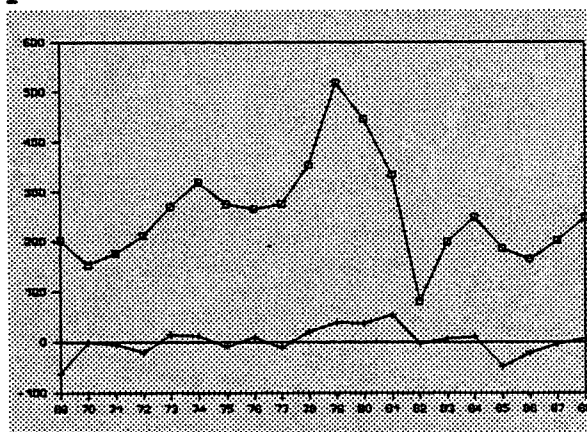


Figure 2-Total NIBEI and Total EI's over the 20 year sample period



VI. Discussion

This paper explores behaviour consistent with the smoothing behaviour of net income before extraordinary items by managers of 170 Canadian firms over the 20 year period 1969-88. This study is particularly applicable to the Canadian setting because until recent amendments to Section 3480 of the CICA handbook Canadian companies had a wide degree of discretion in classifying items as extraordinary or not. This is unlike the U.S. institutional environment where reporting items as extraordinary has been severely restricted since 1973. The implicit assumption of the pre-amendment regulation was that management had some comparative advantage in identifying items of differential valuation relevance and that they would apply them consistently.

The evidence suggests earnings management, in that behaviour consistent with classificatory smoothing of annual net income before extraordinary items is provided. Evidence suggesting opportunistic management of extraordinary items classification provides support for the notion that earnings components as reported have equal valuation relevance, in that such practices may make component segregation meaningless. If elimination of apparent opportunistic managerial behaviour was a goal of policy-makers, then the more restrictive provisions of Section 3480 appear to have been justified.

However, elimination of the opportunity to manage extraordinary items reporting may have been achieved at a cost to the users of financial statements. There has been no reneging on the belief that segregation of some items which are truly extraordinary, in the spirit of the 1969 Section 3480, is useful disclosure. Curtailment of opportunistic earnings management may have been achieved, but ready access to useful earnings classification may have been lost - classifications of items which by their atypical nature differ in their relevance for evaluation of the firm's future cashflows. It awaits future research to examine the issue of whether extraordinary components of income, as reported in the 1969-1988 period, differed from other earnings components in their valuation relevance. If reported extraordinary items possessed differential valuation relevance than that of operating and unusual item components, then the challenge for future financial reporting in Canada is to ensure that earnings components under the coarser classifications of the revised Section 3480 are disclosed in such a way to maintain the pre-amendment informational environment.

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THE RELATIONSHIP BETWEEN ENVIRONMENTAL UNCERTAINTY AND
THE LEVEL OF SOPHISTICATION EMPLOYED IN EVALUATING
CAPITAL BUDGETING PROJECTS BY MAJOR
CANADIAN CORPORATIONS

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Introduction

The selection of appropriate capital budgeting models as part of making capital investment decisions is an essential managerial activity. Of particular interest to both practitioners and researchers is the degree of environmental uncertainty that determines the degree of rigor employed in evaluating capital budgeting projects [See, for example, Sundem, 1974 and 1975; Schall and Sundem, 1980; Kim, 1982]. This study, designed to fill what appears to be an empirical gap in this area, incorporates several elements of Schall and Sundem's [1980] research and, as well, formulates improved operational definitions of two surrogate measures of sophistication and introduces a perceived firm-specific environmental risk measure. Specifically, Schall and Sundem [1980] found no significant relationship between the degree of firm-specific risk measures and the level of sophistication employed in evaluating capital budgeting projects. Their study used two market-based risk variables (i.e., firm's beta and industry beta) as surrogate measures of firm-specific environmental uncertainty to test the hypothesis that firms operating in an uncertain environment use more rigorous capital budgeting models.

The current study extends and complements Schall and Sundem's approach by (a) also testing for a correlation between a firm-specific environmental uncertainty variable based on ratings provided by questionnaire respondents concerning their firms' corporate risk and the use of more rigorous capital budgeting models, and (b) providing more robust measures of two sophistication variables included in Schall and Sundem.

Based on questionnaire data collected from a sample of 80 firms of the Financial Post 1989 Top 500 Canadian Corporations, our results lend support to Schall and Sundem's [1980] findings regarding the lack of significant correlation between market-based measures of firm-specific environmental uncertainty and the degree of sophistication in evaluating capital budgeting projects. However, our results also reveal a significant correlation between higher level of firm-specific environmental uncertainty as assessed by questionnaire respondents and the use of more rigorous capital investment evaluation models. This provides a meaningful empirically-based contribution to the literature.

Survey of Relevant Literature

Recent empirical research studies reveal an increase in the degree of rigor in evaluating capital budgeting projects [Klammer, 1972; Schall, Sundem and Geijsbeek, 1978; Kim, 1982; Baumgartner and Irvine, 1977; Blazouske, Carlin and Kim, 1988]. At the same time, several researchers explored empirical evidence of the relationship between the underlying degree of sophistication in assessing the feasibility of capital budgeting projects and other firm-related variables such as size, debt ratio, riskiness of firm's environment, and firm's performance [Christy, 1966; Kim, 1982; Klammer, 1973; Schall and Sundem, 1980]. The findings of these studies, however, are not conclusive. Kim [1982] concluded that there is a positive relationship between the level of sophistication of the capital budgeting decision process, firm performance, and size. However, he found no significant relationship between the use of more sophisticated models and risk. In his study, Kim

developed an internal risk measure based on variability of a firm's earnings. He, however, rejected the notion of using a market-based performance measure (i.e., firm's beta) on the grounds that the market participants are not informed on how management evaluates capital investment projects.

Sundem [1974], in a simulated environment, employed a time-state preference model¹ to compare simple vs. sophisticated models. He concluded that at higher levels of uncertainty² the use of sophisticated models (i.e., discounted cash flow methods with assigning projects to different risk classes) outperforms simple models (i.e., payback period or discounted cash flow methods without assigning projects to risk classes). At higher risk levels, sophisticated models significantly contribute more to the value of the firm. Conversely, in a non-simulated environment, Schall and Sundem [1980] found no association between the degree of sophistication in evaluating capital budgeting projects and two market-based risk measures (i.e., firm's beta and industry beta). They rationalized the lack of a significant relationship on the basis that firms' capital investment methods are not publicly available information. Their hypothesis that companies operating in an uncertain environment tend to use more sophisticated capital investment evaluation techniques and risk analysis [1980, p. 7], was tested by examining the correlation between each of four sophistication measures and two basic measures of risk, with size and the ratio of debt to total capitalization as moderating variables. Industry measure of systematic risk (i.e., industry beta) was used as the basic indicator of environment uncertainty.

Apart from the lack of statistically significant results as already mentioned, their study merits an extension for several reasons. First, there is a need to improve the measures of sophistication. For example, the definition of the sophistication level, in our opinion, should not be limited to discounted cash flow methods. Other finance (i.e., capital assets pricing model, option pricing model and arbitrage theory) and management science (e.g., PERT, CPM, decision theory, linear and dynamic programming) models should be included in the definition. In addition, importance-priority weights, or scores, can be used to assess whether or not a specific firm is a sophisticated user. In our opinion, importance-priority weights are more indicative of the level of sophistication given the fact that survey results consistently show that companies concurrently apply more than one evaluation model. As well, we believe that risk analysis and risk class assignment of investment projects as measures of sophistication can both be measured using an assessment scale. The Schall and Sundem [1980] study classified firms as "sophisticated" if respondents merely indicated that risk associated with a capital investment project was assessed. Also, firms were classified as "sophisticated" if they assigned assets to different risk classes. As a result of our changes, measures of rigor were reduced to two variables: (1) an overall sophistication level measured in terms of importance-priority ratings provided by questionnaire respondents concerning capital budgeting models employed, and (2) an overall degree of sophistication level measured in terms of importance ratings of a set of risk premiums (i.e., adjustments to required rate of return) provided by questionnaire respondents concerning risk analysis

¹ Sundem [1974] used the capital asset pricing model to operationalize the time-state preference model. Capital investment projects were ranked in terms of risk based on the required rate of return (R) generated using the following equation:

$$R = R' + \beta (R_m - R')$$

where,

- R is the required rate of return or cost of capital for a specific project
- R' is the risk free rate
- β is the project's beta or systematic risk
- R_m is the return on market portfolio

² Sundem [1974] concluded that a project's risk level can be based on its required rate of return or individual beta. These two measures should provide similar ranking, given that the market return and the risk free rate are both constant.

of capital investment projects.

Research Hypothesis and Method of Analysis

Research Hypothesis

This study hypothesizes that there is a positive correlation between firm-specific environmental uncertainty levels and the degree of sophistication employed in assessing the feasibility of capital budgeting projects.

Method of Analysis

The 80 firms included in this research study constitute a subset of a sample of 109 companies which responded to a detailed questionnaire administered in December 1989 to the Comptrollers of the Financial Post Top 500 Canadian Firms. A total of 109 questionnaires were completed by comptrollers, treasurers and vice-presidents of finance. The data and firm characteristics provided were then examined in light of the following screening criteria to determine a given firm's inclusion in the study: (1) accessibility of relevant market return data on the Western TSE data base, and (2) availability of other relevant data including total assets, net sales, long-term debt, and total capitalization. The screening process resulted in excluding 29 firms from the study because of lack of data items (1) and (2) referred to above. The remaining sample (80 firms) were classified into two groups: (1) a group of 54 publicly traded firms (study group 1, hereafter) for whom both data items (1) and (2) are readily available; and (2) a group of 26 government-owned and privately held firms (study group 2, hereafter) for whom only data item (2) is available.

In addition, the 80 firms studied represent a broad range of size and industries. As far as size of firm is concerned, the statistics presented in Table 1 present some comparative descriptive statistics for sample firms and the Financial Post top 500 Canadian companies.

Table 1
Descriptive Statistics (\$000,000)

| | Sample Firms* | Top 500* |
|---------------------------|---------------|----------|
| Total Assets: | | |
| Mean | \$ 1,720 | ---- |
| Median | 684 | \$ 628 |
| Minimum | 48 | 10 |
| Maximum | 9,697 | 34,358 |
| Net Sales Revenue: | | |
| Mean | 1,525 | ---- |
| Median | 578 | 358 |
| Minimum | 133 | 114 |
| Maximum | 15,943 | 19,312 |

* Based on 1988 financial information.

In addition, the sample firms represent a wide range of industries. The data in Table 2 reveal that sample firms are dispersed as far as the type of business is concerned. As revealed in Table 2, manufacturing firms represent a higher percentage of firms in study group 1 (about 41% of total number of firms in this group). The percentage of manufacturing firms in study group 2, however, is lower (about 19%, including two manufacturing conglomerates). Natural resource firms in study group 1 and 2 represent about 24% and 19% of

total number of firms in the two groups, respectively.

Table 2
Sample Distribution by Industry

| Industry Type | Group 1 | Group2 | Total |
|-------------------|---------|--------|-------|
| Manufacturing | 22 | 5 | 27 |
| Merchandising | 2 | 2 | 4 |
| Natural Resources | 13 | 5 | 18 |
| Utilities | 4 | 6 | 10 |
| Service | 8 | 5 | 13 |
| other | 5 | 3 | 8 |
| Total | 54 | 26 | 80 |

Measures Used

The following is a brief description of the operational definitions of the variables considered, along with the source of data components used in constructing each:

A - Degree of Sophistication Variables:

(a) Capital Budgeting model (Ω) - Importance and priority score on several sophisticated and simple models³ was used to determine whether a specific respondent should be classified as a sophisticated or a naive user. Two scores are calculated for each respondent as follows^{4,5}:

$$\Omega_{ii} = [\sum_i (\alpha_i + \Gamma_i + \delta_i + \dots)] + [\sum_i (a_i + b_i + c_i + d_i + e_i)] \quad (1)$$

$$\Omega_{2i} = [\sum_i (\epsilon_i + \Theta_i + \mu_i + \dots)] + [\sum_i (a_i + b_i + c_i + d_i + e_i)] \quad (2) \quad \text{where,}$$

Ω_{ii} and Ω_{2i} represent the sum of importance and priority ratings of sophisticated and naive models, respectively, for respondent (i),

$\alpha_i, \Gamma_i, \delta_i, \dots$ represent importance scores provided by respondent (i) for sophisticated models (equation 1),

$\epsilon_i, \Theta_i, \mu_i, \dots$ represent importance scores provided by respondent (i) for naive models (equation 2), and

³ The current study treats the following evaluation models as sophisticated: (1) Discounted cash flows methods, (2) Capital Asset Pricing Model (CAPM), (3) Sensitivity analysis, (4) Critical Path Method (CPM), (5) Program Evaluation and Review Technique (PERT), (6) Linear or non-linear programming, (7) Decision theory, (8) Certainty equivalent, (9) Simulation, and (10) Option Pricing Model (OPM). The following were classified as naive or simple models: (1) Payback period, (2) Accounting Rate of Return (ARR) or Return on Investment (ROI), (3) Business intuition, (4) Zero-Base Budgeting (ZBB), and (5) Career experience.

⁴ Respondents were asked to assign importance scores on a 1-7 scale to each model they employ. A score of 1 represents "not useful" and a score of 7 represents an "extremely useful" model. Cronbach's alpha for the reliability of naive models is .37. Other definitions of naive models (e.g., business intuition and career experience) can bring the alpha coefficient to .68. Alpha for the sophisticated models is .81.

⁵ Respondents were asked to list the primary, secondary, third, fourth, and fifth from among capital budgeting models listed in footnote (3) the company employs for most capital projects. A priority score that is based on a 1-5 scale was used by the researchers to complement the importance score, where a score of 5 is assigned to the primary method, a score of 4 is assigned to secondary method, etc.

a_i, b_i, c_i, d_i, e_i measure the importance scores of sophisticated models ($\alpha_i, \Gamma_i, \delta_i, \dots$ in equation 1) or naive models ($\epsilon_i, \Theta_i, \mu_i, \dots$ in equation 2), provided the particular model is used as primary (a), secondary (b), third (c), fourth (d), or fifth (e) technique by respondent (i).

A respondent was classified as a sophisticated user if the combined score on the sophisticated models exceeds the score on the naive models [$\Omega_{ii} > \Omega_{2i}$ -- coded 1]; otherwise the respondent was classified as a naive user [coded 0].

(b) **Risk Adjustment or Analysis (π)** - This variable combines the importance of seven risk premiums⁶ with the extent to which they are incorporated into the respondent's Required Rate of Return (RRR). The actual measure is based on the total importance scores of all risk premiums incorporated into the RRR, i.e., the sum of a respondent's score on the seven risk premiums. A respondent is classified as a sophisticated user (coded 1) if the total importance score exceeded 24.50 (i.e., average score of the seven risk premiums); otherwise a respondent is classified as naive (coded 0). The data in Table 3 reveal the distribution of firms into sophisticated and naive as a result of applying the two measures of sophistication described in (a) and (b).

Table 3
Distribution of Respondents Into
Sophisticated and Naive Users

| | Method (Ω) | | Risk Analysis (π) | |
|-----------|------------------------|---------------|----------------------------|---------------|
| | Naive | Sophisticated | Naive | Sophisticated |
| Group (1) | 22 | 32 | 36 | 18 |
| Group (2) | 7 | 19 | 20 | 6 |

B - Environmental Uncertainty Variables:

(1) **Firm's Beta (β)** - was measured as the slope of Sharpe's market model [1963] for each of the 54 firms included in study group 1. Monthly stock returns for a 60-month period (July 1984-June 1989) were regressed on the total market return for the same period. The data on stock and total market returns were obtained from the Western TSE data base.

(2) **Industry Beta (B)** - a separate measure was obtained for each of the 54 firms included in study group 1, using a relevant industry total market return index that fits the specific firm's type of business. The industry monthly total returns for the period July 1984-June 1989 were regressed on the monthly total market returns for the same period. The required data were obtained from the same source mentioned in (3).

(3) **Respondents' Perception of Environmental Uncertainty (Φ)** - a measure of corporate risk as perceived by questionnaire respondents. Participants were asked to rate several factors⁷ assessing the overall level of risk of the

⁶ The seven risk premiums include: (1) inflation, (2) growth in earnings, (3) firm's systematic risk (firm's beta), (4) uncertainty of long-term cash flows, (5) asset's mobility, (6) political risk, (7) fluctuation of foreign exchange rates. Cronbach's alpha for the 7-point scale is .73.

⁷ These include: (1) a measure of the degree of competitiveness of the firm's business environment; regulated firms received zero score on this measure, (2) a measure of the degree of stability of firm's business environment, (3) a measure of the degree of uncertainty of firm's business environment, (4) a measure of the importance of the rate of change of firm's environment in determining the firm's choice of primary evaluation technique(s), and (5) a measure of the importance of the level of uncertainty of firm's environment in determining the firm's choice of primary forecasting technique(s). All the above were rated on a 1-7 scale where 1 represents low competitiveness (in No. 1), very stable (in No. 2), low uncertainty (in No. 3), and

firm's business environment. The actual measure used in the analysis is the sum of respondent's ratings of the five factors divided by 5.

$$\Phi_i = \{ \sum (N_i + O_i + P_i + Q_i + R_i) / 5 \} \quad \text{Where,}$$

Φ_i represents the overall average rating score of management perception of environmental uncertainty for firm (i), and

N_i, O_i, P_i, Q_i, R_i represent respondent's ratings on the five environmental factors listed in footnote (7) for firm (i).

C - Moderating Variables:

(1) Size (Z) - Size was assessed in terms of the Average Annual Net Sales for the Period 1984-1989. The required information was obtained from companies' annual reports stored on microfiche, or from Moody's International Manuals covering the same period.

(2) Debt Ratio (K) - was measured as the percentage of average long term debt to average total capitalization (total debt plus owners equity) for the period 1984-1989. The required data were obtained from the same sources mentioned in (1).

Results and Discussion

The results of the statistical analysis of partial correlation between sophistication variables and environment uncertainty variables are presented in Tables 4 and 5. The researchers employed nonparametric statistics to avoid possible violations of normality assumptions. The primary research hypothesis mentioned earlier was translated into a set of testable operational hypotheses. In total, twelve such hypotheses were developed and tested to allow for all possible correlations between the two sophistication variables (Ω, π) and the three environment uncertainty variables (β, B, Φ), with and without control for size (Z) and debt ratio (K):

$$\begin{array}{llll} H_{01}: Y_{\Omega\beta} = 0 & H_{02}: Y_{\Omega B} = 0 & H_{03}: Y_{\Omega\Phi} = 0 & H_{04}: Y_{\pi\beta} = 0 \\ H_{05}: Y_{\pi B} = 0 & H_{06}: Y_{\pi\Phi} = 0 & H_{07}: Y_{\Omega\beta ZK} = 0 & H_{08}: Y_{\Omega B ZK} = 0 \\ H_{09}: Y_{\Omega\Phi ZK} = 0 & H_{10}: Y_{\pi\beta ZK} = 0 & H_{11}: Y_{\pi B ZK} = 0 & H_{12}: Y_{\pi\Phi ZK} = 0 \end{array}$$

The results presented in Table 4 indicate that respondents' assessment of environmental risk or uncertainty (Φ) is consistently correlated with the two measures of sophistication (Ω and π). More importantly, the results indicate that the correlation between perceived risk and the level of sophistication is positive. These results call for rejecting the null hypotheses H_{03}, H_{06}, H_{09} and H_{12} . Thus, one may conclude that Group 1 respondents rate the importance of the more sophisticated capital budgeting models significantly higher when operating in what they perceive as a risky corporate business environment. The results presented in Table 5 (group 2) are mixed, and only three null hypotheses, H_{03}, H_{06} and H_{12} , are rejected. Correlation between the two variables (π and Φ) stands at 40% before controlling for size and financial risk. The measure, however, drops to 33% after controlling for size and financial risk.

It is important to note, however, that the data in Table 4 also reveal that market-based risk measures (β and B) are not statistically correlated with any of the two sophistication methods (Ω and π). The lack of correlation is evident with or without controlling for size (Z) and debt ratio (K). This

unimportant (in No. 4 and 5). A score of 7 represents very high competitiveness (in No. 1), very fast changing (in No. 2), very high uncertainty (in No. 3), and extremely important (in No. 4 and 5). Cronbach's Alpha for this 7-point scale is .78.

part of Table 4 confirms the results obtained by Schall and Sundem [1980].⁸

Table 4
Partial Rank Correlation Coefficients (Study Group 1-54 Firms)
(One-tail Test of Significance)

| Measure of sophist. | Environment Risk Measures | | | Moderating Variables | |
|-------------------------------|-------------------------------|-------------------------|--|----------------------|-----------------------|
| | Market Assessment | | Management Assessment of Environment Uncertainty (Φ) | Size (Z) | Financial Risk (K) |
| | Firm's Beta (β) | Industry Beta (B) | | | |
| Method (Ω) | -.1543 (.13) | .1053 (.22) | .2180 (.06) | .0111 (.47) | .0463 (.37) |
| Risk Analysis (π) | .0753 (.29) | .0232 (.43) | .3062 (.01) | .3132 (.01) | .1860 (.11) |
| Method (Ω) | -.1513 (.14) | .1071 (.23) | .2152 (.06) | | |
| Risk Analysis (π) | .1091 (.22) | .0428 (.38) | .2589 (.03) | | |

In addition, the results in Tables 4 and 5 support empirical evidence documented by earlier research studies that size is a significant factor in determining the sophistication level used in evaluating capital budgeting projects. The results in Table 5 show that size is significantly correlated at the .04 and .06 for both Ω and π , respectively, with the two sophistication measures for study group 2. The results in Table 4 show that for study group 1, size shows a significant correlation with variable π at the .01 level.

The interpretation of the empirical evidence obtained in this study is difficult. The lack of relationship between the use of more sophisticated capital budgeting models and market-based risk measures can be easily explained on several grounds. First, the managerial decision to use a specific model is not directly observable by the stock market participants. Second, the small size sample may also contribute to the lack of correlation between market-based risk measures and the degree of sophistication.⁹ Third, there is the problem of using a universally acceptable and understood definition of the terms sophisticated and simple 'naive' techniques. Redefining or modifying the definition may cause a change in the results of the statistical analysis and may eventually lead to a different conclusion.

⁸ Schall and Sundem [1980] indicated that firm's beta can be substituted for industry beta and used as a surrogate measure for environmental uncertainty under certain circumstances, such as in the case where there is significant correlation between size or debt ratio and any of the sophistication measures. In the current study, size and debt ratio both show significant correlation with risk analysis or adjustment variable. Thus, firm's beta would be the appropriate measure for environmental uncertainty. Unfortunately, such a substitution does not add to the results shown in Table 4.

⁹ The researchers also analyzed the relationship between market-based variables and the two measures of sophistication, using the logistic regression technique. The results of the statistical analysis confirmed the results presented in this paper.

For example, some authors have concluded that the payback period model has some logical and theoretical basis that may place it among the sophisticated models category [See, for example, Blatt, 1979]. Fourth, the fact that the information used to operationalize the two measures of sophistication was derived from questionnaire data. As well, only firms that met our screening criteria were included in the final sample. Overall, such considerations limit the researchers' ability to generalize to the general population.

Table 5
Partial Rank Correlation Coefficients (Study Group 2- 26 Firms)
(One-tail Test of Significance)

| Measure of sophist. | Environment Risk Measures | | | Moderating Variables | |
|-------------------------------|-------------------------------|---|----------------|----------------------|----------------|
| | Market Assessment | Management Assessment of Environment | Uncertainty | Size | Financial Risk |
| | Firm's Beta (β) | Industry Beta (B) | (Φ) | (Z) | (K) |
| Method (Ω) | N/A | N/A | .3274 (.05) | .3439 (.04) | .1380 (.47) |
| Risk Analysis (π) | N/A | N/A | .3971 (.02) | .3146 (.06) | .1118 (.29) |
| Method (Ω) | N/A | N/A | .2042 (.17) | | |
| Risk Analysis (π) | N/A | N/A | .3274 (.06) | | |

Contribution and Conclusion

Notwithstanding the lack of relationship between market-based risk measures and the selection of certain capital budgeting techniques, the current study documents important empirical evidence of a significant correlation between a perceived risk measure of business environment and the two measures of sophistication. This provides further evidence for the usefulness of managers' risk perception as opposed to market risk perception. With that in mind, it is possible to conclude, that the reported use of more sophisticated capital budgeting methods is a common practice among questionnaire respondents who perceive their firm's business environment as more risky or uncertain. This "observed" perception and practice among respondents can be explained and understood on several grounds. First, the need to use more sophisticated capital budgeting techniques in an uncertain environment is an appropriate managerial response in most difficult-to-diversify situations. Accordingly, it is expected that these managers conduct more careful and rigorous analysis of capital investment projects with increased environmental risk and uncertainty. Second, respondents could be concerned with environment uncertainty on a personal level. This could be true considering the possible implications of managerial decisions on managers' promotions, tenure and overall job security. Managers facing a

highly competitive or limited job market, may have to support or defend capital investment decisions by showing a higher level of sophistication and rigorous analysis. The contractual relationship between management and shareholders or owners may allow for certain types of compensation contracts which may also contribute to the use of more sophisticated techniques, especially when a risky environment prevails. Other factors that may significantly influence managers' behavior in this area include an observed increase in user-friendly electronic data analysis software that can facilitate the process of applying the more sophisticated techniques, and a higher level of university and in-house management education and training among corporate managers.

The research presented here did not consider all the potential factors at different organizational levels or contexts that might affect the relationship between the main variables delineated in our research hypothesis. However, the results obtained add to the stock of present knowledge by extending prior research and revealing some new dimensions of the relationships examined. On balance, the study should be viewed as a stage in model-building efforts in the search for a better understanding of capital budgeting technique use.

Further research may benefit from examining the role of other moderating variables such as managerial executive compensation structure and corporate planning horizon in influencing the utilization of simple vs. sophisticated forecasting techniques. The compensation structure - planning horizon interaction deserves clarification, as both appear to be partially designed to help managers counter the problem of environmental uncertainty.

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**THE INCREMENTAL INFORMATION OF SUPPLEMENTARY FINANCIAL
DISCLOSURES IN PREDICTING BUSINESS FAILURE:
SOME EMPIRICAL EVIDENCE**

ABSTRACT

In the last decade, a large number of empirical research has examined the incremental information in the general price level (GPL) and current cost (CC) over the historical cost information. Most of these studies focused on the stock market reaction to these types of information (for example Hopwood and Schaefer [1989], Lobo and Song [1989], Beaver et al [1980, 1982, 1983, 1985], Bulitz et al [1985], Gheyara and Boatsman [1980], Sunder and Waymire [1983], and Watts and Zimmerman [1980]...).

A few studies have examined the incremental information in the GPL or CC over the HC information in predicting business failure or bond rating changes. Empirical studies using data that have been adjusted for general price level changes include those of Ketz [1978], Monahan and Bareenbaum [1983], and Norton and Smith [1979]. Aly et al (forthcoming 1992) examined the usefulness of the current cost information originally required by SFAS No. 33 versus historical cost information in predicting bankruptcy. Mensah [1983], used data adjusted for specific price changes.

This study replicates and extends Aly et al (forthcoming, 1992) by examining the incremental information of the general price level (GPL), and the current cost (CC) as compared to that of historical cost information in classifying and predicting business failure. The study also examines the usefulness of CC information versus GPL when each is used as a supplement to HC information.

Two multivariate statistical techniques, multiple discriminant analysis (MDA) and logistic regression analysis (LRA) are used to derive the ex-post classification results. Five functions are developed based on ratios computed with HC, GPL, CC, the combined HC/GPL and the combined HC/CC model.

The main results of the various analyses indicate that the combined HC/CC model has more discriminant power than does the HC, the GPL, the CC, or the combined HC/GPL models in each of the three years before bankruptcy. The results also indicate that LRA has a better classification rate than MDA for the selected sample.

THE INCREMENTAL INFORMATION OF SUPPLEMENTARY FINANCIAL DISCLOSURES IN PREDICTING BUSINESS FAILURE: SOME EMPIRICAL EVIDENCE

1. INTRODUCTION

A major concern of accounting professionals and policy makers in the latter part of the twentieth century has been the usefulness of published accounting information. Published accounting information refers to all data that are of a financial nature and are traditionally contained in corporate reports (annual and quarterly).

Accountants are primarily responsible for providing financial information about the corporation to investors and creditors so that the performance of corporate management can be evaluated objectively. However, most published accounting information is measured with an unstable unit of measurement in an ever-changing environment of costs and prices. This fact has led the interested parties such as investors, creditors, and other users to criticize the nominal-dollars historical cost measurement convention as it ignores the impact of inflation on the reported earnings and financial positions of corporations. In response to this problem, the authoritative bodies of the accounting profession in the United States, Canada and other countries (for example, England, Sweden and Australia) have taken several actions to deal with the impact of changing prices on published financial statements, prepared by employing the nominal-dollar historical cost convention as a measurement unit.

In March, 1976, the Securities and Exchange Commission (SEC) called for footnote disclosures of inventories, plant assets, cost of goods sold, and depreciation expense on a replacement cost basis for the largest 1,000 publicly held corporations registered with the Commission. These requirements were set forth in ASR 190. In September, 1979, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 33, Financial Reporting and Changing Prices. This statement required large publicly held corporations to issue supplementary financial statements which included both constant-dollar and current-cost information along with their primary financial statements. In 1984, after examining the results of SFAS No. 33 disclosure requirements for five years, the FASB issued SFAS No. 82 to eliminate some of the requirements imposed earlier. SFAS No. 82 eliminated the constant dollar measures of historical cost but continued to require current cost disclosures. Under SFAS No. 82, firms could substitute constant dollar historical information for current cost when the latter could not be ascertained.

The FASB believed that SFAS No. 82 would eliminate some of the complexities of preparing supplementary information, reduce costs incurred in preparing financial statements, and eliminate confusion on the part of decision-makers in using the supplementary information. However, in December, 1986, FASB approved by a narrow vote SFAS No. 89 which encouraged, but no longer required, companies to disclose supplementary information on the effects of changing prices on financial statements.

In December 1982, the Canadian Institute of Chartered Accountants (CICA) issued Section 4510 of its Handbook, requiring large corporations to include supplementary current cost information in their financial statements. This information enabled readers of financial statements to make new assessments of business performance, and added a new dimension to the information provided for decision making.

2. SCOPE AND OBJECTIVES OF THE STUDY

Aly et al (1992) examined the usefulness of current cost information, as compared to historical cost information, in discriminating business failure. Their results indicate that the combined historical cost and current cost model has more discriminant power than does the historical cost model alone in each of the three years before bankruptcy. However, the study did not address the usefulness of general price level information in discriminating bankruptcy as compared to current cost information or historical cost information.

The current study intends to investigate the usefulness of supplementary financial disclosures in predicting business failure and alleviating the above problem associated with the first study [1992]. Specifically, This study investigates the usefulness of the general price level information (GPL) and the current cost information (CC) as compared to that of historical cost information (HC) in predicting business failure. The study also examines the usefulness of GPL data versus CC information when each supplements HC information.

The study focuses on the role of alternative sets of accounting information as primary predictor of business failure. A comparison of these predictors was made in order to identify the accounting system that yields a better prediction. This type of research is important as an aid to policy-makers who are continually faced with the problem of choosing an appropriate reporting method from among several alternative accounting measures. One of these problem areas is accounting for changing prices. FASB pointed out that there is a need to some studies in the area of changing prices to measure the effect of inflation on the reported earnings and financial positions of firms.

In addition, this study compares and contrasts the two multivariate statistical techniques, multiple discriminant analysis (MDA) and logistic regression analysis (LRA), most often used to predict business failure, and evaluate each for power, robustness, and applicability for the objective at hand.

RESEARCH METHODOLOGY

STATEMENT OF HYPOTHESES

The null hypotheses are:

1. **H₀:** There are no significant differences in the ability to discriminate bankrupt from non-bankrupt firms between the models using financial ratios computed with CC data or GPL data and the models using financial ratios computed with HC data.

Since SFAS No. 33 called for GPL and CC data to be disclosed on a supplementary basis, the predictive power of models using CC or GPL as a supplement to HC may be compared to that of models using HC data only. Solomon and Beck [1980] pointed out that Norton and Smith's [1979] study failed to examine the possible usefulness of GPL data when it is used to supplement HC. Therefore the second null hypothesis to be tested is as follows:

2. **H₀:** There are no significant differences in the ability to discriminate bankrupt from non-bankrupt firms between combined HC/CC models or combined HC/GPL and the models using HC data only

DATA COLLECTION PROCEDURES

Identification of Failed Firms:

Data collection for bankrupt firms requires a definition of failure and specifications of the population of firms from which sample firms are to be drawn. For the purpose of this study, business failure is defined as filing a bankruptcy petition under the Federal Bankruptcy Act (Chapter VII, Chapter X, and Chapter XI). Criteria used for selection of failed firms for this study are as follows:

- a) firms that failed during the period 1979 to 1984;
- b) firms whose shares were traded on any stock exchange;
- c) firms which were classified as industrial companies;
- d) firms whose financial statements and supplementary information were available for the three year period prior to the failure.

The first criterion is chosen because it represents the required period of the SFAS No. 33 as a mandatory disclosures. The second criterion excludes small or privately held corporations and allows the use of the COMPUSTAT tapes as the source for non-bankrupt firms for the use in the matched pairs sample. The third criterion excludes utilities, transportation companies, service and merchandising firms, finance companies, etc. Companies in such categories are structurally different from those of industrial firms. Inclusion of the latter categories which are structurally different, may distort the normal range of the financial ratios employed in this study as independent variables.

A listing of all known firms which failed between 1979 and 1984 was compiled from the COMPUSTAT Research File and the Wall Street Journal Index. After eliminating firms which did not meet the above criteria, twenty six firms remained to be included in this study. While a larger number of firms would be desirable for analytical purposes, the following observations should be noted:

1. The firms included represent the entire population of firms meeting the specified criteria rather than a selected sample of such firms.
2. The relatively short time period for which general price level and current cost disclosures were required guarantees that only a limited number of firms could be expected to meet this criteria.
3. The size of firms which were required to provide supplementary financial statements which showed both the current cost information and the constant-dollar information necessitates that each of the failures would be classified as a major one.

Identification of Non-failed Firms:

A set of non-bankrupt companies was selected for a matched pair sample design. A matched pair design is applied for the following reasons: (1) Most prominent researchers have used matching pair design; (2) Zmijewski [1984] has examined conceptually and empirically the choice-based sample bias that results from over sampling bankrupt firms relative to their proportions in the population. Zmijewski found that the bias did not affect the statistical inferences or the overall classification rates for the

financially distressed model and the samples tested; (3) the current cost data and the constant-dollar are not available in the COMPUSTAT tapes; and (4) to control for outside economic factors that might create financial difficulties for both bankrupt and non bankrupt firms.

To control for industry-wide and economy-wide effects, the non-failed firms were matched with the failed firms for variables such as industry, size, fiscal year, and the internal accounting methods used for depreciation computations and inventory valuations. The non-failed firms were chosen from the COMPUSTAT annual tapes. Industry is defined as the three-digit (SIC) code for each firm.

Matching by size was based on the assets of the failed firms within a given industry. The non-bankrupt firm with the asset size most similar to its bankrupt counterpart was chosen. Asset size, rather than net sales, was chosen as the matching criterion since this characteristic tends to be more stable across time. The matched pair "t" test was used to test whether the difference in the assets of the failed and non-failed firms is significantly different from zero. The results in Table 1 indicate that the differences at alpha 5% are not significant for each of the three years before bankruptcy.

insert table 1

Data Collection:

Financial statement data were collected for the failed and non-failed firms for three years prior to failure. All of the financial statements for the failed firms used in this study were issued before the firms actually failed. The primary sources of information for financial statements for the bankrupt and non-bankrupt firms were the 10-K financial statements and annual reports available on Microfilm.

VARIABLES

In the absence of a theory of corporate failure, empirical researchers Altman [1968, 1973], Chen and Shimerda [1981] Damolena and Khoury [1980], Deakin [1972], Edmister [1972], Elam [1975], Gombola and Ketz [1983], Ketz [1978], Norton and Smith [1979], Ohlson [1980], Pinches, Eubank, Mingo and Caruthers [1975], have chosen variables for inclusion in models in an ad hoc fashion. Based on these studies, fourteen financial ratios are selected on the basis of stability among these studies. These fourteen financial ratios are computed for each of the three years prior to bankruptcy. Table 2 lists the financial ratios which are used in this study to form the basis of the bankruptcy classification.

insert table 2

STATISTICAL ANALYSIS AND RESULTS

Two multivariate statistical techniques, namely multiple discriminant analysis (MDA) and logistic regression analysis (LRA), are applied to derive the ex-post classification results. This section is divided into two major components. The first section is devoted to the evaluation of MDA models and the second to the investigation of results of the LRA models.

RESULTS OF MULTIPLE DISCRIMINANT ANALYSIS

The linear and quadratic functions of MDA are used in this study. However, the linear function results are reported because the results of the two functions in general are similar. These findings support some of the findings of the previous research. Marks and Dunn [1974] found that the linear model performs better than the theoretically more appealing quadratic model for small samples. Altman [1968] found that the level of accuracy achieved by the linear model is usually almost equal to that of the more complex quadratic function. Other studies such as Collins and Green [1982], suggest that the linear discriminant function performs quite well, especially if the sample sizes are small. Collins and Green [1982], state that in the bankruptcy context, two important assumptions of MDA are violated. First, the distribution of financial ratios is usually not normal, second, the variability of the financial ratios of bankrupt firms is likely to be much different than that of non-bankrupt firms. MDA linear models, however, produce reliable results and are fairly robust to the violations of its assumptions created by problems in predicting bankruptcy.

The fifty two firms being studied, are classified on the basis of their Z-scores as belonging to one of two mutually exclusive groups: bankrupt or non-bankrupt. Five discriminant functions are developed for each year. The first function is based upon the HC financial ratios; the second is based upon the ratios from GPL data; the third is based upon HC and GPL as a combined model; the fourth is based upon the ratios from CC data; and the fifth is based upon HC and CC as a combined model. This analysis is performed for three time periods: one, two, and three years before the bankruptcy of the failed firms.

A backward elimination selection method is used in developing the three discriminant functions. Although the stepwise method is used in several studies of bankruptcy, such as Norton and Smith [1979], and Mensah [1983], this method does not examine the worth of a group of variables which individually may not be statistically significant but as a group are highly significant. Backward elimination overcomes this deficiency. The selection criteria is the minimization of Wilk's Lambda for all three of the discriminant functions.

To determine whether a significant difference exists in the ability of the five models to discriminate bankrupt from non-bankrupt firms, a chi square test is used to test whether the difference in the classification accuracy between any two models is significant. This test is used by Elam [1975] and Mensah [1983] in comparing the predictive accuracy of two models constructed from different data. The results of these comparisons are described in table 3 through table 7. These tables show the actual group membership, the classified group membership, the overall percentage of firms correctly classified and computed chi square.

1. The HC discriminant model vs. the GPL discriminant model.--Table 3 presents a comparison of discriminant hypotheses testing between the HC model and GPL model. The results indicate that HC model produces better classification rate in year three prior to bankruptcy than it does in year one and year two (76.90 percent in year three, 73.10 percent in year one, and 75 percent in year two). The results also indicate GPL model produces better classification rate in year one prior to bankruptcy than it does in year two and year three (80.77 percent in year one, 78.85 percent in year two, and 71.15 percent in year three). However, Chi Square tests indicate that there are no significant differences in the overall percentages of correct classifications derived from the two models in each of the three years before bankruptcy.

insert table 3

2. The HC discriminant model vs. the combined HC/GPL discriminant model.--When HC is combined with GPL in a single model, the discriminant functions are slightly improved as compared to either the HC model or GPL model. The overall percentages of correct classification of the combined HC and GPL model are 80.77 percent in the first year, 80.77 percent in the second year, and 84.62 percent in the third year prior to bankruptcy. Chi square tests in Table 4 show that the difference in discriminant power is not significant in any of the three years before bankruptcy.

insert table 4

3. The HC discriminant model vs. the CC discriminant model. The data in Table 5 present a comparison of the ability of the CC model and the HC model to discriminate between bankrupt and non-bankrupt firms. The results reveal that HC model produces better classification rates in year one and year two prior to bankruptcy than CC model does (73.10 percent versus 71.20 percent in year one and 76.90 percent versus 75 percent in year three). The results also indicate CC model produces better classification rate 76.90 percent in year two prior to bankruptcy than HC model does 75 percent. However, Chi Square tests indicate that there are no significant differences in the overall percentages of correct classifications derived from the two models in each of the three years before bankruptcy.

insert table 5

4. The HC discriminant model vs. the combined HC/CC discriminant model.--When the HC is combined with the CC in a single model, it outperforms the HC model in discriminating between bankrupt and non-bankrupt firms. The overall classification results are 90.38 percent in year one, 88.46 percent in year two and 92.30 percent in year three before bankruptcy. Chi square tests in

Table 6 indicate that the differences in discriminant power are significant in each of the three years before bankruptcy.

insert table 6

5. The combined HC/GPL discriminant model vs. the combined HC/CC discriminant model--Table 7 presents a comparison between the performance of the model that combines HC with GPL and the performance of the model that combines HC with CC. The results indicate that the HC and CC model produces a classification rate superior to that of the HC and GPL model. The overall classification results are 90.38 percent versus 80.77 percent in year one, 88.46 percent versus 80.77 percent in year two, and 92.30 percent versus 84.62 percent in year three prior bankruptcy. However, The differences in discriminating power are not significant in each of the three years before failure.

insert table 7

RESULTS OF LOGISTIC REGRESSION ANALYSIS

A multivariate statistical technique, logistic regression analysis (LRA), is applied to derive the ex-post classification results. LRA has been used in several corporate failure models: Chesser's [1974] study of commercial loan noncompliance, Santomero and Vinso's [1977] analysis of the failure of commercial banks, Ohlson's [1980] study of the probability prediction of bankruptcy, Mensah's [1983] study of the differential bankruptcy predictive ability of specific price-level adjustments, and Zavgren's [1983] study of the relationship between financial failure and certain attributes of industrial firms, to cite the major models.

Logistic regression models are usually formulated mathematically by relating the probability of certain event, E, occurring, conditional on a vector, X, of explanatory variables. A cumulative probability distribution assumption is needed in order to constrain the predicted values to comply with the acceptable (0, 1) limiting values of probability distributions. The coefficient of each variable can be interpreted as the effect of a unit change in an independent variable on the probability of the dichotomous Y variable.

Five logistic regression functions are derived to classify bankrupt and non-bankrupt firms. The first function based on ratios computed with HC information; the second function based on ratios computed with CC information; the third function based on ratios computed with GPL information; the fourth function based on a model that combines ratios computed with both HC and CC information; and the fifth function based on a model that combines ratios computed with both HC and GPL information. This procedure is repeated for three time periods: one, two, and three years prior to bankruptcy. A

A backward elimination selection method is used in developing the five logistic regression functions. Maximum likelihood estimation is used to derive the logistic regression parameters. This method of estimation is used by Ohlson [1980], and Mensah [1983].

To determine whether a significant difference exists in the ability of the five models to discriminate bankrupt from non-bankrupt firms, a chi square test is used to test whether the difference in the classification accuracy between any two models is significant. This test is used by Elam [1975] and Mensah [1983] in comparing the predictive ability and accuracy of two models constructed from different data. The classification results of logistic regression analysis for the five functions described above are presented in Table 8 through Table 12. These tables show the actual group membership, the classified group membership, the overall percentage of firms correctly classified, and computed chi square.

1. The HC logistic model vs. the GPL logistic model.--The data in Table 8 present a comparison between the HC model and the GPL model in discriminating bankrupt firms from non-bankrupt firms. The results reveal that HC model produces better classification rate in year one prior to bankruptcy than it does in year two and year three (84.60 percent in year one, 78.80 percent in year two and in year three). The results also indicate GPL model produces better classification rate in year two prior to bankruptcy than it does in year one and year three (86.54 percent in year two, 82.69 percent in year one, and 75 percent in year three). However, Chi Square tests indicate that there are no significant differences in the overall percentages of correct classifications derived from the two models in each of the three years before bankruptcy.

insert table 8

2. The HC logistic model vs. the combined HC/GPL logistic model.--The data in Table 9 reveal that when HC information is combined with GPL information in a single model, it outperforms the HC model alone in discriminating between bankrupt and non-bankrupt firms. The overall percentages of correct classification of the combined HC and GPL model are 84.62 percent in the first year, 86.53 percent in the second year, and 84.62 percent in the third year prior to bankruptcy. Chi square tests in Table 9 show that the difference in discriminant power is not significant in any of the three years before bankruptcy.

insert table 9

3. The HC logistic model vs. the CC logistic model.--The data in Table 10 present a comparison between the HC model and the CC model in discriminating bankrupt firms from nonbankrupt firms. The results reveal that there are no significant differences in the classification rate of the two models in the three years before bankruptcy. The overall percentages of correct classification of the CC model are 76.90 percent in the first year, 84.62 percent in the second year, and 82.70 percent in the third year prior to bankruptcy.

insert table 10

4. The HC logistic model vs. the combined HC/CC logistic model.-- The data in Table 11 reveal that when HC information is combined with CC information in a single model, it outperforms the HC model alone, in discriminating between bankrupt and nonbankrupt firms in the three years prior to bankruptcy. The overall classification results are 100 percent in year one, 100 percent in year two and 98.90 percent in year three before bankruptcy. Chi square tests in Table 11 indicate that the differences in discriminant power are significant in each of the three years before bankruptcy at Alpha 5%.

insert table 11

5. The combined HC/GPL logistic model vs. the combined HC/CC logistic model.--In comparing the performance of the model combining HC and GPL information to the model combining HC and CC information, the results in Table 12 reveal that the combined HC/CC model produces a superior overall classification rate to the combined HC/GPL in each of the three year before bankruptcy. The overall classification results are 100 percent versus 84.62 percent in year one, 100 percent versus 86.53 percent in year two, and 98.90 percent versus 84.62 percent in year three prior bankruptcy. The differences in discriminating power are significant in each of the three years before failure at alpha 5 percent.

insert table 12

In conclusion, the results indicate that the statistical analysis of LRA functions are consistent with the results of the MDA. Both techniques show that CC information is useful as a supplement to HC information for the purpose of discriminating between bankrupt and non-bankrupt firms.

COMPARISON OF THE CLASSIFICATION ACCURACY OF THE MDA ANALYSIS WITH THE LRA ANALYSIS

One of the main objectives of this study was to compare the classification accuracy of multiple discriminant analysis to that of logistic regression analysis. A chi square test is used to determine whether the difference in the classification accuracy of the two techniques is significant. This test has been employed in previous studies by Zmijewski [1984] and Mensah [1983], when comparing the predictive accuracy of two different models used in the case of bankruptcy. Table 13 reveals that the overall performance of the LRA is superior to that of the MDA in its ability to discriminate between bankrupt and non-bankrupt firms. The LRA produces better classification rates in year one when the HC model, the GPL, model, the CC model, the combined HC/GPL, or the combined HC/CC model is used to derive the logistic functions. These functions produce 84.62 percent, 82.69 percent, 76.90 percent, 84.62 percent and 100 percent respectively, while MDA functions produce 73.10 percent, 80.77 percent, 71.20 percent, 80.77 percent, and 90.38 percent correct classification respectively.

In year two, the logistic functions achieve better results than MDA when the HC model, the GPL, model, the CC model, the combined HC/GPL, or the combined HC/CC model is applied to estimate the logistic functions. These functions produce 78.80 percent, 86.53 percent, 84.62 percent, 86.53 percent and 100 percent respectively, while MDA functions produce 75.00 percent, 78.85 percent, 76.90 percent, 80.77 percent, and 88.46 percent correct classification respectively.

In year three, the logistic functions have better classification rates than MDA when the HC model, the GPL, model, the CC model, or the combined HC/CC model is applied to estimate the logistic functions. These functions produce 78.80 percent, 75.00 percent, 82.70 percent, and 98.90 percent respectively, while MDA functions produce 76.90 percent, 71.15 percent, 75.00 percent, and 92.30 percent correct classification respectively. However, the logistic function produces the same classification rates as MDA when the combined HC/GPL model is applied to estimate the logistic function 84.62 percent.

insert table 13

CONCLUSIONS

Several conclusions can be drawn from this study. First, the three information systems--HC, GPL, and CC--are equally useful for classifying the firms used in this study as bankrupt or non-bankrupt. second, the combined HC/CC model shows superior results over the HC model, and the combined HC/GPL model. The findings of this study support the FASB's decision in SFAS No. 82 to change the minimum disclosure requirement from both CC and constant dollar information to CC information alone. Based on the usefulness of CC data alone (without considering the cost of gathering such data), the decision in SFAS No. 89, eliminating the requirement for CC information, appears regrettable for bankruptcy studies. Perhaps other research can determine whether CC information has usefulness for other areas of analysis. Third, the results indicate that LRA has a better classification rate than MDA for the selected sample.

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TABLE 1
T-TEST-ASSET SIZE BETWEEN BANKRUPT AND NON-BANKRUPT FIRMS

| Year | Type | No. of Cases | Mean | Std. Deviation | Probability |
|------|------|--------------|---------|----------------|-------------|
| 1 | B | 26 | 516,966 | 526,948 | .968 |
| | N | 26 | 522,483 | 464,314 | |
| 2 | B | 26 | 525,490 | 535,820 | .796 |
| | N | 26 | 490,935 | 417,194 | |
| 3 | B | 26 | 466,597 | 487,705 | .895 |
| | N | 26 | 450,450 | 387,072 | |

B-Bankrupt N-Non-bankrupt

TABLE 2
FINANCIAL RATIOS

| |
|--|
| 1. Current assets to current liabilities |
| 2. Working capital to total assets |
| 3. Cash flow* to current liabilities |
| 4. Cash flow* to net worth |
| 5. Net worth to total assets |
| 6. Net worth to total liabilities |
| 7. Sales to working capital |
| 8. Sales to inventories |
| 9. Sales to fixed assets |
| 10. Sales to total assets |
| 11. Net income to sales |
| 12. Net income to net worth |
| 13. Net operating profit to total assets |
| 14. Net operating profit to total debt |

Cash flow = Net income plus depreciation

TABLE 3
COMPARISON OF DISCRIMINANT HYPOTHESIS
TESTING BETWEEN HC AND GPL MODELS

| Year | HC | | GPL | | Computed |
|---------------------------|--------------|---------------------|--------------|---------------------|------------|
| | Correct B | Classification N | Correct B | Classification N | Chi Square |
| 1 | 19/26 | 19/26 | 23/26 | 19/26 | .867 |
| Overall | 73.10% | | 80.77% | | |
| 2 | 20/26 | 19/26 | 21/26 | 20/26 | .217 |
| Overall | 75.00% | | 78.85% | | |
| 3 | 19/26 | 21/26 | 17/26 | 20/26 | .450 |
| Overall | 76.90% | | 71.15% | | |
| B-Bankrupt N-Non-bankrupt | | | | | |

TABLE 4
COMPARISON OF DISCRIMINANT HYPOTHESIS TESTING
BETWEEN HC AND COMBINED HC/GPL MODELS

| Year | HC | | HC/GPL | | Computed |
|---------------------------|--------------|---------------------|--------------|---------------------|------------|
| | Correct B | Classification N | Correct B | Classification N | Chi Square |
| 1 | 19/26 | 19/26 | 20/26 | 22/26 | .867 |
| overall | 73.10% | | 80.77% | | |
| 2 | 20/26 | 19/26 | 24/26 | 18/26 | .502 |
| overall | 75.00% | | 80.77% | | |
| 3 | 19/26 | 21/26 | 22/26 | 22/26 | .990 |
| overall | 76.90% | | 84.62% | | |
| B-Bankrupt N-Non-bankrupt | | | | | |

TABLE 5
COMPARISON OF DISCRIMINANT HYPOTHESIS
TESTING BETWEEN HC AND CC MODELS

| Year | HC | | CC | | Computed |
|---------|---------|----------------|---------|----------------|------------|
| | Correct | Classification | Correct | Classification | Chi Square |
| | B | N | B | N | |
| 1 | 19/26 | 19/26 | 20/26 | 17/26 | |
| overall | 73.10% | | 71.20% | | .048 |
| 2 | 20/26 | 19/26 | 21/26 | 19/26 | |
| overall | 75.00% | | 76.90% | | .053 |
| 3 | 19/26 | 21/26 | 18/26 | 21/26 | |
| overall | 76.90% | | 75.00% | | .053 |

B-Bankrupt N-Non-bankrupt

TABLE 6
COMPARISON OF DISCRIMINANT HYPOTHESIS TESTING
BETWEEN HC AND COMBINED HC/CC MODELS

| Year | HC | | HC/CC | | Computed |
|---------|---------|----------------|---------|----------------|------------|
| | Correct | Classification | Correct | Classification | Chi Square |
| | B | N | B | N | |
| 1 | 19/26 | 19/26 | 23/26 | 24/26 | |
| overall | 73.10% | | 90.38% | | 5.22* |
| 2 | 20/26 | 19/26 | 26/26 | 20/26 | |
| overall | 75.00% | | 88.46% | | 3.16** |
| 3 | 19/26 | 21/26 | 24/26 | 24/26 | |
| overall | 76.90% | | 92.30% | | 4.73* |

B-Bankrupt N-Non-bankrupt

* Reject at Alpha .05 ** Reject at Alpha .10

TABLE 7
COMPARISON OF DISCRIMINANT HYPOTHESIS TESTING BETWEEN
COMBINED HC/GPL AND COMBINED HC/CC MODELS

| Year | HC/GPL | | HC/CC | | Computed |
|---------------------------|--------------|---------------------|--------------|---------------------|-------------------------|
| | Correct B | Classification N | Correct B | Classification N | Chi Square |
| 1 | 20/26 | 22/26 | 23/26 | 24/26 | 1.95 |
| overall | 80.77% | | 90.38% | | |
| 2 | 24/26 | 18/26 | 26/26 | 20/26 | 1.18 |
| overall | 80.77% | | 88.46% | | |
| 3 | 22/26 | 22/26 | 24/26 | 24/26 | 1.51 |
| overall | 84.62% | | 92.30% | | |
| B-Bankrupt N-Non-bankrupt | | | | | R** Reject at Alpha 15% |

TABLE 8
COMPARISON OF LOGISTIC REGRESSION HYPOTHESIS TESTING
BETWEEN HC AND GPL MODELS

| Year | HC | | GPL | | Computed |
|---------------------------|--------------|---------------------|--------------|---------------------|------------|
| | Correct B | Classification N | Correct B | Classification N | Chi Square |
| 1 | 23/26 | 21/26 | 23/26 | 20/26 | .070 |
| overall | 84.60% | | 82.69% | | |
| 2 | 21/26 | 20/26 | 22/26 | 23/26 | 1.075 |
| overall | 78.80% | | 86.54% | | |
| 3 | 20/26 | 21/26 | 19/26 | 20/26 | .217 |
| overall | 78.80% | | 75.00% | | |
| B-Bankrupt N-Non-bankrupt | | | | | |

TABLE 9
COMPARISON OF LOGISTIC REGRESSION HYPOTHESIS TESTING
BETWEEN HC AND HC/GPL MODELS

| Year | HC | | HC/GPL | | Computed Chi Square |
|---------|--------------|---------------------|--------------|---------------------|------------------------|
| | Correct B | Classification N | Correct B | Classification N | |
| 1 | 23/26 | 21/26 | 21/26 | 23/26 | .000 |
| overall | 84.62% | | 84.62% | | |
| 2 | 21/26 | 20/26 | 24/26 | 21/26 | 1.075 |
| overall | 78.80% | | 86.53% | | |
| 3 | 20/26 | 21/26 | 22/26 | 22/26 | .580 |
| overall | 78.80% | | 84.62% | | |

B-Bankrupt N-Non-bankrupt

TABLE 10
COMPARISON OF LOGISTIC REGRESSION HYPOTHESIS TESTING
BETWEEN HC AND CC MODELS

| Year | HC | | CC | | Computed Chi Square |
|---------|--------------|---------------------|--------------|---------------------|------------------------|
| | Correct B | Classification N | Correct B | Classification N | |
| 1 | 23/26 | 21/26 | 20/26 | 20/26 | .990 |
| overall | 84.62% | | 76.90% | | |
| 2 | 21/26 | 20/26 | 22/26 | 22/26 | .580 |
| overall | 78.80% | | 84.62% | | |
| 3 | 20/26 | 21/26 | 22/26 | 21/26 | .248 |
| overall | 78.80% | | 82.70% | | |

B-Bankrupt N-Non-bankrupt

TABLE 11
COMPARISON OF LOGISTIC REGRESSION HYPOTHESIS TESTING
BETWEEN HC AND HC/CC MODELS

| Year | HC | | HC/CC | | Computed Chi Square |
|---------|--------------|---------------------|--------------|---------------------|------------------------|
| | Correct B | Classification N | Correct B | Classification N | |
| 1 | 23/26 | 21/26 | 26/26 | 26/26 | 8.67* |
| overall | 84.60% | | 100.00% | | |
| 2 | 21/26 | 20/26 | 26/26 | 26/26 | 12.30* |
| overall | 78.80% | | 100.00% | | |
| 3 | 20/26 | 21/26 | 26/26 | 25/26 | 9.52* |
| overall | 78.80% | | 98.90% | | |

B-Bankrupt N-Non-bankrupt

* Reject at Alpha .05

TABLE 12
COMPARISON OF LOGISTIC REGRESSION HYPOTHESIS TESTING
BETWEEN HC/GPL AND HC/CC MODELS

| Year | HC/GPL | | HC/CC | | Computed Chi Square |
|---------|--------------|---------------------|--------------|---------------------|------------------------|
| | Correct B | Classification N | Correct B | Classification N | |
| 1 | 21/26 | 23/26 | 26/26 | 26/26 | 8.67 |
| overall | 84.62% | | 100.00% | | |
| 2 | 24/26 | 21/26 | 26/26 | 26/26 | 7.51 |
| overall | 86.53% | | 100.00% | | |
| 3 | 22/26 | 22/26 | 26/26 | 25/26 | 5.96 |
| overall | 84.62% | | 98.90% | | |

B-Bankrupt N-Non-bankrupt

R* Reject at Alpha 5%

TABLE 13
COMPARISON OF THE CLASSIFICATION ACCURACY
OF MDA WITH LRA

| ===== | | | | | | |
|-------|----------|-------|----------------------|-------|--------|--------|
| Year | Function | HC | Type of Model GPL | CC | HC/GPL | HC/CC |
| 1 | MDA | 73.10 | 80.77 | 71.20 | 80.77 | 90.38 |
| | LRA | 84.62 | 82.69 | 76.90 | 84.62 | 100.00 |
| 2 | MDA | 75.00 | 78.85 | 76.90 | 80.77 | 88.46 |
| | LRA | 78.80 | 86.53 | 84.62 | 86.53 | 100.00 |
| 3 | MDA | 76.90 | 71.15 | 75.00 | 84.62 | 92.30 |
| | LRA | 78.80 | 75.00 | 82.70 | 84.62 | 98.90 |

"RELATED PARTY TRANSACTIONS"

- A CASE STUDY OF INTERACTIONS BETWEEN GOVERNMENT
AND THE PROFESSION OVER THE 'DEVELOPMENT' OF
DISCLOSURE RULES.**

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INTRODUCTION

It is widely argued¹ that standard-setting in accounting is a "political" process, and involves "lobbying" by groups seeking to advance their own self-interest. Most studies of this activity have focused on written submissions to a standard-setting body, and have considered either the incentives facing respondents to lobby or examined the decisions reached by standard-setting agencies in the face of lobbying.

Some have argued that these lobbying and standard-setting activities are part of a far larger political process whereby the accounting profession continues to seek to control the rule-making process (e.g. Chatov, 1975). Some have questioned whether standard-setting should be undertaken within the public or private sector (Horngren, 1972; Chatov, 1975; Benston, 1980; Moran & Previts, 1984).

Yet the regulatory arrangements adopted in western countries have not involved the use of a single agency to produce all accounting rules (let alone assume responsibility for other aspects of regulatory activity: monitoring compliance with those rules, and imposing sanctions for non-compliance). In most western countries both public-sector and private-sector agencies are involved in the formulation of accounting rules.

Over time, initiatives for change may come from either sector; there may be disagreements about the interpretation of existing rules, or about the need to draft rules rigorously or loosely. There may also be contests over the structure of regulatory arrangements and the composition of boards charged with performing regulatory functions. In short, contests over the regulation of accounting can be viewed as an on-going process rather than a series of finite "events".

This paper seeks to contribute to our understanding of the rule-making process by examining interactions between "government" and the "profession" in relation to a particular issue: proposals for the disclosure in

Australian company annual reports of information concerning related party transactions (RPTs).

The term "government" is used in a broad sense to encompass both politicians and executive government, including members and staff of regulatory agencies. The term "profession" is similarly used to encompass the leadership of professional bodies, the members and staff of profession-sponsored standard-setting agencies, and also accounting firms and practitioners. One of the themes which emerges from the case is that the behaviour of individual elements of "government" and the "profession" is not uniform, but that the initiatives of the profession are generally directed towards reducing professional responsibilities and watering down the impact of regulations which (while conducive towards accountability) might be unpopular with clients.

The longitudinal case study spans eight years, and examines the fate of government-sponsored proposals for disclosure of RPTs in corporate annual reports. It begins with government-initiated proposals for the disclosure of RPTs in 1982. It ends at 31 December 1989 with the official passage of an "approved accounting standard" ASRB 1017 - amid some controversy about the content of that rule and the processes used to secure its introduction. Appendix One provides a chronology of the major events accompanying the development of a disclosure made for RPTs.

Evidence was obtained from both an examination of publicly-available documents and copies of correspondence made available by interest-groups, and from interviews with key participants.²

AUSTRALIAN REGULATORY ARRANGEMENTS

During the period under review, Australian companies and securities matters were regulated in terms of a "Co-operative Scheme" established by a 1978 agreement between the Commonwealth of Australia and the separate states. The Scheme was directed by the Ministerial Council for Companies

and Securities, composed of ministerial representatives of the commonwealth government and the governments of the states (plus, more recently, the Northern Territory). Most members held the office of Attorney-General.

The principal administrative body in this arrangement was the Melbourne-based National Companies and Securities Commission (NCSC). In practice, day-to-day administration was performed by the state Corporate Affairs Commissions (CACs) acting as "delegates" to the NCSC. The state CACs were both delegates of the NCSC and advisors to individual members of the Ministerial Council.

After criticisms of aspects of the Co-operative Scheme from the business community and the findings of a Senate Standing Committee on Constitutional and Legal Affairs on the role of parliament in relation to the scheme (1987), the Hawke Labor government enacted commonwealth legislation providing for centralised control of the regulation of companies and securities matters. This move was contested by several states, and (pending the outcome of a constitutional challenge in the High Court of Australia) the Corporations Act was enacted in 1989 but not proclaimed. While awaiting the outcome of the challenge, the commonwealth proceeded to establish a new body, the Australian Securities Commission (ASC), with plans for the ASC to commence operations in mid-1990. The debate over disclosure requirements for related party transactions took place at a time when these changes in regulatory arrangements were in train, but the newly-formed ASC took no part in the events described.

"DEVELOPING" AN ACCOUNTING STANDARD ON THE DISCLOSURE OF RELATED PARTY TRANSACTIONS 1982-89

Before 1982, the Australian Society of Accountants (ASA) and the Institute of Chartered Accountants in Australia (ICAA) had not considered the possibility of producing an accounting standard on RPTs. The profession's only concern had been for the potential distortion of financial information which

could arise from RPTs. The joint accounting bodies had cautioned auditors to consider the impact of RPTs when expressing an opinion on financial statements (AUP 7, 1981). This commentary was concerned with the credibility of financial statements and did not canvass concerns with disclosure of the existence of RPTs in their own right. The subject of RPTs also arose in two subsequent Statements of Auditing Practice (AUP 10, 1983; AUP 26, 1986) both of which concerned the risk to auditors of ignoring RPTs rather than with the accountability of directors to shareholders.

Pre-dating the profession's interest in RPTs were a series of requirements in state companies legislation and (after 1978) the uniform commonwealth Companies Act and state Companies Codes. These requirements mainly concerned the contents of prospectuses. For example, the NSW Companies Act of 1874 prescribed disclosure of the full particulars of the interests of current and proposed directors and experts associated with the promotion or formation of a company (section 69). Where a director had an interest in an existing or proposed contract with a company, he was obliged to disclose this to fellow directors and have it recorded in the minutes of the meeting at which the declaration was made. But once a company was floated, there were no statutory requirements for disclosure of RPTs in annual reports.

The only on-going requirements relating to RPTs were established by the stock exchanges. Since the early 1900s listing rules required companies to make certain RPT disclosures - though not directly to all shareholders. For example the 1912 Official List of the Sydney Stock Exchange required companies to include in their Articles of Association rules which obliged directors to disclose to their fellow directors their interest in any contract or arrangement the company was to undertake.

In subsequent years, the Stock Exchanges added other RPT disclosure rules that required a company to (i) advise its Home Exchange of any material contracts involving directors' interests, (ii) separately disclose in its annual report to the Exchange the particulars of such contracts, and (iii) have approved by shareholders, in general meeting, the requisition or disposal of property from or to "related parties" where the consideration

exceeded a proportion of a specified base.

The stock exchange requirements did not spell out exactly what was intended by references to the "particulars" of contracts. It appears that in practice, such disclosures as were made by listed companies were descriptive and frequently did not disclose the terms and conditions of payments or the consideration involved in any such transactions.

The idea of requiring disclosure of RPTs in annual reports to be distributed directly to shareholders was propelled on to the agenda in 1982-83 by a government agency (the NCSC) rather than by the stock exchanges or the profession.

Overseas regulatory agencies and standard-setting bodies had been requiring disclosure of RPTs for some time:

- The USA's Securities and Exchange Commission (SEC) provided a detailed definition of "related parties" (Reg. S-X, 210.1-02(t)) and required extensive disclosures of material RPTs (Reg.S-X, 210.4-8).

The Financial Accounting Standards Board (FASB) in FAS 57 (March 1982) defined "related parties" in a similar fashion to the SEC and adopted equivalent disclosures with one exception. That was to prohibit unsubstantiated representations that RPTs were undertaken on an arms-length basis. They also required disclosure of a controlling relationship even when no RPTs had been undertaken.

- The Canadian Institute of Chartered Accountants (CICA) issued rules on RPTs in 1979. The Canadian definition of related parties was particularly wide-ranging (e.g. it encompassed any person who cohabits with a person deemed to exercise control over the reporting entity), and the rule required full disclosure of all RPTs.

- The International Accounting Standards Committee (IASC) released an exposure draft in March 1983 (leading to publication of IAS 24 in 1984). IAS 24 excluded certain parties as not being related (e.g. providers of finance, trade unions, public utilities and government departments and agencies) and required extensive disclosures of all RPTs (e.g. the pricing policies adopted for transactions between related parties).

However the Australian accounting profession had taken no initiatives regarding disclosure of RPTs until after the NCSC had embarked on a review of Schedule 7 of the Companies Act and Codes - the section of the regulations accompanying the Australian uniform companies legislation which contained the bulk of statutory requirements for corporate reporting. During 1982 the NCSC held discussions with interested parties about possible amendments and extensions of these rules, and in 1983 published a "Green Paper" crystallising a series of proposals for public comment (NCSC, 1983).

The 1983 Green Paper included proposals for disclosure of RPTs. The proposed revisions to Schedule 7 were subject to several rounds of public comment and review, and the RPT proposals survived this process to be incorporated in a draft revision of Schedule 7 of the Companies Code produced by the commonwealth Attorney-General's Department (CAG) in 1986. However at the last minute these clauses were dropped from Schedule 7 without any public explanation. Less-demanding disclosure requirements were later incorporated in an accounting standard AAS 22 issued by the accounting bodies in 1988, and in the legally-backed "approved accounting standard" ASRB 1017 issued by the Accounting Standards Review Board (ASRB) in 1989. After an unsuccessful attempt by the Australian Shareholders' Association to have this standard disallowed the ASRB agreed to re-consider the standard within six months and to provide the opportunity for public comment on its provisions.

These events took place in three main phases:

- (i) the NCSC's "Green Paper" proposals and subsequent review;
- (ii) drafting of a revised Schedule 7 by the commonwealth Attorney-General's Department;
- (iii) the profession's accounting standard and its subsequent approval by the ASRB.

Phase (i): the NCSC's "Green Paper" proposals

When the NCSC announced plans to review the statutory requirements governing the accounts and group accounts of companies, it was undertaking the first major review of disclosure rules since that conducted by the Eggleston Company Law Advisory Committee in 1968 (Masel, 1982). The NCSC's approach was to announce its plans and solicit written comments from interested parties about matters warranting review.

The accounting profession immediately argued that the whole exercise was misplaced. In a joint submission, the ASA and ICAA argued that Schedule 7 "... should be dispensed with and its contents, after appropriate amendments, incorporated in appropriate existing and new accounting standards" (August 1982). In the event that Schedule 7 was to be retained, the accounting bodies submitted that the requirements should be confined to 'disclosure matters' only.

Nevertheless the NCSC and the Ministerial Council determined that Schedule 7 should be retained, and proceeded with its review. Drafts of a discussion document were prepared by a consultant, discussed with an NCSC working party (with one representative from the ACT Corporate Affairs Commission) and finally edited, revised and extended by the NCSC. The outcome was the publication of Financial Reporting Requirements of the Companies Act and Codes in June 1983.

The Green Paper proposed a series of major reforms to the structure of corporate reporting requirements (e.g. differential disclosure, standard-format accounts) together with a series of detailed proposals on topics which had not been addressed by the profession's AARF in exposure drafts (e.g. joint ventures, disclosure of operating revenues and expenses, current values of properties, superannuation commitments, RPTs, schedules of commitments) or standards (e.g. funds statements, the application of equity accounting, segment reporting, and goodwill).

On RPTs, the Green Paper canvassed three approaches which would have required companies to disclose:

- (a) details of all related party transactions;
- (b) particulars only of related party transactions which individually or in aggregate were material; or
- (c) particulars of transactions in which the consideration was less than favourable to a company had those transactions been between informed parties acting independently at arm's length in an open and unrestricted market (NCSC, 1983, p. 95).

The Green Paper adopted a conservative approach to the definition of "related parties", adopting a far narrower definition than that adopted in North American requirements.

Written comments on the various Green Paper proposals were requested by November 1983, and 45 of the 94 respondents referred to the RPT issue. Of these a clear majority from all categories of respondents favoured the introduction of more extensive disclosure requirements (see Table 1).

Table 1

**ANALYSIS OF SUBMISSIONS TO CONSULTATIVE DOCUMENTS
INDICATING PREFERENCES FOR RPT DISCLOSURE
REQUIREMENTS**

| Consultative Document Respondent Group | Green Paper (1983) | |
|---|-----------------------|--------|
| | favour | oppose |
| Accounting Practitioners/firms | 12 | 5 |
| Corporations | 12 | 4 |
| Representative bodies | 7 | 2 |
| Academics | 2 | 0 |
| Government departments and agencies | 1 | 0 |
| Total | 34 | 11 |
| Respondents | 45 | |

Few respondents commented on the tests used to identify "related parties" - perhaps reflecting the relatively narrow definition adopted in the Green Paper. Those who expressed support for RPT disclosures indicated that (i) they should be limited to material transactions or those not at arms-length, and (ii) transactions within wholly owned groups should be excluded.

Opponents argued that (i) the existing Companies Code requirements for disclosure of loans to directors were sufficient, (ii) no real benefits could be derived from such disclosures, (iii) there were difficulties in identifying and reporting RPTs (iv) the proposals would impose an excessive burden.

As previously noted, the NCSC's review of Schedule 7 had proceeded despite claims by the accounting profession that the Schedule should be abolished and its contents incorporated in legally backed accounting standards developed by the profession. (The ASRB was not established until 1984). Many responses to the Green Paper were to reiterate this theme. Meantime, a leader of the profession endeavoured to expand support for the scrapping of Schedule 7. ICAA national president Michael Sharpe, a partner in Coopers & Lybrand, issued a press release arguing that accounting standards should be the backbone of disclosure requirements and that Schedule 7 should be reduced to minor disclosure items of "domestic or political nature". (Australian Financial Review - hereafter AFR - 14 Oct. 1983). Other practitioners disagreed: Dr W.J. Kenley (National Technical Director of Auditing and Accounting for Hungerford Hancock and Offner) responded that special disclosures "in the public interest" should still be required by Schedule 7 (AFR, 19 Oct. 1983).

Notable among the 94 submissions received by the NCSC was a joint submission from the ASA and ICAA (13 December 1983). This repeated their 1982 views that Schedule 7 should be transferred to accounting standards. The submission noted that the ASRB was soon to be established, and claimed that there was no need for the Companies Act to "embody two sources of financial reporting requirements". The accounting bodies reported that AARF had considered "a significant number of important projects" and had "reached the stage where the [NCSC] had had the opportunity of reviewing specific proposals".

On this point the accounting bodies were not supported by other respondents. Of the 54 submissions which commented on the relative roles of Schedule 7 and accounting standards, only 11 argued for the incorporation of Schedule 7 requirements into accounting standards (with only one accounting firm supporting this view: Coopers & Lybrand). Of the remainder of the submissions, four argued for an increase in the scope of Schedule 7, and 39 apparently accepted the case for the retention of the Schedule while arguing that the regulations should only be concerned with

disclosure matters (see Table 2). Several respondents made the point that RPT disclosure requirements in Schedule 7 were more likely to be complied with than comparable rules issued by the profession.

Table 2
Submission re NCSC 'Green Paper' on
Relative Roles of Schedule 7 and Accounting Standards

| Response Group | Increase scope of Schedule 7 | Limit scope of Schedule 7 to disclosure items | Incorporate Schedule 7 in accounting standards |
|------------------------------------|---------------------------------|--|---|
| Accounting practitioners/ firms | 2 | 15 | 1 |
| Corporations | 2 | 9 | 7 |
| Representative bodies | 0 | 9 | 2 |
| Academics | 0 | 6 | 1 |
| Total | 4 | 39 | 11 |

Deliberations of the first Schedule 7 Working Party: The NCSC invited state CACs to nominate officers to review responses to the Green Paper. A working party was formed, consisting of staff from the ACT, NSW and Victorian CACs, a consultant to the NCSC, several NCSC officers, and, from time to time, an officer of the CAG.

The working party's brief was to formulate final proposals for an amended Schedule 7 for consideration by the NCSC and then transmission to a draftsman for rewriting prior to final consideration by the Ministerial Council.

The working party met on five occasions between December 1983 and April 1984, and its recommendations were brought together into two documents, one providing a draft of the proposed Schedule 7 and the other explaining the draft and presenting recommendations. These documents were to be considered by the advisors to the NCSC and NCSC Commissioners before being finally transmitted to the Ministerial Council.

In mid April 1984 the ASA, in association with the Group of 100 (accountants from Australia's 100 largest public and private sector enterprises), arranged for NCSC Commissioners J.A. Coleman and A.B. Greenwood to participate in breakfast briefing sessions to preview the forthcoming amendments to Schedule 7.

Press reports suggest that the proposals were coolly received by members of the accounting profession (AFR, 24 April 1984) and caused "... massive perturbation in the business community" (Business Review Weekly hereafter BRW - 5 May 1984). Commissioner Greenwood was reported as stating that for those concerned by the proposals "... there is the protection that we'll be throwing the whole thing open again later" (BRW 5 May 1984).

Notes of these briefing sessions were prepared by Dr. A. McHugh (then "Senior Advisor, Accounting" for the NCSC) and circulated to members of the working party. Several companies and accounting firms made written submissions directly to the NCSC during the following two months (though this correspondence is not publicly available).

The working party reviewed formal and informal responses and agreed upon a definition of "related parties", the transactions that would be classified as RPTs, and the form of disclosure required. These decisions were transmitted to the NCSC and ultimately accepted by the Ministerial Council in August 1984. The text of the proposals was then passed to the Legislative Drafting Branch of the CAG. However, the redrafted proposals did not become available for public comment as an "exposure draft" until December 1985.

Phase (ii): Drafting of a revised Schedule 7 by the commonwealth Attorney-General's Department

The exposure draft invited submissions on the proposed Schedule 7 to be forwarded to the NCSC by 28 February 1986. In their final form the references to RPTs appeared in Clause 15 which identified only those transactions which individually, or in the aggregate, were material, and for which the consideration was "less favourable to the company than would have been the case had they been between informed parties acting independently in an open and unrestricted market". In those cases, the accounts were to include a note that specified the nature of the relationship between the company and that class of related party, a statement of the aggregate amount of those transactions between the company and that class of related party, and a general description of the terms of those transactions (CAG, 1985, p.36).

These submissions were then considered by a second working party with a brief to finalise the proposals. The NCSC's involvement was less significant since this working party included greater representation of state CACs (Queensland, NSW, Victorian and South Australia) and from the CAG, who would all ultimately be advising their representatives on the Ministerial Council about the proposals. By now, the Attorney-General's Department effectively had carriage of the matter.

The number of submissions on the RPT proposals in the last draft of Schedule 7 were far fewer, falling from 45 to 27 (of which seven were apparently made on a confidential basis and were not available for inspection in terms of Freedom of Information legislation). Of these 20 submissions, only three condemned the proposals outright, with the balance expressing general support for additional disclosure requirements (see Table 3). The most common responses suggested that the reference to "relatives" in the definition of "related party" be restricted to close family relationships, and that references to "material" RPTs be better specified. But five submissions (including that from the profession) argued either that the

proposal be deferred until further research had been undertaken, or that the subject should be left to an accounting standard.

Table 3
ANALYSIS OF SUBMISSIONS TO CONSULTATIVE DOCUMENTS
INDICATING PREFERENCES FOR RPT DISCLOSURE REQUIREMENTS

| Consultative Document Respondent Group | Draft Schedule (1985) | | Green Paper (1983) | |
|---|--------------------------|--------|-----------------------|--------|
| | favour | oppose | favour | oppose |
| Accounting Practitioners/firms | 5 | 1 | 12 | 5 |
| Corporations | 6 | 0 | 12 | 4 |
| Representative bodies | 6 | 2 | 7 | 2 |
| Academics | 0 | 0 | 2 | 0 |
| Government departments and agencies | 0 | 0 | 1 | 0 |
| Total | 17 | 3 | 34 | 11 |
| Respondents | 20 | | 45 | |

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It appears that great weight was placed on these submissions by Commonwealth officers who argued for the omission of the RPT requirements pending further consideration. Participants in those meetings recall that the case for deletion of the RPT requirement included:

"We looked at some Canadian reports and the disclosures were not as we would have liked".

"The feeling was that as the profession was already looking at it, and there were problems with the definition of related party, it wasn't worth holding the whole thing up while we sorted out the problem".

Participants recall that the outcome was a split vote: half (including the commonwealth and NCSC representatives) voting for deferral, half voting for retention.

Contrary recommendations were forwarded from the working party to the Administration and Legislative Policy Committee (ALPC) - a body consisting of state Commissioners for Corporate Affairs (or their equivalent) and senior officers from the NCSC. The ALPC met prior to meetings of the Ministerial Council to finalise recommendations. It recommended that the RPT clause be deleted.

Thus, when the new Schedule 7 was finally gazetted in August 1986, the RPT disclosure rules had been omitted.

Phase (iii): the profession's accounting standard and its subsequent approval by the ASRB

The AARF first placed RPTs on its agenda in the latter half of 1982. The plan was for a background paper to be prepared that year, an exposure draft in 1983, and a standard released in 1984. However, it was not until March 1983 that any public statement was made about the addition of RPTs to AARF's work programme - and (despite earlier optimism) by that time work had yet to commence.

AARF's Accounting Standards Board (AcSB) discussed RPTs in June 1983. Apparently because its own project had made no progress the AcSB resolved to distribute an exposure draft already prepared by the IASC (E 25, March 1983) to a limited number of selected parties - a step undertaken by September 1983. Plans to produce a standard by 1984 were falling behind, since by December 1983 AARF had only collated the responses to its limited

circulation of E 25 and had preliminary discussions within the AcSB. By this time RPTs had been reclassified in AARF's planning documents under the heading "Other Active Projects" rather than "High Priority Projects - Ensuing 12 Months". AARF's revised timetable called for the issue of an exposure draft and a standard on RPTs in 1985.

By August 1984, the AARF had again amended its plans and indicated that it intended to issue an exposure draft in the last quarter of 1985 and a standard in 1986. While the topic of RPTs remained classified as an "Active Projects" on the formal agenda, a report of AARF activities in The Australian Accountant in November 1984 made no reference to progress on the project.

A further exposure draft was released for "selective exposure" in May 1985. Evidently members of the AcSB were not infected with a sense of urgency and a further year elapsed before a four-page official exposure draft (ED 33) was released for public comment.

The 19 clauses in ED 33 largely reflected the content of the IASC standard on RPTs, IAS 24 "Related Party Disclosures" (July 1984). A major variation was that whereas IAS 24 deemed certain parties not to be related parties (e.g. providers of finance, trade unions, public utilities and government departments and agencies), ED 33 was silent on such definitional issues.

AARF received 31 responses to ED 33 by 31 August 1986. As shown in Table 4, a clear majority agreed that RPT disclosures were desirable. But there was less than unanimous support for the subject to be handled in the profession's accounting standards. At this stage, a draft Schedule 7 had been issued, and respondents may have thought that proposals along the lines of those in the NCSC Green Paper were also to be introduced.

Table 4

**ANALYSIS OF SUBMISSIONS TO CONSULTATIVE DOCUMENTS
INDICATING PREFERENCES FOR RPT DISCLOSURE REQUIREMENTS**

| Consultative Document Respondent Group | ED 33 (1986) | | Draft Schedule (1985) | | Green Paper (1983) | |
|---|-----------------|--------|--------------------------|--------|--------------------------|--------|
| | favour | oppose | favour | oppose | favour | oppose |
| Accounting Practitioners/firms | 5 | 1 | 5 | 1 | 12 | 5 |
| Corporations | 11 | 4 | 6 | 0 | 12 | 4 |
| Representative bodies | 3 | 0 | 6 | 2 | 7 | 2 |
| Academics | 1 | 0 | 0 | 0 | 2 | 0 |
| Government departments and agencies | 5 | 0 | 0 | 0 | 1 | 0 |
| Total | 26 | 5 | 17 | 3 | 34 | 11 |
| Respondents | 31 | | 20 | | 45 | |

Despite the profession's campaign for Schedule 7 to be abandoned and the contents restated as approved accounting standards, the submissions on ED 33 revealed surprising support for the retention of government accounting rules. Eight of the 26 respondents favouring disclosure of RPTs suggested that the existing Companies Act and the proposed Schedule 7 requirements should be the minimum requirements. Five were more direct in suggesting that an accounting standard was not required.

As with the material produced by the NCSC, respondents commented on a range of technical issues dealing with the definition of "related party". Twelve

respondents expressed concern with the references to "control" and "significant influence"; most arguing for definitions which narrowed the range of persons or entities encompassed by the definition of related parties.

The main feature of ED 33 was that it adopted a different approach to the type of disclosures to be made regarding RPTs. The NCSC Green Paper had canvassed the idea of a form of exception reporting which would have avoided detailed disclosures of non-material transactions which were in the ordinary course of business and for a consideration no different from that obtained in the market. During the initial review of Schedule 7, a selection of North American corporate reports had been examined and some of these included trivial disclosures about RPTs. According to a member of the working party:

"I remember seeing one set of accounts for a corporation with a shareholders' equity of over US\$1 billion. They devoted a great deal of space to reporting that an airline ticket worth around \$140 had been purchased through a travel agent owned by a relative of a senior executive.

"The idea was to avoid disclosure of that kind of trivia, and concentrate on the abnormal transactions, the kind of deals which were hidden payments to directors, or which ripped off shareholders".

Hence the draft Schedule 7 had referred to transactions where the consideration was not "commercial". Opposition to the Green Paper and draft Schedule 7 had not centred on this approach of having some form of "exception reporting". However ED 33 took a different stance. A "guide" to ED 33 explained its approach in the following terms:

Pronouncements on related party disclosure have been issued by the standard-setting bodies in the U.S.A. and Canada and by the International Accounting Standards Committee. The exposure draft is compatible with all of these pronouncements.

The definitions of related party are similar to the definition in the exposure draft, and, consistent with the draft, none of the overseas pronouncements requires remeasurement of related party transactions not conducted at fair value.

ED 33 simply required disclosure of information about material RPTs: a requirement which avoided the Schedule 7 approach of placing responsibility on directors and auditors of identifying those transactions where the consideration was "not commercial".

Further, whereas the abandoned clause in the draft Schedule 7 had required disclosure of the aggregate amount of RPTs, ED 33 only required disclosure of "the value or volume" of RPTs as percentages of all other transactions of the same (undefined) "type".

In these respects ED 33 proposed less onerous reporting requirements than those emerging from the NCSC's initiatives. In justifying this approach by claiming compatibility with overseas standards, AARF had apparently disregarded the way that the USA's FAS 57 (1982) obliquely led to the identification of RPTs in which the consideration was "not commercial". FAS 57 prohibited any representations that RPTs had been "consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated" (clause 3). In practice, this encouraged those US corporations which could do so to note that the consideration was fully "commercial"; the absence of any such statement signalled that the consideration was not at arm's length, and commonly led to detailed explanations of the matters being reported (see Goodman and Lorensen, 1985).

AARF's "guide" to ED 33 did not identify this as an issue warranting discussion. Yet nine respondents pressed the need to identify RPTs that were not undertaken on a commercial basis, with eight of those arguing for "exception" reporting which dealt only with the non-commercial transactions.

It has been noted that ED 33 contained less onerous requirements for

directors and auditors than the NCSC's Schedule 7 proposals. In this context, one of the more remarkable submissions came from Dr. A. McHugh, then "Senior Advisor - Accounting" at the NCSC. McHugh had been a member of the initial "Green Paper" committee which initiated the proposals for disclosure of RPTs; he had been a member of the first Schedule 7 working party which refined those proposals; and he had been a member of the second working party which in 1986 rejected those same proposals. McHugh's submission to AARF on ED 33 concluded:

Given the implications for companies and auditors, I recommend that this topic be approached cautiously for it is possible to produce onerous consequences if the disclosures are drawn too broadly. (McHugh to AARF, 11 Aug. 1986).

Caution was the keyword for AARF's deliberations. ED 33 was shelved. Meantime, the accounting profession was reviving its argument that the contents of Schedule 7 should be transferred to approved accounting standards.

Transferring Schedule 7 to accounting standards: The profession had argued in 1982 and 1983 that Schedule 7 be abandoned and its content transferred to accounting standards which were given legal backing. The establishment of the ASRB in 1984 provided an opportunity for this argument to be revived, since "legal backing" for accounting standards was now a reality. However on several occasions the NCSC and the Ministerial Council had resisted these proposals.

When a revised Schedule 7 was produced by the commonwealth legislative draftsman, the drafting was complex and (in the opinion of some) excessively legalistic. Public servants recall that the Victorian Attorney-General Mr. Kennan was scathingly critical of the document, and favoured the idea of a single "reporting code" combining statutory requirements, listing rules and accounting standards. While Kennan did not want to proceed with Schedule 7 other members of the Ministerial Council successfully argued that it was better to have something in place now than

face further delays.

As a concession, the Ministerial Council directed the NCSC and the (second) working party, in consultation with the ASRB, to advise on a possible corporate reporting code and whether Schedule 7 could be simplified and brought into line, as far as practicable, with international standards.

The delays in implementation of Schedule 7 attracted the attention of one interest group, the Australian Shareholders' Association. In May 1986 the Association wrote to the then NSW Attorney-General and chairman of the Ministerial Council, Mr. Terry Sheahan expressing concern about those delays and also about reports that Schedule 7 might be scrapped in its entirety in favour of approved accounting standards.

The Australian Shareholders' Association welcomes and supports proposals for fuller reporting of the emoluments and benefits receivable by directors and senior executives, and for the reporting of information concerning 'related party transactions'. It does not consider that these subjects are properly the subject of accounting standards which may be prepared by the accounting profession and adjudicated upon by the Accounting Standards Review Board (Rofe to Sheahan, 23 May 1986).

In reply, Sheahan wrote:

Whilst I am aware that the accounting bodies have proposed that Schedule 7 be repealed and replaced by approved accounting standards, it is clear that the Schedule cannot be totally repealed because it deals with, as you point out, matters concerning the fiduciary responsibilities and accountability of company officers (Sheahan to Rofe, 16 June 1986).

Despite these assurances, in July 1986, the Ministerial Council agreed in

principle for the progressive transfer of Schedule 7 to approved accounting standards (Financial Markets Briefing, 24 Aug. 1986). However the Ministerial Council did not envisage the transfer of all provisions, only most of the disclosure requirements. The text of the resolution was as follows:

That most disclosure requirements should, as soon as practicable, be progressively transferred from Schedule 7 to approved accounting standards (with the consequence that the Council will need to consider, from time to time, what amendments may be required to Schedule 7 and other legislative provisions to ensure that they do not overlap with approved accounting standards).

Later it appears that the resolution was interpreted by AARF, the NCSC and the ASRB as relating to all of Schedule 7, including provisions which dealt with "the fiduciary responsibilities and accountability of company officers".

Meantime, Sheahan announced that the revised Schedule 7 would become operational as from 1 October 1986 (Media release, 28 August 1986).

A second exposure draft - ED 41 (1987): AARF's second exposure draft on RPTs was issued in June 1987. AARF explained that it considered re-exposure of its proposals to be necessary in light of two factors: the submissions received on ED 33, and the need to translate Schedule 7 into accounting standards.

The claim that ED 33 was being modified in the light of formal submissions is not consistent with the evidence. The major change between ED 33 and ED 41 was the omission of the earlier requirements for disclosure of the "measured" or "book value" of RPTs in favour of general disclosures of "the nature of the terms and conditions of the transactions".

Yet only two of the 26 respondents to ED 33 had commented adversely on proposals for the disclosure of "book values" of RPTs - arguing that such disclosures would be of "no great worth" or "generally meaningless". A

majority had wanted more than book values disclosed - and were critical of the omission of Schedule 7-style proposals for reporting of transactions in which the consideration was "not commercial". In the preamble to ED 33 AARF had created something of a straw man in the form of a suggestion that reporting entities may have been required to remeasure and report the consideration in RPTs; 10 respondents duly commented that remeasurements at a later date could be unreliable and could be "commercially damaging"). On the other hand, other respondents directly argued that such remeasurements would disclose relevant information and should be provided where feasible.

A second major change between ED 33 and ED 41 involved the inclusion of requirements similar to those already contained in Schedule 7 for the disclosure of directors' emoluments. Perhaps for that reason the stated purpose of the draft standard was enlarged to note that disclosure about RPTs was intended to ensure "the accountability" of directors. And perhaps AARF felt it could chance its arm: the revised Schedule 7 had (at the insistence of the Ministerial Council) required disclosure of the remuneration received by directors and senior executives in "bands". This had proved controversial, incited vigorous lobbying, and led to a revision of Schedule 7 within months of its implementation (the revision varied the requirements for the disclosure of executive remuneration). ED 41 proposed disclosure of directors remuneration and other benefits - but only the aggregate amount paid or payable to all directors.

Other changes noted in ED 41 concerned the definition of "related party". The draft now echoed the IASC's E 25 (which AARF had distributed in 1983) by excluding providers of finance, trade unions, government departments and statutory authorities from the definition of related party. ED 41 provided more detail as to the evidence required before related parties were identified in terms of tests of "control" and "significant influence". It abandoned the ED 33 requirement for disclosure of the identify of related parties even if there had been no RPTs during a period.

ED 41 advised that submissions should be lodged by 31 August 1987. In a

note to this advice, AARF observed that the ASRB may decide not to seek further comment on this topic and encouraged all interested parties to take the opportunity of providing comments on ED 41.

Table 5
ANALYSIS OF SUBMISSIONS TO CONSULTATIVE DOCUMENTS
INDICATING PREFERENCES FOR RPT DISCLOSURE REQUIREMENTS

| Consultative Documents Respondent Group | ED 41 (1987) | | ED 33 (1986) | | Draft Schedule (1985) | | Green Paper (1983) | |
|--|-----------------|--------|-----------------|--------|--------------------------|--------|-----------------------|--------|
| | favour | oppose | favour | oppose | favour | oppose | favour | oppose |
| Accounting Practitioners/firms | 10 | 0 | 5 | 1 | 5 | 1 | 12 | 5 |
| Corporations | 8 | 1 | 11 | 4 | 6 | 0 | 12 | 4 |
| Representative bodies | 2 | 0 | 3 | 0 | 6 | 2 | 7 | 2 |
| Academics | 0 | 0 | 1 | 0 | 0 | 0 | 2 | 0 |
| Government departments and agencies | 2 | 0 | 2 | 0 | 0 | 0 | 1 | 0 |
| Total | 22 | 1 | 28 | 5 | 17 | 3 | 34 | 11 |
| Respondents | 22 | | 31 | | 20 | | 45 | |

AARF received 27 submissions in response to ED 41 (10 from practitioners or firms, 9 from corporations, 2 from representative bodies and 6 from government departments and authorities). Of these, 26 were generally supportive of the standard (see Table 5).

However many responses echoed the earlier Green Paper and draft

Schedule 7 approaches. Three respondents felt that all of the ED's draft requirements were better located in Schedule 7 while another two submitted that the requirements relating to directors' remuneration should remain in Schedule 7. Nine respondents expressed a preference for the NCSC's approach of disclosing only (or separately) RPTs undertaken on a non-commercial basis. However, six other respondents argued that all RPTs should be disclosed. ED 41 had avoided quantifying RPTs and eight respondents agreed with this approach while three argued that quantified disclosures were appropriate and another three even submitted that "remeasurement" was desirable. On all of these points a majority of respondents appeared to favour the earlier "Green Paper" approach in preference to the profession's ED 33 and ED 41 approach of unquantified disclosure of all material RPTs.

The definition of "related party" remained controversial, with 15 commenting on this issue. Some wanted the terms "director" and "relative" defined in a similar fashion to the Companies Act. Others looked for a consistency in the definition of "control" and "significant influence" between proposed standards (i.e. ED 40 on consolidated statements) and existing standards (AAS 14 on equity accounting).

There were also concerns about the extent of application of the standard, with 11 submissions suggesting that RPTs involving wholly owned subsidiaries should be excluded, while six submitted that the disclosure requirements should not apply to exempt proprietary companies. The responses from government departments and authorities questioned the exclusion of the public sector from the ambit of the proposed disclosure requirements.

By June 1988, the accounting bodies had completed their consideration of the draft standard and AAS 22 "Related Party Disclosures" was released with an implementation date of 30 June 1989. The major variation in the requirements specified for RPT disclosures in AAS 22 (as compared to those in ED 41) was that RPTs between a parent and wholly-owned subsidiary need not be disclosed if consolidated accounts are prepared.

The ASRB's consideration of AAS 22: It appears that after the issue of AAS 22, AARF forwarded the standard and copies of submissions to the ASRB.

The ASRB had recently been merged with AARF's AcSB after the Ministerial Council adopted the NCSC's recommendations for a merger - after a period in which the accounting bodies had called for a streamlining and rationalisation of the standard-setting process (Prosser, Nov. 1988) and criticised the need for standards to be considered twice, by its board and then the ASRB. The ASRB remained a quasi-statutory authority, even though it was now being served by AARF rather than an independent secretariat.

It is noteworthy that the ASRB did not itself announce that it would not be separately inviting submissions on any draft standard on RPTs. Nor had AARF communicated its warning about the possibility of no further public exposure to other interested parties outside the profession. Nor did the ASRB immediately abandon its practice of advertising its agenda and inviting submissions on matters before it - as prescribed by its Release 200, "Procedures for the approval of accounting standards", Oct. 1986). During 1989, when considering seven of the profession's standards the ASRB publicised that review and invited public comment. Furthermore, some 16 months after AARF suggested that the ASRB might not itself "expose" the standard on RPTs, the ICAA's executive director Vic Prosser explained that he envisaged that only one round of public exposure would be required for "future accounting standards" (Prosser, Nov. 1988).

Nevertheless, in 1989 the profession's standard on RPTs was considered and "approved" by the ASRB without any prior public announcement or invitations to comment. It was the first occasion that the ASRB had adopted this practice, which conflicted with its own rules governing its procedures, published in Release 200.

It is not clear why the ASRB chose not to invite submissions on its draft standard on RPTs, particularly since the text of AAS 22 was extended to

incorporate additional clauses drawn from Schedule 7. At this time the ASRB had developed a very close relationship with AARF. The AcSB of AARF had been combined to form an "enlarged" ASRB, and in September 1988 the Ministerial Council (on the recommendation of the NCSC) had accepted the profession's proposals for a merger and its plans for the larger board to eventually set standards for both the public and private sectors. The ASRB had lost its own technical staff and was being served by a former employee of AARF. The ASRB moved from Sydney to the AARF offices in Melbourne.

Perhaps the ASRB or AARF was concerned that publicity might threaten the profession's ambition of having Schedule 7 abolished - as Ministers or interested parties realised the profession's plans to transfer the Schedule 7 provisions relating to the fiduciary responsibilities and accountability of company officers into approved standards.

In any event, while other interest groups were not aware of plans to translate AAS 22 into an approved standard, the ASRB's deliberations became quickly, if not immediately, known to the AARF and accounting bodies. In July 1989, the accounting bodies announced that the AAS 22 requirements relating to directors loans, remuneration and superannuation need not be complied with (Media release, 5 July 1989) and that AAS 22 did not apply to exempt proprietary companies (Media release, 18 July 1989). The latter announcement acknowledged that the relief granted to exempt proprietary companies was a consequence of decisions taken by the ASRB on 6-7 July 1989.

On 30 October 1989, the ASRB "approved" ASRB 1017 "Related Party Disclosures" and, as anticipated by the accounting bodies, the requirements in the approved accounting standard did not apply to exempt proprietary companies. Furthermore, the ASRB standard replicated many of the remaining Schedule 7 related party disclosures in the belief that those requirements would be removed.

However, ASRB 1017 departed from AAS 22 by requiring the disclosure of

the aggregate and/or proportions of RPTs for each type of transaction. When announcing the approval of ASRB 1017, the ASRB noted that it had included the quantification requirements

... to ensure that company accounts present a more complete picture of related party disclosures to the users of the accounts (Media Release, 3 November 1989).

The Australian Shareholders' Association had become aware from the July 1989 announcements of the accounting bodies that the ASRB was looking at the subject of RPTs and contacted the ASRB seeking a copy of the standard. The request was rejected, so the Association wrote to NCSC chairman Bosch seeking his assistance in obtaining a copy, and either ensuring public exposure of the draft or (if the standard had already been "approved") his assurances that he would advise the Ministerial Council of concerns about the adequacy of public exposure of the standard (Walker to Bosch, 2 November 1989).

The letter was sent only a day before the ASRB's announcement that the standard had been "approved". Ironically, the last few months of 1989 saw extensive media coverage of material RPTs involving what (were then) listed public companies (see, e.g. "Qintex's \$42m in fees 'tip of the iceberg'", The Australian, 31 Oct. 1989). Neither AAS 22 nor ASRB 1017 would have required disclosure of the dollar value of those transactions.

Late in November (after no reply had been received from Bosch - but ASRB 1017 had been published) the Australian Shareholders' Association contacted the NCSC chairman and was advised that the Commission would shortly be forwarding documents to Ministers seeking a vote on the approval of that standard, and that any submission the Association cared to make by that afternoon could be distributed. A submission urging "disallowance" of the standard was duly provided to the NCSC for transmission to the Ministerial Council on 24 November 1989.

Perhaps because of an oversight, the NCSC did not immediately distribute

this document to the Ministerial Council. The Companies Act and Codes called for any motion for disallowance to be resolved within 60 days after the ASRB had formally "approved" a standard (sub-section 266B(3)).

During interviews with CAC staff, it was revealed that earlier in December the NCSC had recommended that Ministers vote to approve the standard, while expressing certain "reservations" about the text, and indicating that the ASRB had agreed to review the standard within six months. The NCSC's advice to Ministers made no mention of the submission from the Shareholders' Association that the standard be disallowed and returned to the ASRB for public "exposure" and comment. When the Shareholders' Association became aware that its submission had not been forwarded to members of the Ministerial Council, it complained to the NCSC, and the documents were finally distributed several days later (on 23 or 24 December 1989).

A vote was required by 31 December 1989, and a majority of Ministers (five of nine) would have had to record a negative vote for the draft standard to be disallowed. Few ministers voted, so 1989 ended with the profession's standard obtaining "legal backing".

Yet it seemed unlikely that this would have ended debate about the disclosure of RPTs. State CACs had been alerted to the failure of ASRB 1017 unequivocally to require disclosure of the dollar value of transactions with related parties - a sensitive issue in the light of information emerging after the failure of a series of high-profile companies. There were also concerns about restrictions on the application of ASRB 1017 to those transactions deemed "material".

Late in 1989 the ASRB issued a rather curious press release explaining that the standard did not override certain requirements of Schedule 7 requiring the separate disclosure of dividends and interest payments between related parties, and explaining that the Board intended that RPTs involving a token consideration could be regarded as "material" (Media Release, 21 December 1989). Also in December 1989 the newly-formed Australian

Securities Commission had published a discussion paper outlining proposals for law reform on "loans to directors, loans to related and connected companies, and executive and intra-group remuneration".

Early in 1990 (and outside the period of this case study) the outgoing chairman of the NCSC Henry Bosch told a luncheon meeting that Australian business needed to disassociate itself from "the scum of collapsed paper entrepreneurs". While advocating self regulation, he identified three main areas of business misconduct, and two concerned RPTs: "directors who enriched themselves with large fees" and "directors who transferred assets between companies" (Sydney Morning Herald, 23 Feb 1990). After referring to concern that "some directors have personally enriched themselves and their immediate associates at the expense of their companies and their shareholders by paying themselves astonishingly high salaries and bonuses or by making themselves large loans", he continued:

The second cause of public concern has been the practice of directors diverting very large sums of money from the companies with which they are responsible, to other companies with which they are associated. Many different devices have been used such as so called "management fees" and payments for "services", but most common has been the payment of uncommercially high prices for "assets" bought from related parties, sometimes with put and call options attached.

These practices have been more frequent and the sums of money involved have been much larger than the direct payments to individuals, but the outcry has been more muted mainly, I suspect, because they are more complex and more difficult to understand.

This was a remarkable statement, given the NCSC's prior role in dropping rules on RPTs from Schedule 7, and ensuring the passage of the weak rules in ASRB 1017. But, as noted earlier, contests over accounting regulation are on-going processes rather than a set of finite events.

THE DEVELOPMENT OF A STANDARD - IN RETROSPECT

The 1980's opened with a strong commitment by government to improving the quality of securities market regulation, and in particular the quality of corporate financial reporting. The creation of the ASRB and a wide ranging review of the disclosure requirements embodied in Schedule 7 signaled a more proactive role for government. However, by the middle of the decade this commitment had started to waver. 1987 saw the biggest stock-market "adjustment" in the history of Australian securities markets. The end of a long-running bull market coupled with high interest rates produced a series of major company failures. Receivership and liquidation proceedings produced evidence indicating that some company directors had initiated transactions with related parties with little heed to their fiduciary responsibilities to shareholders. Local commentators were critical of the work of accountants and auditors while overseas critics referred to the looseness of Australian accounting standards.

Debate about RPTs took place in this general context, and at time when the profession was lobbying for the scrapping of government regulations in Schedule 7 of the Companies Act and Codes in favour of the profession's accounting standards. This had been debated in 1982 but government regulations were retained. In 1983 the profession again sought the abandonment of Schedule 7, again unsuccessfully. The argument was revived in 1986 - but this time supported by Attorney-General Kennan who had reacted to the complexity of the legalistic drafting of Schedule 7. The Ministerial Council agreed to the transfer of "most" of Schedule 7 to accounting standards; by 1989 the qualifier, "most" had been forgotten. The profession's campaign had continuity, and eventually prevailed.

Reviewing the debate about RPTs during 1982-89, it was clear that the topic was propelled on to the regulatory agenda by the NCSC, a government agency. That produced a response from AARF in the form of the release of a series of exposure drafts (IASC E25, ED 33). Thereafter the government agencies seemed content to let the profession assume carriage of the

matter: perhaps because they viewed their role as being complete once agenda entrance had been secured.

The profession's response to the Schedule 7 proposals was criticism, and the production of a set of less onerous proposals (ED 33). The working party's response was not based on technical analysis but may have been guided by a desire to avoid criticism from, or conflict with, the profession. The RPT proposals were dropped from the final draft of Schedule 7.

Again, these events reflected disagreement within areas of "government". Two working parties had supported the introduction of provisions dealing with RPTs but in 1986 the NCSC and commonwealth decided to oppose these plans, permitting the accounting profession to introduce much less stringent requirements. The RPT standards produced by AARF in 1988 and the ASRB in 1989 were less demanding than those adopted by overseas professional bodies: by CICA in 1979, by the FASB in 1982, the IASC in 1984, and the New Zealand Society of Accountants in 1988. At times AARF had justified its approach by (selective) appeals to the authority of overseas practices - particularly by references to the difficulties of "remeasurement". Ironically, by the end of the decade the UK's Accounting Standards Committee was favouring disclosure of "abnormal items" and the "remeasurement" of these where feasible (see ED 46, 1989; Boyle, 1989).

EXPLAINING THE RULE-DEVELOPMENT PROCESS

Case studies provide the opportunity to consider whether the events studied are consistent with broader descriptions of regulatory processes.

The foregoing account of the debate over rules regarding RPTs indicates limitations on a research approach which focuses on the activities of a single agency when trying to describe the political processes involved in rule-development. The most critical events in the development of rules on RPTs arose from interactions between key players - government and the profession (and, at later stages, other bodies - such as the Australian

Shareholders' Association or the Australian Securities Commission). The NCSC placed the item on the regulatory agenda. Criticisms of the proposals from key elements of the profession appear to have encouraged the NCSC and the commonwealth to propose deletion of the item from the revised Schedule 7. NCSC submissions to AARF signalled that government would not oppose less stringent requirements. The ASRB approved a lax standard without any public exposure, with both the agreement (and participation) of the NCSC. (ASRB members defended this action on the basis of AARF's statement at the time it released ED 41). Later the NCSC - deliberately or inadvertently - prevented any serious review of objections to the standard by the Ministerial Council before the ASRB 1017 could attain legal status.

Pluralism: One way of reviewing political processes is to assume that standard-setting bodies operate with due regard to the precepts of "pluralism", or to investigate whether observed lobbying behaviour is consistent with the pluralist ideal.

The hypothesis of "pluralism" may be appropriate when considering the deliberations of a single agency (such as AARF or the ASRB) but it is not clear that it can readily be translated to an environment where regulatory arrangements are more complex. Some agencies may react to the views of factions within its own constituency: for example, auditors or corporate accountants could hold quite different views about the content or drafting of accounting rules.

Even in such a limited context, the evidence regarding RPTs suggests that individual agencies did not operate in a manner consistent with pluralism. As shown in Table 3, the NCSC ignored majority votes across all major groups of its constituents regarding the desirability of having requirements for RPTs in Schedule 7 (in favour of submissions from the profession). Likewise AARF ignored the views of its constituents on whether RPT requirements should be in Schedule 7 or accounting standards; later it overrode majority opinion regarding the desirability of having quantified disclosures.

As suggested above, the submissions of individual constituents of the NCSC were less significant than the activities of AARF - and vice versa. The case study suggests that a better understanding of regulatory processes may be obtained by examining inter-organisational relationships.

Corporatism: The model of regulatory processes known as "corporatism" recognises the significance of inter-organisation relationships. "Corporatism" has been described as

a system of interest representation in which constituent units are organized into a limited number of singular, compulsory, non-competitive, hierarchically ordered and functionally differentiated categories, recognised or licenced (if not created) by the state and granted a deliberate representational monopoly within their respective categories in exchange for observing certain controls on the selection of leaders and articulation of demands and supports (Schmitter, 1974, p.86).

According to Schmitter (1979, p.27), corporatist arrangements emerge because the state requires the professional expertise that can only be provided by "singular hierarchically ordered consensually led representative monopolies". In turn, the "representative monopolies" (such as professional associations) exploit their distinguishing expertise to achieve their own interests. A related notion of "neo-corporatism" describes the efforts of governments to secure consensus by granting certain interest groups privileged access to the policy making process (see Schmitter and Lehmbruck, 1979; Lehmbruck & Schmitter, 1982; Wilson, 1983).

Such notions of corporatism can be readily invoked to describe how the accounting profession has organised itself (Willmott, 1986; Richardson, 1989) or sought to regulate accounting practice (Willmott, 1985; Puxty, Willmott, Cooper & Lowe, 1987; Walker, 1987). The decisions of the Ministerial Council to transfer Schedule 7 to approved accounting standards, and to abandon government initiatives to require disclosure of RPTs in favour of promised profession-developed standards, are consistent

with the corporatist approach.

Yet a description of a set of arrangements as "corporatist" may not be adequate to describe the dynamics of regulatory processes on particular issues. The state may be happy to delegate responsibility for the development of accounting rules to the profession - but may still intervene when the profession's performance is plainly inadequate. It can be noted that the NCSC used a review of Schedule 7 to place pressure on the accounting profession to lift its output of accounting standards; the Ministerial Council's efforts to establish an ASRB represented both a limitation on the extent of the profession to have control over the rule making process, and an attempt to tighten those rules and direct more attention to the enforcement of those rules.

Corporatist arrangements may not be uncontested, or stable. After the profession regained control of the standard-setting process (through the 1986 changes to the composition of the ASRB, the 1988 merger of that body with AARF's AcSB, and the 1986 campaign to persuade politicians to abandon "most" of Schedule 7), the corporatist arrangement established through the ASRB was potentially unstable, since it excluded certain interests (such as security analysts and other "users" of financial reports) from having a strong voice in standard-setting. Moreover the viability of those arrangements remained vulnerable to the possibility that outside events might highlight the manner in which control over the standard-setting process was being used to advantage some interests and disadvantage others - as occurred toward the end of 1989 when corporate scandals and failures highlighted the laxity of Australian accounting standards - thereby encouraging politicians to take some visible responses.

Interactions between government and the professions: It has been suggested that in order to understand the development of regulation, one needs to acknowledge that it takes place in context of a complex set of regulatory arrangements which involve a variety of agencies (both public and private sector) whose operations overlap either in relation to rule-enforcement, or both. Equilibrium may be established in the short-run

through formal delegations of authority for rule-development (e.g. the establishment and membership of the ASRB), or informal delegations (e.g. the NCSC's avoidance of the enforcement of accounting standards in favour of the accounting profession's self-regulatory procedures). While the legislature may extend certain powers to regulatory agencies (e.g. the NCSC's powers to enforce ASX listing rules) the regulatory agency in turn may regard enforcement activities as being of low priority. A case in point was the NCSC's apparent disregard of opportunities to enforce the ASX's listing rule 3C (which required disclosure of the particulars of certain RPTs) in terms of section 42 of the Securities Industry Code.

Rule development often takes place through a series of interactions between major participating parties, including regulatory agencies with overlapping jurisdiction. In this context, an initiative undertaken by a regulatory agency may expose other regulatory agencies to various forms of threats. The initiative may challenge another's authority to make rules in a given arena, or to dominate the rule-making process. Or the initiative may challenge long-standing procedures - e.g. by compelling more openness about draft proposals, or extending the range of persons invited to join standard-setting bodies beyond the ranks of the profession, or insisting on greater clarity and less permissiveness in the drafting of accounting standards.

Diversity of activity within "government": One matter highlighted by the history of the RPT debate is that the activities of "government" were not always integrated and cohesive. Different government departments or agencies pursued different objectives. Conflict arose when the NCSC sought to draft Schedule 7 in plain language and the commonwealth insisted that the regulations be prepared by parliamentary draftsmen. Some representatives of state CAC's supported proposed rules for RPTs in Schedule 7 whereas others, and commonwealth and NCSC representatives were happy to see the matter handled by the profession. Perhaps the most puzzling inconsistency is the way that the NCSC had initiated revisions of Schedule 7 and opposed the establishment of the ASRB - yet later recommended abandonment of Schedule 7, supported the merger of AARF's AcSB and the ASRB, and promoted the transfer of Schedule 7 to

approved accounting standards. It was a remarkable reversal of policy.

Interaction as a form of domain defence, management and maintenance: If the corporatist model does not adequately explain the dynamics of regulatory activity, better explanations may be provided by viewing the interaction between public and private sector interest groups in terms of efforts by organisations (such as regulatory agencies or professional bodies) to extend their area of influence, and to defend, manage and maintain their domains (see Baysinger 1984).

Domain defence refers to an organisation's activities aimed at counteracting challenges to the legitimacy of its goals and purposes - as opposed to its methods of pursuing them. Domain maintenance refers to strategies used to rebuff threats to the method an organisation implements to pursue its goals and purposes. Domain management refers to the strategies a regulatory organisation employs to manage its relationship with other regulatory organisations.

The initiatives of the NCSC in reviewing Schedule 7 can be seen as efforts to establish the newly-formed NCSC's authority over the domain of accounting regulation. Earlier, the NCSC had taken steps to ensure that schedules to the Companies Act and Codes were regulations rather than parts of a statute which required parliamentary approval - an exercise which also played a significant part in establishing the NCSC's domain.

The NCSC initiative may have meant that the dominant body of accounting rules would be in Schedule 7 rather than the profession's standards. The Schedule 7 Green Paper had proposed accounting rules on a wide range of topics not previously addressed in the 13 standards issued by AARF to March 1983. The profession's response can be seen as an exercise in domain defence. It argued against the inclusion of accounting rules in the Companies Act and Codes, and promoted the idea of legally-backed accounting standards (to be produced by the profession).

Later the profession adopted "domain maintenance" strategies by

challenging suggestions that its methods of standard-setting were inappropriate. It argued that Schedule 7 should be limited to "disclosure rules" - a strategy consistent with the objective of maintaining the profession's influence over rule-making regarding "measurement" (notwithstanding the predominance of "disclosure" rather than "measurement" rules in its own standards).

Incidental to this strategy was the profession's attempt to forestall Schedule 7 proposals by referring to work it had already undertaken on particular topics. This argument was advanced many times and eventually succeeded with the deletion of the RPT disclosures from Schedule 7.

The establishment of the ASRB was another challenge to the profession's authority; the profession in turn adopted "domain management" strategies designed to "capture" that agency (Walker, 1987) as well as "domain maintenance" strategies aimed at retaining the drafting style it used in its standards.

When the profession sought to have Schedule 7 abandoned and transferred to approved accounting standards it was seeking to recapture a lost domain. It was also managing its domain by enlisting the support of politicians on the Ministerial Council to reinstate a profession-dominated standard-setting body as the dominant source of accounting rules. When the profession set out to incorporate the Schedule 7 provisions relating to directors' accountability into an approved accounting standard on RPTs it was seeking to extend its domain.

The curious behavior of the NCSC in supporting the abandonment of Schedule 7 is explainable in terms of "domain maintenance" - though here the interactions were largely within the public sector, while the domain being protected was defined in relation to the profession. Having established that its domain extended to accounting regulation, the NCSC may have been concerned that its influence may have been lessened with the passage of that set of regulations. During interviews, some public servants suggested that the NCSC must have become aware that control of Schedule 7 had

passed to the CAG since the latter was responsible for the final drafting (and content) of those regulations. However the NCSC could continue to strongly influence the ASRB and did so - effecting major changes in the pattern of representation of membership in 1986, promoting the 1988 merger of the AcSB and ASRB, and prompting the Board to approve standards on "debt defeasance" relatively quickly (NCSC Media release 30 March 1988; ASRB 1014, "Set-off and extinguishment of debt", June 1988).

Examples of how interactions between government and the profession can be fitted within this typology of domain defence and maintenance can be multiplied. However, the typologies of domain defence, domain maintenance and domain management are not mutually exclusive and a strategy employed by a regulatory organisation may involve elements of each (e.g. the profession's argument that its accounting standards should be legally backed legitimises not only the right of the profession to issue such rules but also confirms the rule development procedures and implementation effects of such rules).

With that proviso, the process of identifying the "domains" of participants in the standard-setting process, and analysing threats to those domains created by other parties, appears to go further than existing accounts in explaining the regulatory process. At the same time, it must always be acknowledged that the process is a multi-player game, involving a variety of governmental and private-sector bodies. The most significant interactions may occur between government regulatory agencies and the profession's standard-setting body. But initiatives undertaken by other interest groups may also threaten the domains of major players. Outside events (such as a much-publicised corporate failure) may also add instability to laboriously-negotiated territorial arrangements between government and the profession.

FOOTNOTES

1. Commentaries on the political dimension of standard setting include Zeff (1972), Gerboth (1973), Horngren (1972 and 1973), Moonitz (1974), Armstrong (1977), Stamp (1979), Tonkin (1981), Hines (1983) and Walker (1987).
2. One of the joint authors was a consultant to the NCSC when the 1983 proposals were drafted, and later participated in the (first) working party reviewing these proposals. He was also a director of the Australian Shareholders' Association during the latter period of the case study.

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APPENDIX ONE

CHRONOLOGY OF MAJOR EVENTS IN THE DEVELOPMENT OF AN
ACCOUNTING RULE FOR RELATED PARTY TRANSACTIONS

DATE EVENT

1982

June National Companies and Securities Commission (NCSC) commences consultation with relevant parties over review of company disclosure requirements (Schedule 7). Comment received that disclosure of related party transactions (RPTs) required.

August

Australian Society of Accountants (ASA) and Institute of Chartered Accountants (ICAA) submit that proposed review of Schedule 7 is misplaced and argue for incorporation of disclosure requirements into accounting standards.

Australia Accounting Research Foundation (AARF) places RPTs on its standard setting agenda. Plans to issue exposure draft (ED) in 1983 and standard in 1984.

Ministerial Council decides to continue with review of Schedule 7. Drafting of discussion paper commences.

1983

June Discussion paper on review of Schedule 7 released with submissions required by November.

September

AARF's Accounting Standards Board (AcSB) discusses RPTs and resolves to selectively expose the International Accounting Standard Committee exposure draft E 25.

AARF issues E 25 on selective exposure.

October

Ongoing public debate between members of the accounting profession over the role of Schedule 7 vis a vis accounting standards issued by the accounting profession.

December

Submission from ASA and ICAA argue that accounting standards should replace Schedule 7 disclosure requirements.

AARF collates responses received on E 25.

1984

January

Accounting Standards Review Board (ASRB) commences work.

to April

First Schedule 7 working party meets on 5 occasions.

April

Proposed Schedule 7 requirements given premature exposure to members of the accounting profession and the business community.

Press reports concern on the part of the accounting profession and sections of the business community over Schedule 7 proposals.

June Further written and formal submissions received by the NCSC over Schedule 78 proposals.

August Ministerial Council accepts proposed revisions to Schedule 7 and passes document to the Commonwealth Attorney's General Department (CAG) for drafting.

1985

May AARF issues proposed RPT standard to selected parties.

December CAG issues exposure draft on Schedule 7 disclosure requirements. Requires submissions to be lodged by the end of February 1986.

1986

February ASA and ICAA argue that consideration of RPT disclosure requirements should be left to an accounting standard approved by the ASRB.

Second Schedule 7 working party commences analysis of submissions received on CAG exposure draft. Tied vote on RPT disclosure requirements. Eventual recommendations to delete RPT requirements made by

May

Administration and Legislative Policy Committee (ALPC) to the Ministerial Council.

AARF issues ED 33 "Related Party Disclosures" for public comment.

Members of Ministerial Council critical of drafting of Schedule 7 requirements and request members of the second Schedule 7 working party, the NCSC and the ASRB to examine the possibility of introducing a corporate reporting code.

ASA, ICAA and AARF continue efforts to have Schedule 7 requirements incorporated into accounting standards.

Australian Shareholders' Association write to chairman of the Ministerial Council expressing concern about the delay in the finalisation of Schedule 7 and rumors that it may be scrapped in favour of an accounting standard.

June

Ministerial Council Chairman responds to the Australian Shareholders' Association and confirms that Schedule 7 requirements cannot be totally repealed.

July

Ministerial Council agrees in principle for the progressive transfer of Schedule 7 to approved accounting standards.

October/November

Australian Shareholders' Association becomes aware of ASRB consideration of RPT requirements and seeks to obtain a copy of proposed approved accounting standard.

ASRB approves RPT accounting standard (ASRB 1017). Ministerial Council has 60 days to exercise veto power.

Australian Shareholders' Association seeks opportunity to present views to the Ministerial Council on ASRB 1017 prior to vote (ie exercise of veto power).

Australian Shareholders' Association submits comment on ASRB 1017 to NCSC for circulation to members of the Ministerial Council.

December

NCSC recommends that the Ministerial Council approve ASRB 1017. Submission from the Australian Shareholders' Association not distributed to members of the Ministerial Council.

Australian Shareholders' Association becomes aware that its comments have not been forwarded to members of the Ministerial Council. Late December sees distribution of Australian Shareholders' Association submission to the Ministerial Council but veto not exercised by members of the Council.

ASRB 1017 becomes an approved accounting standard.

August

Ministerial Council Gazettes a revised Schedule 7 (minus RPT disclosure requirements) and announces that it will become operational in October.

1987

June

AARF releases a new RPT exposure draft (ED 41) as a result of submissions received on ED 33 and the inclusion of Schedule 7 disclosure requirements into accounting standards. AARF notes that ASRB may not re-expose proposed RPT approved accounting standard. Submissions to be lodged by 31 August 1987.

1988

June

ASA and ICAA issue accounting standard on RPTs (AAS 22). RPT standard to become operational June 1989. AARF forwards AAS 22 and submissions on ED 41 to the ASRB.

September

Ministerial Council agrees with a proposal from the accounting profession and the NCSC to absorb the professions AcSB into the ASRB. Enlarged ASRB to be supported by the AARF.

1989

July

ASA and ICAA announce that certain requirements of ASS 22 need not be complied with.