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The Liability Crisis in the US and Its Impact on Accounting

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The Liability Crisis: Audit Failures
<u>or Accounting Principles Failures</u>

The subject of my remarks here today concerns whether the liability crisis facing the public accounting profession in the United States of America is more related to audit failures or accounting principles failures.

For some ten to fifteen years, I have contended that until generally accepted accounting principles are unambiguously defined, auditors of financial statements cannot see clearly the target they intend to strike. So long as asset and liability recognition and measurement standards are fuzzy, auditors of financial statements do not always hit the ball and indeed sometimes strike out when at bat. We need to have clearly articulated standards that result in financial statement descriptions of assets and liabilities and amounts for those assets and liabilities that are clearly understood and, in addition, are relevant.

I think that the cost of the savings and loan bailout and the related litigation are in significant part due to ambiguity in accounting standards regarding revenue recognition on loans and loss recognition on loans. Better accounting could not have prevented the S&L catastrophe; the seeds for that catastrophe were sewn when thrifts were permitted to leave the staid business of long-term residential loans so they could compete with businesses offering uninsured investments with wider returns. One significant way thrifts found that they could compete was by using insured funds to loan builders and developers 100% of the acquisition price of risky assets by way of what has become to be known as acquisition, development, and construction, or "ADC," loans. But ambiguous revenue recognition accounting rules allowed revenue recognition on those loans to continue too far and too long. And ambiguity, or outright contradiction, in loan loss recognition rules postponed too long the recognition of losses on those ADC loans.

ADC loans became prevalent in the thrift industry in the early 1980s. At that time, the only pertinent words on or about revenue recognition in the literature, which did not constitute an accounting rule or even guidance, were contained in old Accounting Principles Board Statement 4, paragraphs 150 and 151, which said in part:

> "Revenue is generally recognized when the earnings process is complete or virtually complete.... Revenue from permitting others to use enterprise resources, such as interest...is recognized as time passes...at the amount expected to be received."

The guidance in the then-existing AICPA Savings and Loan Audit and Accounting Guide (page 33) regarding recognition of income on loans was consistent with the words in APB Statement 4. In fact, the words in the 1979 Guide almost assume that interest income is recognized on loans as per the loan contract and do not suggest much caution regarding revenue recognition.

Even though the drafters of APB Statement 4 and the 1979 Guide had never heard of or seen an ADC loan when those documents were written, the revenue recognition words in those documents were applied to ADC loans, and interest income was recognized on those loans based on the contractual terms of the loans. So was fee income. Fee income and interest income were recognized by the thrift holders of ADC loans, and the loan balances and accrued interest on those balances kept growing and growing even though in most cases no cash was ever received by the thrifts.

During that time, there was, of course, the general provision in the literature that loan losses should be recognized when it was probable such losses had occurred and could be estimated, which is from FASB Statement 5. Statement 5, issued in 1975, addresses when losses should be recognized, not how those losses are to be measured, a point to which I will return. Statement 5, was followed closely in time by Statement 15, which was issued in 1977. Statement 15 addresses troubled debt restructurings.

In paragraph 1 of Statement 15, the FASB said that Statement 15 does not address allowances for estimated uncollectible amounts and does not prescribe or proscribe particular methods for estimating amounts of uncollectible receivables. Statement 5 is in place and presumably Statement 5 governs when there is a loss, but, as I said, Statement 5 does not define how to measure any loss. But, after appearing to defer to Statement 5, Statement 15 then goes on to say that if the holder of a troubled receivable expects to collect the entire carrying amount of the receivable, whether through the medium of interest or principal collection, no loss is to be recognized no matter how long the collection might take. This means that economic losses may be retained in balance sheets and called assets so long as there is some expectation that some day the amount of the loan will be collected. As a result, we have Statement 5 saying to recognize a loss when it is "probable" that a loss has occurred, we have Statement 15 saying not to recognize a loss if the carrying amount of the loan ultimately may be collected, and we have no guidance, in any event, on how to measure such a loss. Talk about confusion. Talk about contradictory guidance. Talk about ambiguity. An entire generation of accountants was plunged into darkness by Statement 15. Those who prepared financial statements did not know whether to go forward, backward, or sideways. Whether to put their left foot first or their right foot first. Independent auditors similarly were confused.

The thrift industry was in stress, so it opted to recognize fee income and interest income on ADC loans and not to recognize any losses on those loans until the project assets were foreclosed, even though the fair values of the ADC projects were known to be less, often far less, than the ADC loan carrying amount and accrued interest. Independent auditors more or less agreed that the authoritative literature either required, or at least permitted, that accounting. Regulators who were trying to keep an entire industry afloat turned a blind eye to the accounting. Ultimately, equity investors were done in, and the American taxpayer is footing the bill through the bailout of the deposit insurance system, and accountants are paying millions to the government and others in legal judgments.

To my mind, the ADC loan case is the perfect case for saying that ambiguous accounting principles, not auditing failure, are to blame for the litigation and resultant auditor liability arising out of the S&L catastrophe.

Some may say that if issuers of financial statements and their independent auditors had put on their thinking caps and looked at the substance of the ADC arrangements rather than their form, then the ADC loan asset would have been accounted for as an investment in real estate rather than as a loan and all of the fee income and interest income would not have been recognized and the problem would not have gotten as serious as it finally did. Well, maybe so, but think about that for a minute.

If accounting for the substance of events, circumstances, arrangements, and transactions is indeed the overarching, guiding rule, then there is no need for any standards. Or any standard-setting body. Presumably all of us can see, clearly see, the substance of things, and will account for the substance of them, and everything will be fine. Not so. If we follow a substance-over-form rule, we will have anarchy in financial accounting and reporting. Substance over form itself is so ambiguous that if people are instructed to use that general rule instead of specific rules or standards, then financial statements will become highly individualized. I will prepare the financial statements for my company the way I perceive the substance of things. You will prepare yours your way. And soon the financial statements that are presented to investors will have little comparability or consistency or understandability or meaning.

By like token, some people say that financial statement preparation ought to be left, in large part, to the judgment of those who prepare and audit financial statements. That we should have broad, general financial accounting and reporting standards emanating from the FASB, with their implementation being left to the issuer of the financial statements and its auditor. That approach will not work either. A lot of people applied their judgment to accounting for ADC loans. That process produced a judgmental mess that is costing untold, uncounted billions. Before Accounting Research Bulletin 51 and FASB Statement 94 on consolidation were issued, issuers of financial statements consolidated the financial statements of whichever subsidiaries they wanted to. Before FASB Statements 8 and 52 on foreign currency translation were issued, issuers of financial statements did their foreign currency translation in a multitude of ways. Before FASB Statement 2 was issued, some issuers of financial statements capitalized R&D costs, some capitalized some R&D costs, and others capitalized none. Before FASB Statement 5 was issued, some issuers of financial statements charged to expense additions to catastrophe reserves and so-called self-insurance reserves and others did not. These examples prove that broad general rules left to the judgment of issuers and their auditors have not worked and will not work.

Currently, judgment is applied to the identification of impaired loans (the "probable" criterion in FASB Statement 5) and to the measurement of losses on impaired loans under Statement 5. We can see in current practice that the probable criterion has not worked. Identification of impaired loans under that criterion is all over the map, which produces wide noncomparability in financial statements. The General Accounting Office has found that the criterion does not work. Likewise, because Statement 5 does not address measurement of loan impairment, there is wide noncomparability on that score in financial statements as well. At least the FASB is working on the measurement aspects of loan impairment as we speak, but despite the warnings of GAO and others, the FASB is retaining the "probable" criterion.

In the area of impairment of cost of marketable debt and equity securities, FASB Statements 12 and 60 require that cost of marketable securities be written down when a decline in value of the security is "other than temporary." That literature does not define "other than temporary," so it is left up to the judgment of the issuer of the financial statements.

Judgment also is applied to the identification and measurement of impairment of the cost of long-lived assets such as land and plant and equipment and patents. The questions the accountant asks, are "will the carrying amount of the asset be recovered through operations, and if not, what is the short-fall?" The

Financial Executives Institute and the Institute of Management Accountants have performed or sponsored research work that has found wide variability in both the identification and the measurement of impairment of the cost, or recoverability of the cost of long-lived assets, resulting in wide noncomparability in financial accounting and reporting.

We can see, for example, that full-cost oil and gas companies must write down the cost of their oil and gas assets whenever the so-called ceiling limitation is exceeded by cost. Successful efforts oil and gas companies do not have such a constraint, and their capitalized costs sometimes exceed what would be allowed for a full-cost company. We also see that some companies, but not full-cost oil and gas companies, in identifying impairment of the cost of assets, and then measuring that impairment, assume that the state of the world that surrounds the assets will improve. That idled drilling rigs, for example, will go back to work drilling oil wells. This assumption, however, is not based on an assumption of a continuation of the current price of oil of say $19 a barrel, but an assumed increase to $25 or $30 a barrel. That a plant producing product at 45% of capacity will increase its production runs to 85% of capacity on the assumption that consumers will buy more of the product in the future despite their prior reluctance. That buildings currently having only 30% occupancy in two to three years will be 80% occupied, even though there is seven to ten years of vacant space to be absorbed. That's what we get when we allow judgment to enter into the accounting process in a major way; management puts on its rose-colored glasses and the auditor is unable to prove that his or her client is wrong.

Accountants and investors currently are seeing judgment being applied in another area, namely, the recognition of deferred tax assets. Under FASB Statement 109, the tax benefits of future tax deductible amounts such as bad debts, warranties, and postretirement benefits other than pensions, and operating loss carryforwards and tax credit carryforwards are recognized as assets. If it is "more likely than not" that a tax benefit, in whole or in part, will not be realized, a valuation allowance is recognized that reduces the amount of the related tax asset. I recently saw the 1992 balance sheet of a registrant where the deferred tax assets are more than 400% of shareholders' equity. The deferred tax asset related just to health care benefits of retirees for that corporation is more than 200% of shareholders' equity. We all know that those benefits will be paid many years in the future and will not represent a tax deduction until paid. In a sense, this company's balance sheet and fortunes are based on anticipated future taxable income, and the company has concluded that future taxable income in amounts sufficient to absorb tax deductions that arise in the future and those on hand today is "more likely than not." The auditor is hard put to second-guess that judgment.

Well, so what, you may say. Ambiguous accounting standards have little or nothing to do with auditor liability. I disagree. I think plaintiffs and their lawyers clearly see that anytime an issuer or an issuer's auditor is in the dock, that person is vulnerable. That person is vulnerable because he or she relies on such fuzzy notions as "probable" and "cost is recoverable through the ordinary operations of a going concern," realization of tax benefits is "more likely than not" and market value declines are "temporary." Those terms, and others of similar ambiguity, are red meat for the plaintiff's bar. After an issuer has failed and it is found that the historical cost of its fixed assets or patents cannot be recovered through a sale of those assets, the issuer's assertion that it thought it could recover its cost of those assets on a going-concern basis is indeed weak. When an issuer's receivables turn out to be no good in fact, but the receivables were thought not to be sour under a notion of "probability," the assertion that there was compliance with the literature is indeed weak. When marketable securities have to be sold at losses, which losses were thought to be temporary, reliance on the literature is indeed weak. When income tax benefits ultimately are not realized, using the literature as a crutch will be of little help.

I think it is in the best interest of investors to have financial statement descriptions and amounts of assets and liabilities that are relevant and that flow from simple and unambiguous accounting standards. For example, if financial statement amounts were required, in the case of assets, to be not in excess of market values, or fair values, and not less than settlement amounts in the case of liabilities, those amounts would be relevant to investors. Investors more readily would understand the financial statements. Investors would be able to evaluate and compare financial position and results of operations of companies A, B, and C with greater ease and with more certainty than is possible today. Likewise, it seems to me that, from the standpoint of auditors protecting themselves from the risks of litigation, they too should welcome simple and unambiguous accounting standards that produce financial statements that can be easily understood by reasonable investors and by the courts. Simple and straight-forward standards may be the only way to end costly legal debates over the reasonableness of judgment calls made, often times, many years in the past in a world of conflicting pressures and rapidly changing circumstances.

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