The Primacy of "Present Fairly" in the Auditor's Report*

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ABSTRACT

In this paper, the author examines the historical evolution in the United States of the use of the term "present fairly" in the auditor's report, as well as the experience and arguments in the United States and Canada regarding the use of a "two-part" opinion in the report. He then develops an argument for the adoption of a "two-part" opinion, decoupling "present fairly" from conformity with generally accepted accounting principles, which would place primary emphasis on "present fairly".

Keywords Auditing standards; Auditor's report; Present fairly

LA PRÉSÉANCE DE LA FORMULE « DONNE UNE IMAGE FIDÈLE » DANS LE RAPPORT DU VÉRIFICATEUR

RÉSUMÉ

L'auteur examine l'évolution, au fil du temps, de l'usage de la formule « donne une image fidèle » (« *present fairly* ») dans le rapport du vérificateur aux États-Unis, ainsi que l'expérience du Canada et des États-Unis et les arguments qui y sont invoqués pour justifier l'expression d'une « opinion en deux parties » dans le rapport. Il élabore ensuite une argumentation légitimant l'adoption d'une telle opinion distinguant l'« image fidèle » de la conformité aux PCGR, ce qui donnerait préséance à l'« image fidèle ».

One of the hottest issues in accounting today is "principles versus rules", but it goes back a long way. I have in my files a letter in which the top partner in one of the major U.S. public accounting firms wrote me as follows:

> I suspect that the greatest single difficulty at the present time is that we have forgotten what the word "principle" means. Many of the accounting controversies today and in the recent past actually deal with rather detailed accounting treatments and methods.

The author of these words was Herman W. Bevis, the senior partner of Price Waterhouse and a former member of the Accounting Principles Board (APB). He wrote them to me in a letter dated May 5, 1967. Leading figures in the accounting profession later complained about *APB Opinion No. 15*, issued in 1969, on earnings per share being a "cookbook" of rules (see Zeff, 2003: 197). "Principles versus rules" is hardly a new issue in this country.

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What I wish to do in this paper is to draw on history to propose an important change in the opinion that the auditor gives on a company's financial statements. I wish to refocus the "principles versus rules" controversy from the role and performance of the standard-setter to the role and performance of the external auditor. My proposal is to decouple the two elements in the phrase "present fairly in conformity with generally accepted accounting principles", to "present fairly and were prepared in conformity with generally accepted accounting principles", thus obliging the external auditor to give two opinions, not just one. The first opinion, on a matter of principle, is whether the financial statements "present fairly". The second opinion, on a matter of conformity with the practices specified in accounting standards and other authoritative pronouncements, is conformity with generally accepted accounting principles (GAAP).

The focus of my paper is primarily the audit environment in North America.

I will first delve into some history and then indicate how the issue of giving a separate opinion on "present fairly" is a live one today. I will conclude with my argument.

A BIT OF HISTORY

Origin of "Present Fairly"

The origin in the United States of the term "present fairly" in the standard form of the auditor's report may be traced to the report of a special committee set up in 1932 by the American Institute of Accountants (AIA). After engaging in correspondence with the New York Stock Exchange (NYSE), the special committee recommended the "modern" form of the auditor's report, whose opinion paragraph included the wording "fairly present, in accordance with accepted principles of accounting" (AIA, 1934: 31). Walter A. Staub, the senior partner of Lybrand, Ross Bros. & Montgomery and one of the six signatories of the special committee's letter to the NYSE of December 21, 1933, in which it recommended the format of the auditor's report, wrote in 1942 that the committee meant that the auditor should give separate opinions on "fairly present" and "in accordance with accepted principles of accounting" (Staub, 1942: 75). Perhaps the comma between "fairly present" and "in accordance with accepted principles of accounting" was intended to signify a disengagement of the two elements into two separate opinions.

Note should be taken of the somewhat embarrassing origin of "fairly". The term "fairly … present" was an innovation put forward in January 1933 by Richard Whitney, the president of the New York Stock Exchange (AIA, 1934: 16). Five years later, Whitney pleaded guilty to two counts of grand larceny, was expelled from the NYSE, and was sentenced to a term of 5 to 10 years in Sing Sing prison.[1]

George O. May, the chair of the Institute's special committee, made it clear that "principles of accounting" was intended to mean norms of accepted usage, and not the rules, conventions, or methods that are applications of the principles (May, 1937: 423–4).[2] The

1. For Whitney's downfall, see "Richard Whitney," Wikipedia (http://en.wikipedia.org/wiki/Richard_Whitney) and Seligman (2003: 169).
2. For further discussion, see Storey (1964: 11) and AIA (1934: 4–14).

special committee believed the principles were few in number. The term "generally accepted accounting principles" was used for the first time in an Institute publication in 1936 (AIA, 1936: 1). The idea was that accounting principles had to secure acceptance by more than just a few companies — thus the term "generally". "Accepted" was preferred over "acceptable" as setting a more objective standard.[3] This was before the Institute authorized a committee to develop a body of accounting principles on a programmatic basis in order to guide judgements. Despite the intention to limit "accounting principles" to norms of accepted usage, in 1949 the authors of the leading auditing textbook said that "generally accepted accounting principles" had come to mean rules, conventions, and doctrines (Montgomery, Lenhart, and Jennings, 1949: 66).

By 1937, it was reported that the special committee's recommended format was being used in substance by the auditors of more than 95 percent of the corporations, other than railroads, listed on the New York Stock Exchange (The auditor's report, 1937: 246–7).

In 1939, the AIA's Committee on Auditing Procedure altered the wording of the opinion paragraph to: "present fairly … , in conformity with generally accepted accounting principles" (Committee on Auditing Procedure, 1939). Andrew Barr, who was on the accounting staff of the Securities and Exchange Commission (SEC) in 1939, subsequently said that he was "fairly certain that SEC staff urged including 'generally' to strengthen the [auditor's] certificate".[4] This wording has, but for a recent change to indicate the country of origin for GAAP (for example, U.S. GAAP or Canadian GAAP), remained essentially the same in all the years since then.[5] Again, the comma, mentioned above, appeared. The comma continued to appear in the same format recommended in *Statement on Auditing Standards* (*SAS*) *No. 2* (Auditing Standards Executive Committee [AudSEC], 1974: para. 7). The comma was removed in 1988, in *SAS No. 58* (Auditing Standards Board [ASB], 1988a: para. 8). After conferring with several of those who took part in the development of *SAS No. 58*, I have concluded, with some surprise, that there was no awareness that the deletion of the comma was a substantive issue.[6]

But this was not the end of the "comma affair". Four years later, in *SAS No. 69* (ASB, 1992), which superseded and reaffirmed *SAS No. 5* (AudSEC, 1975) (see below), the comma suddenly reappeared in the rendering of the standard form of the auditor's opinion

3. Letter from Samuel J. Broad to the author, dated January 3, 1966. Broad was chair of the AIA committee that drafted the 1936 report, *Examination of Financial Statements by Independent Public Accountants* (AIA, 1936).
4. Letter from Andrew Barr to the author, dated September 3, 1987. The term "generally accepted accounting principles" appeared for the first time in an SEC annual report in 1939 (SEC, 1940: 47–8, 118).
5. The decision to specify the country of origin was made in *SAS No. 93* (Auditing Standards Board [ASB], 2000: para. 3).
6. Carelessness about the comma was evident before then. In *The Independent Auditor's Reporting Standards in Three Nations* (Accountants International Study Group [AISG], 1969), a cooperative venture among the professional accounting bodies in the United States, the United Kingdom, and Canada, the comma was omitted from the standard form of the U.S. auditor's report given in paragraph 26. This AISG booklet was prepared by staff of the American Institute of Certified Public Accountants (AICPA).

(ASB, 1992: para. 1). Evidently, punctuation was not a strong suit at the Auditing Standards Board.

The comma finally disappeared from auditing statements in 2000, when *SAS No. 93* was issued (ASB, 2000: para. 3).

What practice do the Big 4 audit firms follow? In a casual sample of 75 annual reports for 2004 issued by U.S. companies, I found that Deloitte, Ernst & Young, and KPMG, with a few exceptions, insert the comma, while PricewaterhouseCoopers, also with a few exceptions, omits the comma. Evidently, there is a "comma crisis" in the profession!

"Present Fairly": The Upside

In 1952, Eric L. Kohler wrote in *A Dictionary for Accountants* that "present fairly" meant that the presentation of the financial statements "conforms to overall tests of truth, justness, equity, and candor" (1952: 177).

In 1961, R. K. Mautz and Hussein A. Sharaf, in their classic work *The Philosophy of Auditing* (1961: 169), wrote:

> [T]he determination of accounting propriety is ultimately a matter of audit judgment. Although the auditor borrows generally accepted accounting principles from the field of accounting, he does so with full recognition that he may have to reject their application in some cases. To the extent that they are satisfactory in bringing about a realistic portrayal of the facts of business activity and conditions he is grateful to them; to the extent that they fail, he must draw upon his knowledge of their goals and develop solutions which his experience and judgment tell him are constructively useful.

In 1969, Judge Henry J. Friendly of the U.S. Court of Appeals for the Second Circuit ruled in the *Continental Vending* case (*United States v. Simon*, 1969) that the auditor's judgement about what is called for by GAAP does not necessarily mean that the financial statements "present fairly". In effect, he regarded "present fairly" and "in conformity with GAAP" as separate opinions. His ruling is still valid law today (Mano, Mouritsen, and Pace, 2006: 60).[7]

In February 1975, John C. (Sandy) Burton, the SEC chief accountant, sided with those who believe that " 'fairly' adds something significant to the auditor's representation beyond attesting to conformity with generally accepted accounting principles" (1975: 28). He said that the SEC "for many years has taken the position that fairness connotes something beyond conformity with generally accepted accounting principles" (32).

In 1975, SEC commissioner Al Sommer made the point even more emphatically: "The increased concern with the fairness of financial statements poses an opportunity to move away from the rigidities of generally accepted accounting principles and other deterrents to meaningful financial disclosure" (1976: 23).

7. For a recent application of *United States v. Simon*, see the decision reported in the case of *United States of America v. Bernard J. Ebbers* in the Court of Appeals for the Second Circuit, dated July 28, 2006.

"Present Fairly": The Downside

"Present fairly" has had an uncertain career. In 1972, probably influenced by the *Continental Vending* decision, the Institute's Committee on Auditing Procedure recommended deletion of "fairly" from the auditor's report, but in the end it withdrew the recommendation.[8]

In 1974, Douglas Carmichael, the Institute's director of auditing standards, contended that a two-part opinion "might be as chaotic as using fairness alone. The state of confusion would be blatantly apparent in auditor's reports" (1974: 85). He concluded that "the essential meaning of the auditor's opinion that financial statements are fairly presented in conformity with GAAP is that the accounting principles a company uses are appropriate for the circumstances to which they are applied" (86).

In July 1975, the Auditing Standards Executive Committee issued *SAS No. 5*, also a reaction to *Continental Vending*, which said that the auditor should apply "fairness" within the framework of GAAP. "Without that framework", *SAS No. 5* went on, "the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and changes in financial position in financial statements" (AudSEC, 1975: para. 3). To the untutored reader, this advice seems to suggest that "present fairly" adds little, if anything, beyond conformity with GAAP. In February 1975, Sandy Burton pointed out that he was instructed by the SEC Commissioners to advise AudSEC, "We believe that it is apparent from court cases and other sources that 'present fairly' cannot be defined by simple references to generally accepted accounting principles" (Burton, 1975: 34). Hence, AudSEC instead referred to "the framework" of GAAP, which was not much different.

In 1978, the American Institute of Certified Public Accountants (AICPA) Commission on Auditors' Responsibilities recommended, with the full support of its founding chair, former SEC chair Manuel F. Cohen, that "present fairly" be deleted from the auditor's report because fairness "is not a property that can be objectively measured by the auditor" (Commission on Auditors' Responsibilities, 1978: 13, 14). Two years later, the Auditing Standards Board proposed the deletion of "fairly" from the auditor's report because "the word is subjective and is interpreted differently by different users of the auditor's report" (ASB, 1980: 6). Finally, after reading the letters of comment and reconsidering, the board decided not to delete "fairly" (Carmichael and Winters, 1982: 18). Carmichael was the research director of the Commission and was the AICPA's Vice-President, Auditing at the time of these deliberations on "fairly".

"Present Fairly" Versus "Not Misleading"

Since at least 1938, the SEC has held financial statements to the standard of being not "misleading", a term that would appeal more to lawyers than would "fair presentation". The term "misleading" is cited in the SEC's *Accounting Series Release No. 4* (SEC, 1938), in rule 4-01(a) of the SEC's *Regulation S-X*, and in rule 203 under the AICPA's *Code of Professional Ethics*, now known as the *Code of Professional Conduct*, which took effect

8. See Carmichael and Winters (1982: 14–5). For the Committee on Auditing Procedure's proposed format of the auditor's report, see Aranoff (1975: 31–2).

on March 1, 1973 (AICPA, 1972: 22). The latter obliges the auditor, in "unusual circumstances", to countenance a departure in the financial statements "from an accounting principle promulgated by bodies designated by Council to establish such principles" (such as the Financial Accounting Standards Board [FASB]) where the use of the principle would have caused the financial statements to be "misleading". Interestingly, the first draft of rule 203 referred to "fair presentation" instead of to "misleading" (Revised text, 1972: 9, 11). Sandy Burton said that rule 203 "seems to indicate that a fairness test should be applied, at least on a negative basis" (Burton, 1975: 34). And Judge Friendly, in the *Continental Vending* decision, seemed to use "fair presentation" and "not materially false and misleading" as rough equivalents.

It strikes me that "fair presentation" means that the financial statements meet a positive standard of informativeness. By contrast, "not misleading" connotes that readers have not been led astray. The object of financial reporting is to convey useful financial information, not merely to avoid a deception. R. J. Chambers once wrote that "if accounting is to be related to choices, it requires 'leading information,' not 'not misleading information' " (1982: 53). I agree with Chambers that "not misleading" is not a phrase equivalent in substance and connotation to "fair presentation".

Mautz and Sharaf (1961: 169, footnote omitted) have written:

> An approach sometimes followed is one that finds acceptable any [accounting] method that is "not misleading". Such a negative attitude should not be condoned and certainly does not satisfy the concept of accounting propriety. Surely the auditor should insist upon something more constructive than the mere absence of injury; unless a practice actually aids and furthers understanding, it should be held deficient.

SHOULD THE AUDITOR GIVE ONE OR TWO OPINIONS? THE RECORD SO FAR

As mentioned above, Walter Staub believed in 1942 that his special committee's recommended form of the auditor's report implied the giving of separate opinions on "fairly present" and "in accordance with accepted principles of accounting". Whether auditors in the 1930s believed that they were to give separate opinions is not known.

Arthur Andersen & Co. Adopts the Two-Part Opinion

In 1946, the upstart Chicago-based accounting firm of Arthur Andersen & Co., whose lead partners — Arthur Andersen himself and Leonard Spacek — believed that the firm should stand up for what it believed, decided that the firm could no longer countenance giving an opinion that clients' financial statements "present fairly" when they used accounting principles or applications thereof that were, in its judgement, not appropriate, even if they were "generally accepted".[9] The firm therefore decoupled its single opinion into two, on "present fairly" and on "in conformity with generally accepted accounting principles". To

9. This section on Arthur Andersen & Co.'s two-part opinion is based on Zeff (1992).

do so, it added three words (shown here in italics) in the opinion paragraph of its auditor's report: "present fairly *and were prepared* in conformity with generally accepted accounting principles". The firm continued to use the two-part opinion in its auditor's report until 1962.

The firm had two levels of concern about GAAP. First, some generally accepted practices were not appropriate in the circumstances or were not believed to be proper accounting. Examples at that time were full costing versus successful-efforts costing in oil and gas exploration and the propriety of deferred tax accounting when companies adopted full costing in their financial statements but successful-efforts costing for tax purposes. Today, one could cite last-in, first-out (LIFO) versus first-in, first-out (FIFO), the use of accelerated versus straight-line depreciation methods, whether the capital lease or operating lease method should be adopted for long-term, noncancelable leases — if bright lines do not appear in the standard, as with *International Accounting Standard* (*IAS*) *No. 17 Revised* (International Accounting Standards Committee [IASC], 1997) — whether the conversion of bonds into stock should be accounted for at historical cost or at the market value of the issued shares, whether the proper treatment of marketable securities should be as "available for sale" or "trading", and by what method the cash received from installment sales should be recognized as revenue. Andersen believed that it was the professional responsibility of an audit firm to assess the propriety of the manner in which clients applied accounting principles, and not just to accept any application that was generally accepted. It believed that some applications of GAAP did not "present fairly" in all circumstances.

It is interesting to speculate whether such an interpretation of the audit firm's responsibility, by overriding the unquestioning adherence to GAAP rules, would have prevented any of the accounting and auditing scandals we have witnessed in the last number of years.

Second, Andersen believed that some non-GAAP did "present fairly". The best illustration of this was the firm's advocacy of depreciation based on general price-level restatements or current valuations of fixed assets, especially for its public utility clients, because of the importance of calculating a fair rate of return. In the 1950s and 1960s, the firm used its auditor's report to comment favorably on the "fair presentation" of these departures from GAAP (see below).

What did the SEC think of Andersen's two-part opinion? As far as is known, none of the three chief accountants between 1946 and 1962 — William W. Werntz, Earle C. King, and Andrew Barr — objected to it. They did insist that GAAP be followed, but the firm's opinion on "present fairly" was its own decision.

In 1958, Carman G. Blough, a former SEC chief accountant who was then the AICPA's director of research, criticized Andersen's two-part opinion, arguing that "present fairly" should be judged within the framework of GAAP and should not be decided by each auditor "for himself" (1958a: 76). In this respect, Blough anticipated *SAS No. 5*, issued 18 years later. Another prominent accountant, Maurice E. Peloubet, a former president of both the New York State Society of Certified Public Accountants and the New Jersey Society of Certified Public Accountants, as well as a former member of the AIA's Committees on Auditing Procedure and Accounting Procedure, disagreed with Blough. He argued that, where there are choices within GAAP, it is incumbent on the auditor to decide whether the methods chosen by the client are appropriate in the circumstances. If not, the auditor

should qualify his opinion on fairness. Otherwise, Peloubet said, "why bother about 'present fairly'?" (1958: 73).

Arthur Andersen's 16-year experiment with the two-part opinion represented a pioneering attempt to communicate the firm's judgement on the propriety of the accounting norms used in its clients' financial statements, and thus to infuse more meaning into the auditor's report.

Why did Arthur Andersen revert to the single opinion in 1962? The reasons were several, but one was singled out by Leonard Spacek: "We could not get our clients to prepare statements according to our view and be out of step with other companies".[10]

By the second half of the 1970s, Arthur Andersen's position on "present fairly" had changed. It wrote, "'Fairness' in the presentation of financial data is a desirable objective, but the goal should be an *authoritative adoption* of 'fair' standards and principles on behalf of the profession [that is, by the standard-setter] and not the *personal definition* of 'fairness' by thousands of auditors" (Arthur Andersen & Co., 1977: 39).

Alexander Grant & Company Also Supports the Two-Part Opinion

Alexander Grant & Company, another major accounting firm based in Chicago, signified its support of the two-part opinion in its submission to the Accounting Objectives Study Group, known as the Trueblood Committee, in 1972.[11] Charles Werner, who testified at the Study Group's public hearing on behalf of the partners of the firm, said, "we believe that more is expected of us as professionals than simply compliance with a rulebook." He asked, "isn't the concept of fairness in presentation as clear to the professional accountant as honesty and decency are to the public?" (Werner, 1972: 1.59). There is no sign, however, that the firm actually used the two-part opinion in its audit engagements.

Canada Adopts the Two-Part Opinion

It was not only Arthur Andersen that broke the mold. From 1967 (some would say even earlier) to 1976, the Canadian Institute of Chartered Accountants (CICA) required the auditor to give two opinions, on "present fairly" and on conformity with GAAP.[12] It seems that there was no clear rationale behind the adoption of the two-part opinion. The decision to move to a single opinion in 1976 was, in part, because one major audit firm allowed a client to use an accounting practice, the discounting of deferred tax, without noting that it was a departure from GAAP. The practice had little support in Canada and caused a furor within the profession. Another reason for the change was that the regulatory authorities declared the *CICA Handbook* to be the authoritative source of GAAP. It was therefore decided that the *CICA Handbook*, not each auditor, should be the arbiter of GAAP. But the CICA's decision in 1976 to change to a single opinion said that "the auditor must exercise his professional judgment as to the appropriateness of the selection and application of

10. Letter from Leonard Spacek to the author, dated June 8, 1986.
11. The firm's suggested auditor's opinion was reproduced in Rosenfield and Lorensen (1974: 80).
12. See Zeff (1992: 444–7) and Eckel (1973).

[accounting] principles to the particular circumstances of an enterprise" (CICA, 1977: section 5400.13, "The Auditor's Standard Report"), which led one commentator to exclaim, "In effect, we still have a two-part opinion!" (Johnston, 1979: 53). In effect, the CICA had seemed to exempt only non-GAAP from the opinion on "fairness".

Contemporary Signs of Interest in the Primacy of "Present Fairly"

Sarbanes-Oxley Act (2002)

In the Sarbanes-Oxley Act of 2002, the term "fairly present" in connection with corporate financial reporting entered federal legislation for the first time, in reference to the certification by the chief executive officer (CEO) and the chief financial officer (CFO) of their company's annual and quarterly reports, including the financial statements. Section 302(a)(3) mandates that these corporate officers certify that "the financial statements, and other information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer". "Fairly present" stands as the lone criterion of propriety, without any reference to conformity with GAAP. Lynn Turner, who helped draft that provision, has said that he and the Senate Banking Committee's staff, who managed the drafting of the bill, wanted to preserve the spirit of the *Continental Vending* decision, which elevated "present fairly" to a position of primacy in the auditor's report. Especially in the light of recent accounting scandals, they believed strongly that preparers should not be allowed to hide behind GAAP (Turner, 2005).

If preparers should not be allowed to hide behind GAAP in this certification, should they be allowed to take refuge in GAAP when their auditors opine on whether their financial statements "present fairly"?

IAS No. 1 (2003)

IAS No. 1, "Presentation of Financial Statements", issued in 1997 by the International Accounting Standards Committee and revised in 2003 by the International Accounting Standards Board (IASB), expresses a preference to treat "fair presentation" as an overriding concept and not, as in the United States, as coextensive with GAAP. To be sure, the IASB counsels, "In virtually all circumstances, a fair presentation is achieved by compliance with applicable [IASB standards]" (IASB, 2003: paras. 13, 15, 17, 18). Above all, the purport of the revised standard is that "fair presentation" means adhering to the objective of financial statements and the definitions in its conceptual framework.

U.S. Comptroller General's Address (2004)

On August 10, 2004, at the American Accounting Association's annual meeting in Orlando, U.S. Comptroller General David M. Walker, a former partner in Arthur Andersen & Co., argued in a plenary address that auditors should give two opinions: one on "present fairly" and one on conformity with GAAP.[13]

13. The Government Accountability Office (GAO) kindly supplied the slides for Walker's address. The GAO, then the General Accounting Office, took a similar position for a short period in the early 1970s. See Rosenfield and Lorensen (1974: 80).

Public Company Accounting Oversight Board Meeting (2005)

The Public Company Accounting Oversight Board held a 25-minute discussion of the following question at the October 5, 2005 meeting of its Standing Advisory Group:

> B4. Would a requirement for the auditor to express separate opinions on whether the financial statements (1) present fairly and (2) are in conformity with GAAP improve the quality of audits or audit reports? If so, how? (Office of the Chief Auditor, 2005: 10)

Views were expressed on both sides during the meeting.

These recent developments suggest that the subject of this paper continues to be a live one in accounting and regulatory circles. It is now my intention to develop the argument.

SHOULD THE AUDITOR GIVE ONE OR TWO OPINIONS? THE ARGUMENT

A Possible Framework

Expectations rose for auditors in the 1960s and 1970s, and they have risen again since the beginning of the 1990s. Fair value accounting has become a riveting issue not only in standard-setting circles but also for SEC chair Richard C. Breeden, if only because of the failure of historical cost accounting to reveal massive unrealized losses in mortgage portfolios until after many savings and loans associations had entered bankruptcy. Breeden convened a conference entitled “Relevance in Financial Reporting: Moving Toward Market Value Accounting” on November 15, 1991, the first conference on accounting standards ever hosted by the SEC, a body that has, with few exceptions, always championed historical cost accounting.[14] During the 1990s, issues such as accounting for marketable securities and other financial instruments, employee stock options, and business combinations have sidelined historical cost accounting in favor of a wider use of fair values. Concerns have also been expressed at the SEC and elsewhere about the absence, in large measure, of intangibles from company balance sheets, which, for many companies, may be the bulk of their total asset values. On April 11–12, 1996, SEC commissioner Steven M. H. Wallman convened an SEC symposium on “Financial Accounting and Reporting of Intangible Assets”, which addressed the omission of many intangibles from company balance sheets. One sees good evidence, therefore, that the SEC has begun to question the propriety of long-standing GAAP.

There has been a growing belief that a company’s financial statements should reflect the economic substance of transactions, also characterized as economic reality. In a leading financial accounting textbook, Lawrence Revsine, Daniel Collins, and Bruce Johnson state that U.S. financial reports are “intended to reflect the underlying economic events and activities of the reporting entity” (2002: 943). Yet in the United States some believe that the “political” compromises made in the setting of accounting standards have led to a significant diminution of the meaningfulness of financial statements. In his last month as SEC chief accountant, in October 2005, Donald Nicolaisen, a former partner in Pricewater-

14. For a report on the conference, see Atchley (1991).

houseCoopers, said in an open meeting, "If I were to opine on a set of financial statements with my own views, there are few that I would find to be other than misleading" (Nicolaisen, 2005). He blamed this circumstance on compromised accounting standards. Is this where GAAP has brought us?

The financial press often cites "present fairly" as a benchmark that it believes is implied by the wording of the standard form of the auditor's report.[15]

In 1950, a partner in a Big 8 firm who was president of the New York State Society of Certified Public Accountants wrote that "[a]ccounts are 'fair' if they are impartial, equitable" (Cochrane, 1950: 458), but that characterization is an anachronism in this day and age. In 1977, a leading Canadian author wrote, "To 'present fairly in accordance with GAAP' is to apply GAAP intelligently, judiciously and appropriately to the fact situation covered by the financial statements" (Anderson, 1977: 485). That is also a period piece. Today, there is an overriding concern that the financial statements reflect economic reality or, otherwise put, the economic substance of the transactions. GAAP, detailed and compromised as it is, will not necessarily reflect this reality. In some major areas, such as accounting for leases and pensions, it is far from economic reality. Paul Miller and Paul Bahnson recently wrote, "We feel so strongly about FASB's erroneous premise that compliance with GAAP automatically yields useful financial reports that we're producing three more columns that show how today's GAAP is too compromised, flexible and outdated to produce what the capital markets need" (2005: 14).

My premise is that principles should supplant, or at least supplement, rules in the conduct of the audit, just as they are being proposed to govern the setting of accounting standards. It should not be enough that the auditor's opinion reflects little more than a ticking off of the company's accounting methods against the rules of GAAP, even as challenging as that assignment is today. To serve the readers of financial statements and make the opinion paragraph of the auditor's report meaningful and not just a boilerplate, the auditor should be expected to treat "present fairly" as a substantive issue, and not as a "rubber stamp" of GAAP. Toward this end, I think that shareholders and the market would be served by decoupling the auditor's opinion into whether the financial statements "present fairly" and whether they are in conformity with GAAP. I realize that myriad legal questions could well be raised about such a change, but that must be the subject of another paper, written by a legal specialist. I will content myself here with recommending that serious consideration be given to decoupling the auditor's opinion into two.

The SEC's *Regulation S-X* should not be an obstacle to a two-part opinion, because the current version of its rule 2-02(c), on the opinion to be expressed in the auditor's report, says, in a rather open-ended manner, that the report is to state clearly "the opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein" (PricewaterhouseCoopers, 2005: vol. 1).[16] Nothing is said about "present fairly" or conformity with GAAP.

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15. For example, see "Why Everybody's Jumping on the Accountants These Days" (1977) and Worthy (1984).
16. In previous versions, *Regulation S-X* referred to the auditor's "certificate".

Now, how would it work? There are three variations:

- a "fairness" opinion on a company's choice to depart from GAAP;
- a "fairness" opinion on a company's choice of one method from among two or more alternatively accepted methods in the application of GAAP, where the auditor assesses whether the company's choice is appropriate in the circumstances;
- a "fairness" opinion on the superiority of a non-GAAP accounting method over a GAAP method used by a company.

First Variation

We have had considerable experience in the United States with the first of these variations. Between the 1950s and the 1990s, three public utilities, a colliery, and a property development company integrated either general price-level (GPL) restatements or current valuations into their basic financial statements, which the AIA's Committee on Accounting Procedure had said should appear, if at all, in supplementary schedules (1953: ch. 9A, para. 17). Beginning in the middle 1950s and into the 1960s, the public utilities that so reported were Indiana Telephone Corporation, Iowa-Illinois Gas and Electric, and Sacramento Municipal Utility District (SMUD); the fourth company was Ayrshire Collieries. The motives of the public utilities were to raise their rate base and to reduce their reported net income (by means of the extra depreciation expense). For the three public utilities and the coal mining company, Arthur Andersen and a small audit firm (between 1954 and 1963 for Indiana Telephone, and Andersen afterward) managed to accommodate this adoption of non-GAAP measurement methods because they believed in their merit.

Iowa-Illinois, SMUD, and Ayrshire inserted into their traditional financial statements an additional depreciation charge based either on GPL restatements or on current valuations. The audit firms affirmed in their report that the financial statements "present fairly" in conformity with GAAP. They also said in their reports that income reflecting a depreciation charge based on GPL restatements or current valuations was "a fairer statement", "a fair statement", or "is more fairly presented", respectively, than GAAP income, based on the methodology adopted and disclosed by the company.[17] Arthur Andersen audited all three companies.

Indiana Telephone divided its financial statements into columns A and B. Column A displayed traditional historical cost figures, while column B showed the corresponding GPL restated figures. The auditor said that the figures in column A "present fairly" in conformity with GAAP. Carman Blough, in one of his monthly columns in the *Journal of Accountancy*, regarded Indiana Telephone's column B as being in line with what the Committee on Accounting Procedure had in mind as "supplementary", but he took exception to the small audit firm's opinion contained in the company's 1956 report that the figures in

17. For a discussion of Andersen's opinion on Ayrshire, see "Price-Level Depreciation in Annual Statements" (1959: 18). Also see Zeff (1992: 457–9).

column B "more fairly reflect the economic truth of the operation of the corporation" (1958b: 49–50). In subsequent years, up to 1963, the small audit firm said that Indiana Telephone's financial statement figures displayed in column B "were more fairly presented" or "more fairly present". From 1964 to 1976, when Arthur Andersen was Indiana Telephone's auditor, it continued to give the same opinion as the small audit firm on column B ("more fairly present").

These unusual opinions given by the audit firms were reproduced in *Accounting Research Study No. 6* issued by the AICPA in 1963 (Staff of the Accounting Research Division, 1963: appendix D). Indiana Telephone, Iowa-Illinois, and Ayrshire were subject to the SEC and therefore had to display the extra depreciation charge below the derivation of income, as a surplus appropriation, in their filings with the SEC.[18]

The property development company was The Rouse Company, which, between 1976 and 1994, presented a current-value balance sheet based on valuations supplied by an appraisal firm. The SEC accepted the current-value balance sheet in lieu of the supplementary disclosures mandated in *Accounting Series Release No. 190* (Palmon and Seidler, 1978: 781). Rouse's audit firm, Peat Marwick (succeeded by KPMG), said in its opinion in every year that the historical cost-based financial statements "present fairly" in conformity with GAAP, but that the current-value balance sheet was "presented fairly" in accordance with the methodology set forth in an explanatory note.

Not all auditors followed this path. In its 1979 annual report, Days Inns of America also presented a current-value balance sheet, based on an appraiser's valuation, but its audit firm, Price Waterhouse, went no further than to say that it provided "relevant information about assets and liabilities of the Company which is not provided by the historical cost financial statements". It declined to say that the current-value balance sheet "presents fairly". In its 1977 annual report, Iowa Beef Processors presented a full set of current-value financial statements in addition to its traditional financial statements. After saying that the current-value statements differed significantly from GAAP, Touche Ross, its audit firm, opined only that the current-value statements "are a reasonable and appropriate presentation of the information set forth therein on the basis indicated in Note 1".

Somehow, corporate financial reporting was not thrown into chaos because of these announced departures from GAAP measures, and three audit firms had the courage to give their opinion on the "fairness" of the information provided by the departures.

Second Variation

As will be seen, the second variation is not as much of a challenge as the third. Let us say that a company selling products on the installment plan were to use the installment method, not the cost-recovery method, of recognizing revenues. Suppose, too, that the audit firm believes that the cost-recovery method is appropriate and that (as many believe) the installment method is not. If the company were adamant in its adoption of the installment

18. For Indiana Telephone, see the letter from Pierre F. Goodrich (1959), the company's president.

method, which is allowed under GAAP, the auditor could well opt to say, if the difference were material, that the financial statements do not "present fairly" even though they are in conformity with GAAP. That would be a useful bit of information for shareholders and the market.

If a company engaged in oil and gas exploration were to use full costing, while the auditor believed, in line with the FASB in *Statement of Financial Accounting Standards* (*SFAS*) *No. 19* (1977), that successful-efforts costing is the appropriate method, the auditor should be obliged to say that the financial statements do not "present fairly" even though a GAAP method was used.

If a construction company were to use the percentage-of-completion method for recognizing revenues in circumstances where the auditor believes that the estimates of total cash eventually to be received and the total construction cost eventually to be incurred were not sufficiently foreseeable to justify the use of this method, the auditor would be obliged to state that, although the financial statements were prepared in conformity with GAAP (though some might contest that assertion), they do not "present fairly".

In other areas of GAAP where optional methods are admissible, the auditor should be expected to opine whether the company has made the appropriate selection so as to "present fairly". If *SFAS No. 13* (FASB, 1976) on leases were modified to be similar to *IAS No. 17 Revised* (IASC, 1997b), which I think is likely, thus removing the bright lines, the auditor would be under an obligation to determine whether, as a lessee, the company should treat long-term, noncancelable leases as operating leases or as capital leases. If the company were to adopt the treatment with which the auditor disagrees, the auditor should qualify "present fairly", even though the company's method falls within the options allowed under GAAP.

Therefore, the second variation would oblige the audit firm to qualify "present fairly" if it were to disagree with the company *in principle* over a GAAP method used, or if it were to disagree with the company on the use of a GAAP method in the light of the particular circumstances in which it is being used. Examples of such circumstances would be a significant difference of view between the auditor and the company over the estimates of key variables (for example, the discount rate, estimated future cash flows, or fair values).

I believe that these qualifications of "present fairly" would be important information to shareholders and the market, and I agree with Arthur Andersen of the 1940s that one of the hallmarks of professionalism is for an auditor to give an opinion on whether a company's financial statements "present fairly", and not hide behind GAAP, or allow the company to hide behind GAAP.

The second variation is somewhat analogous to the attempt by SEC chief accountant Sandy Burton, in *Accounting Series Release No. 177* (SEC, 1975), supplemented by the SEC's *Staff Accounting Bulletin No. 14* (SEC's Office of the Chief Accountant and Division of Corporation Finance, 1977), to oblige the auditor to comment on whether a company's change in accounting "principle", other than a change mandated by a new standard, is "preferable in the circumstances". Because the SEC release dealt with interim reports, it did not explicitly raise the issue of the auditor's opinion on the "fairness" of the financial

statements.[19] Revsine has written, however, that "the method that is chosen should 'present fairly' the financial condition of the firm" (1980: 80). In the context of this paper, the issue facing the auditor should be the appropriateness of a GAAP method, and the question should not arise only when the company changes from one method to another. If the method is, in the auditor's view, inappropriate and the difference is material, "fairness" is called into question.

The second variation also would reflect a strict application of *SAS No. 69* (ASB, 1992), which states that the auditor's opinion on "present fairly" in conformity with GAAP should be based on a judgement concerning five attributes, one of which is that "the accounting principles are appropriate in the circumstances" (ASB, 1992: para. 4(b)). This variation also implements the advice of Maurice Peloubet (1958) and Douglas Carmichael (1974), cited above.

Third Variation

The third variation presents the greatest challenge: whether the auditor believes that a non-GAAP method is superior to the GAAP method adopted by the company on a particular measurement or disclosure issue. This is somewhat the inverse of the first variation, where both the auditor and the company believe that the GAAP method is inferior to a non-GAAP method, and therefore unacceptable. Here, the auditor may believe that the use of historical cost accounting for certain assets or liabilities is inadequate to "present fairly" and that fair value accounting should be used instead, perhaps with the unrealized gains and losses to be taken directly into income. Or the auditor may believe that the omission of certain intangible assets from the balance sheet means that the financial statements do not "present fairly".

Other examples could be cited. Does the auditor regard the recording of non-GAAP accretion or fair value for growing stands of timber as the proper accounting method for a forest products company? Does the auditor believe that non-GAAP proportional consolidation, not the equity method of accounting, should be used to reflect joint ventures? Should the implicit discount on an issuance of convertible securities be recorded instead of the GAAP method of crediting the entire proceeds to the bonds payable account? The options to U.S. GAAP in all three of these circumstances are prescribed as GAAP in Canada or under International Financial Reporting Standards, or both.

Such a difference of opinion will truly test the relationship between the auditor and the company, but professionalism — doing what society expects of a professional — must govern the engagement.

19. "Preferability letters" are still required to be filed by the auditor with the SEC. Since 1971, under APB *Opinion No. 20* (1971: para. 17), the entity has been required to explain why a newly adopted accounting principle is preferable. The FASB's *SFAS No. 154* (2005: para. 17(a)) reaffirmed this requirement.

CONCLUSION

My argument is that the time has arrived, in the light of the heightened expectations for financial reporting, to give serious consideration to decoupling the auditor's opinion into two: whether the financial statements "present fairly", and whether they are in conformity with GAAP. I believe that this reform, which is hardly without precedent in North America, would provide shareholders and the market with useful information.

The question raised in the early 1970s, when *SAS No. 5* (AudSEC, 1975) was being drafted, was, what framework should the auditor use when making "fairness" judgements? The answer then was that the framework should be GAAP. Today, the framework that should be used is the FASB's conceptual framework for business entities, which was completed in 1984. The auditor should call on the conceptual framework to make such judgements.

A problem that I see as being an obstacle to acceptance of the argument in this paper is the absence of evidence that auditors, including the major audit firms, actually invest in *thinking in depth* about accounting principles and their applications and, indeed, about the conceptual framework. There was a time, before the 1980s, when partners in audit firms would give speeches in public forums, write articles, and even write books, in which they debated accounting principles and their applications. It was also a time when their firms issued booklets in which they took reasoned positions on accounting issues facing the Accounting Principles Board or the Financial Accounting Standards Board. They actively engaged in advocacy of their views. One does not see this behavior today and, with rare exceptions, it has not been in evidence for more than 20 years. I have written about the demise of this intellectual discourse and how its absence detracts from professionalism in our field (Zeff, 1986). Do partners and their firms even think about these issues any more? Do they have beliefs about what is "right" and "wrong" about accounting principles and their applications? There is little outward sign that they do. If accounting is to be regarded as a "profession", it would fall within a very shallow definition of the term. For this reason, putting questions of enhanced legal exposure aside, I am pessimistic that we will see a disposition on the part of audit firms to pronounce on "fairness" other than as being coextensive with rule-laden GAAP.

There is, however, a ray of hope. *SAS No. 90* (ASB, 1999), which amended paragraph 7 of *SAS No. 61* (ASB, 1988b), stated, "In each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles applied in its financial reporting. … The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements" (ASB, 1999: para. 11, footnote omitted). These three qualitative characteristics were drawn from the FASB's conceptual framework. This provision was reinforced by section 204 of the Sarbanes-Oxley Act (2002) and the SEC's rule adopted thereunder.[20] I am informed that these discussions between the auditor and the audit

20. See section II(F)(6)(G) of the SEC's adopting release (SEC, 2003) and paragraph 210.2-07, which is the rule itself.

committee are in reality "fairness" discussions and, under section 204, the auditor is required to inform the audit committee of the treatment that he or she prefers. When there are material, unresolved disagreements with management over the accounting principles and their applications adopted by the entity, the next step should, in my view, be a qualification of "present fairly" in the auditor's report.

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