Susan Schmidt Bies: Challenges facing the accounting profession today

Remarks by Ms Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System, to the Cincinnati Chapter of the Ohio Society of Certified Public Accountants, Cincinnati, Ohio, 28 September 2004.

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Introduction

Good evening. Thank you for the invitation to speak to you during your annual CPA Recognition Night. Those of you who are new to the profession no doubt realize, just as your more experienced colleagues do, that you are entering into this noble area of service during a dynamic and crucial time in its existence. You are entering the profession just as new rules, greater responsibility and increased scrutiny are being imposed on accountants and auditors alike in response to the discovery of accounting and auditing improprieties in the recent past. In addition, as the world of commerce and business continues to change, it is vital that the accounting profession responds to meet the challenges of auditing new innovations.

This evening, I will share some of my views on the challenges that the profession faces today, particularly with regard to accounting and auditing in service industries and model-based accounting.

Accounting in a service based economy

I think it is fair to say that nearly all of us, including those of you who are new to the profession, first learned about accounting from the “old economy” perspective of retail and manufacturing. Our accounting text books gave us examples and exercises that pertained to the XYZ Corporation that sold widgets. In this context, we learned that assets and liabilities were valued on a historical cost basis and that the earnings cycle was completed when sales occurred. Indeed, we learned the fundamental concept that revenue was recognized only when it was earned.

Today, our economy is becoming more and more service-based. Unlike in manufacturing and retail trade, where the sale marks the end of the earnings process, in most services the sale of the service marks the beginning of the earnings process. In the case of services, once the sale has closed, revenues are earned over the ensuing period in which such services are rendered. If earnings are recorded at the time of the sale, that is at the beginning of the service process or before risks are transferred, the financial statements may not be reflecting the earnings process. You may recall that the practice of recognizing revenue “up front” was used by some high-tech firms a few years ago, sometimes in inappropriate circumstances. The Securities and Exchange Commission issued guidance at that time to clarify that revenue should be deferred until it is earned.

One major industry affected by these concepts is the financial services industry. While a small amount of revenue is received for transactions, most is generated by sales that lead to future revenue streams, such as that when a checking account is opened. In the context of the financial services industry, the accounting practice used today is sometimes called the “mixed attribute” approach. This means that some assets and liabilities continue to be recorded on a historical cost basis, while others are reported at fair value or at lower-of-cost-or-market (LOCOM). In some instances in the mixed attribute approach, changes in fair value are reported in earnings, while in other cases they are excluded from earnings but affect the equity portion of the balance sheet. For example, assets that are included in the trading account are carried at fair value and changes in fair value are reported in earnings during the period. However, securities that are intended to be held until maturity are reported at amortized cost with no change in fair value recognized in earnings unless permanent impairment has occurred. Loans that are held-for-sale are separately reported on the balance sheet and recorded at LOCOM, while loans that a bank intends to hold for the long-term are reported at amortized cost.

The mixed attribute accounting model is effective for financial services because it reflects differences in the earnings process. Thus, when profits are generated through the trading account, earnings are driven by the activity of buying and selling securities. Traders make decisions about what to buy, and the market timing of the purchases and sales rest on comparisons of relative returns on the alternative securities. The success of a trading account as a business reflects management's ability to identify unusual valuations in the market and quickly act upon them. In this case, a fair value framework is

appropriate for accounting since it is similar to the information and decision process that management is using.

An example of a different business model is a floating rate loan that is made and held on the balance sheet with the intent to service the loan until it is paid off. Here, the floating rate means that changes in market interest rates will not affect the fair value of the loan. Rather, credit quality and the cost to service the loan are the two major drivers of profitability. Management's ability to underwrite the credit initially, manage changes in credit risk over the life of the loan, and limit losses of principal and interest and collection costs should a default occur, are key drivers of credit costs. In addition, the costs to receive and post payments and service the loan over its life are important drivers of the operating costs of making the loan.

In this case of loans made to be held in portfolio, amortized cost is appropriate accounting. The interest received over the life of the loan supports the operating costs to service the loan that are incurred while it is outstanding, as well as credit losses that occur, and the cost to acquire funding for the loan. To the user of financial statements, amortized yield, operating costs, funding costs, and credit quality each need to be visible to the user of financial statements, and be reflected in the period in which they are earned or incurred.

Fair value accounting and auditing

While historical cost accounting methods have well-developed auditing techniques, fair value accounting relies on key assumptions, modeling techniques and judgment. For example, modeling techniques are commonly used in valuing mortgage loan servicing assets. The present value of the estimated future net cash flows of servicing assets attempts to anticipate prepayments of mortgages due to changing interest rates, fees earned from late payments, cost to receive payments and remit funds to investors, costs to handle delinquent and charged-off loans and other factors. Changes in the assumptions used in the modeling approach for any instrument or product will change the resulting values. Further, the models used for financial statements look to what the market would expect these revenues and costs to be, rather than the firm's specific information. Since sales of servicing assets, especially for seasoned loans, is so irregular, it is often difficult to validate the model against actual values seen in the market.

Thus, auditing model-based accounting requires a high level of specialized knowledge. The auditor must fully understand how modeling or other sophisticated techniques are used to determine fair value, and whether the assumptions used in the models are appropriate, and that the data has integrity. Furthermore, “fair value” is not always clearly defined or easily determined for some products or instruments. Certainly, a non-complex instrument that is highly liquid with an observable market price is easier to value with more precision than a highly complex, illiquid instrument. Accountants are being asked to know more than just the proper classification of assets and liabilities, but also the appropriate way to value assets and liabilities.

Let me mention that the Federal Reserve supports a fair value-based measurement for assets and liabilities used in the business of short-term trading for profit, such as the trading account for banks. And we support enhanced disclosures of fair value-based information. However, we believe that the accounting industry should be very careful before moving toward a comprehensive fair value approach, where all assets and liabilities are recorded on the balance sheet at fair value and changes in fair value are recorded in earnings, whether or not realized.

In today's world, with the myriad of complex financial instruments that exist and are constantly being created, developing verifiable and auditable fair value estimates is a major concern. The lack of observable market prices, differences in modeling assumptions, expectations of future events and market conditions, as well as customer behavior make the task of assigning appropriate valuations very difficult. And because fair value models are forward looking, the auditor has an additional challenge of determining the line between normal variability in expectations that surrounds any forecast and earnings manipulation.

To its credit, the Financial Accounting Standards Board (FASB) has recently issued an exposure draft on fair value measurement. The proposal was developed to provide a framework for fair value measurement objectives, and it is just the initial phase of a long-term fair value project. The initial phase is generally intended to apply to financial and nonfinancial assets and liabilities that are currently subject to fair value measurement and disclosure. It is not intended to expand the use of fair value measurements in financial statements at the present time.

In our view, the proposal is a good first step in enhancing fair value measurement guidance, but we believe additional guidance is warranted. Reliability issues should be addressed more comprehensively in the proposal. Most important, the FASB should develop further guidance and conduct further research and testing to enhance the reliability of fair value measurements before the use of fair value is significantly expanded in the primary financial statements. Furthermore, we believe that the FASB should work with other organizations including the Public Company Accounting Oversight Board (PCAOB), American Institute of Certified Public Accountants (AICPA), and accounting firms to enable the development of robust guidance that ensures fair value estimates can be verified and audited.

Transparent disclosure

These concerns, among others, also raise the importance of disclosures in the financial statements that assist readers in understanding how the financial statements reflect the business strategy, risk management, and operating effectiveness of the enterprise. As organizations have grown in size and scope, innovative financing techniques have made it more difficult for outside investors to understand a particular firm's risk profile and the performance of its various lines of business.

Traditional accounting standards have not kept pace with the risk-management tools employed by sophisticated corporations. Thus, more meaningful disclosures of firms' risk-management positions and strategies are crucial for improving corporate transparency for market participants. The improvements in technology, the quick pace of financial innovation, and the evolving risk-management techniques enable businesses to use almost limitless configurations of products and services and sophisticated financial structures. Accordingly, outsiders will have ever more difficulty understanding the risk positions of many large, complex organizations. These developments represent significant challenges to standard setters and to accounting firms. For market discipline to be effective, accounting standards and disclosures must evolve to accurately capture these developments.

Challenges for auditors

Auditing firms are facing the growing challenge to build and pass along the knowledge possessed by their professionals who truly understand the audit and accounting issues around particular business lines. As companies broaden the range of products, services, and delivery channels they offer, clients require more specialized knowledge for each operation. As we are all aware, there are fewer large accounting firms competing in the marketplace today. I understand that many of the larger accounting firms are no longer accepting audit engagements of some smaller or medium-sized companies. This opens an opportunity for small to medium-sized auditing firms to become specialists - so-called “niche players.” In this way, smaller auditing firms can develop the expertise of their auditing staff around the accounting and business practices of the specialized industries or particular types of clients, as knowledge-sharing can be more successful when it is naturally more targeted.

Perhaps a broader question facing the auditing industry today is how to maintain and instill the appropriate professional judgment required of auditors as accounting theory moves towards a more principles-based approach. One impact that the Sarbanes-Oxley Act is having on preparers and auditors of financial statements is the quest for more “bright line” rules so they can more readily know when an interpretation comes close to the acceptable limit. But the changing business world, especially around financial instruments, is making it impossible to write an accounting rule for each potential nuance of innovation, and so we are turning to more principles-based accounting. Thus, sound judgment is becoming a more valuable talent to businesses and their auditors. As CPAs, one of your most important missions is to reinvigorate the profession to successfully address these conflicting goals.

Other challenges

Let me also mention an area that places increased responsibility on auditors. I mentioned earlier the PCAOB. The PCAOB was created through the Sarbanes-Oxley Act to oversee the auditors of public companies. The PCAOB has recently approved Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Conducted in Conjunction with an Audit of Financial Statements. The new standard highlights the benefits of strong internal controls over financial reporting and furthers the objectives of Sarbanes-Oxley. This standard requires external auditors of public companies to

evaluate the process that management uses to prepare the company's financial statements. External auditors must gather evidence regarding the design and operations effectiveness of the company's internal controls and determine whether the evidence supports management's assessment of the effectiveness of the company's internal controls. While the new standard allows external auditors to use the work of others, including work performed by internal auditors, it emphasizes that external auditors must perform enough of the testing themselves so that their own work provides the principal evidence for making a determination regarding the company's controls. Based on the work performed, the external auditor must render an opinion as to whether the company's internal control process is effective, which is a relatively high standard.

In addition, as part of its overall assessment of internal controls, the external auditor is expected to evaluate the effectiveness of the audit committee. If the audit committee is deemed to be ineffective, the external auditor is required to report that assessment to the company's board of directors.

This new standard will certainly put more demands on external auditors and public companies alike. But in the world of business and financial innovation and growing complexity of firms, these standards should encourage greater reliability of corporate financial statements and therefore, regain the confidence of the public and the trust of financial markets.

Conclusion

In conclusion, I hope my views will give you an opportunity to think about some of the challenges both accountants and auditors face in today's business environment. The accounting industry should be cautious and prudent as it debates the merits of fair value accounting. Accountants and auditors alike must be knowledgeable of the models and assumptions used in determining the fair value of products and services. A models-based approach to valuations must produce results that accountants, auditors, and market participants feel are objective. Standardsetters have the daunting task of balancing the need to provide accounting principles that keep pace with financial innovation with the need to promulgate standards that produce accurate, reliable and verifiable results.