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Fair Presentation: Another View

John C. Burton

FAIR PRESENTATION : ANOTHER VIEW*

by
John C. Burton
Chief Accountant
U.S. Securities and Exchange Commission
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[Introductory note: A graduate of Haverford College with a Master's degree and a Ph.D. from Columbia University, Dr. John C. Burton is also a Certified Public Account and has been Chief Accountant of the Securities and Exchange Commission since June of 1972.

Prior to joining the SEC, Dr. Burton was for ten years Professor of Accounting and Finance at Columbia University. During that time he also served as a director of several corporations and as a consultant to many business firms and financial institutions. He was, before joining the Columbia faculty, a member the accounting staff of Arthur Young & Company.

He is the author of *Accounting for Business Combinations* and the coauthor of *Auditing: A Conceptual Approach*. He is also a regular contributor of articles to numerous professional journals.

As Chief Accountant of the Securities and Exchange Commission, Burton is especially well qualified to speak on " Fair Presentation: An View." He traces the development and expansion of the term "present fairly conformity with general accepted accounting principles" and defines the accounting model within which fairness can be evaluated.

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For nearly forty years independent public accountants have been attesting that the financial statements of their clients are presented fairly and in conformity with generally accepted accounting principals. The meaning of this simple phrase has been subject to considerable and continuing debate and diverse interpretation both in accounting literature and in the courts.

The essence of this disagreement rests upon the question of whether the word "fairly" adds anything to the phrase. Like the traditional debate over how many angels can dance on the head of a pin, the solution to this problem rests on differing definitions and perceptions.

In an attempt to strengthen the authoritative literature on the subject the Auditing Standards Executive Committee of the American Institute of CPAs has recently developed a new Statement on the subject which attempts to articulate what the profession believes is meant by this phrase. The pendency of this Exposure Draft is perhaps a sound reason for reviewing both professional literature and judicial determinations in regard to this issue and for suggesting an additional personal viewpoint as to what the phrase does, in fact, mean today.

There is a significant body of thinking that suggests that the word "fairly" add nothing to the key phrase. Those who believe this seem to base their conclusion on one of three possible interpretations.

The first group suggests that an underlying concept of fairness is an integral part of generally accepted accounting principles; and, hence, generally accepted accounting principles include fairness by definition. Under this interpretation the phrase is redundant.

A second approach holds that fairness may be defined for this purpose as being conformity to generally accepted accounting principles, since financial statements must be recognized as being based on a set of adopted conventions which have nothing to do with abstract concepts. This argument suggests that there is no inherent "truth" in financial reporting and fairness can, therefore, be nothing but meeting defined norms. There can be no standards for fairness beyond generally accepted accounting principles, and without standards the term has no effective meaning.

In addition to those who believe that GAAP includes fairness and those who believe that fairness is conformity to GAAP, there is a third group that takes the historical perspective and argues that the phrase "fairly presents" was an historical accident written into the short form report without great consideration primarily to emphasize that financial statements were matters of estimation and judgment, not truth. They point out that "fairly presents" was an attempt to lessen, not increase, the auditor's responsibility from the previous "certification" that the accounts were "correct." As they review the genesis of the current auditor's report in the correspondence between the American Institute of Accountants and the New York Stock Exchange, they conclude that "fairness" was included to measure uncertainty, not to create a sense of innate justice. On the basis of this legislative history they suggest that fairness cannot have a constraining meaning.

It is certainly true that a view of historical auditors' reports prior to the standard now in common use indicated that auditors did, indeed, make reference to the correctness of the financial statements. Marwick, Mitchell & Company's report on the 1923 financial statements of General Electric Company, for example, stated in part:

> "We have examined the books and accounts of the General Electric Company for the year ended December 31, 1923 and hereby certify that the Condensed Profit and Loss account and Balance Sheet are in accordance with the books and, in our opinion, correctly record the results of the operations of the Company for the year and the condition of its affairs as at December 31, 1923." (1)

In these early days there was no uniformity among accountants' reports and the concept of fairness did appear in some. For example, a Price Waterhouse report for the year 1923 on the accounts of the American Locomotive Company contained the following opinion:

> "We certify that, in our opinion, the balance sheet is properly drawn up so as to show the financial condition of the American Locomotive Company at December 31, 1923 and the relative income account is a fair and correct statement of the net earnings for the fiscal year at that date." (2)

While such historical analysis provides some support to those who suggest that fairness was not originally intended to be a confining attribute, it is not clear that in the forty years since the standard opinion was adopted it has not come to have such a meaning. There are a substantial number of accountants who rest on the other side of the argument and suggest that "fairly" adds something significant to the auditor's representation beyond attesting to conformity with generally accepted accounting principles. Some suggest that fairness is a separate quality that must be explicitly covered in the report. This is the approach taken by the Canadian Institute of Chartered Accountants in its handbook where it establishes the auditor's responsibilities as follows:

> "The auditors should express an opinion, or report that they are unable to express an opinion, as to whether:
> (a) the financial statements present fairly the financial position of the enterprise, the results of its operations and, where applicable, the source and application of its funds, and
> (b) the financial statements were prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period." (3)

Others suggest that while fairness may be viewed from the viewpoint of a professional accountant, it does connote more than simple conformity. This approach was recently articulated by David James, a partner in Arthur Young & Co., in a speech in which he said:

> "'Fairly presented,' in my opinion, means just that. We say fairly presented in accordance with generally accepted accounting principles and that usually gives a fair answer. However, when a combination of generally accepted accounting principles does violence to the common sense of an experienced professional, it is common sense that somehow should be made to prevail." (4)

The test of common sense of a professional which is suggested in this quotation is the one applied by many who have complained about abuses of fairness.

Another group, who believes that "fairly" adds something to GAAP, suggests that fairness implies the selection of appropriate principles, not just acceptable ones, and disclosure requirements. This appears to be the approach of the Auditing Standards Executive Committee of the AICPA in its Exposure Draft. In this Draft they offer the following judgment:

> "The opinion that financial statements present fairly in conformity with generally accepted accounting principles requires judgment as to whether: (a) the principles selected and applied have been generally accepted, (b) the principles are appropriate in the circumstances, (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation, (d) the financial information is presented, classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed, and (e) the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and changes in financial position stated within a range of acceptable limits that are reasonable and practicable to attain in financial statements."

It is apparent that the courts and the SEC have both come down in their decisions on the side of fairness meaning more than the mechanical application of the rules. Various decisions have taken somewhat different approaches, and while some of the reasoning developed by the courts is difficult for accountants to agree with completely, the cases are part of the record, and it is therefore worthwhile analyzing them.

The best known court decision is that in the Continental Vending case, (5) although the decision is sometimes overstated by commentators. In this case the trial court charged the jury that the critical test to be considered was whether the financial statements as a whole "fairly presented the financial position of Continental as of September 30, 1962 and whether it accurately reported the operations for fiscal 1962." In reaching such a judgment the court charged the jury that proof of compliance with generally accepted standards was "evidence which may be very persuasive but not necessarily conclusive." In the case expert testimony was that the treatment of the item in the financial statements was in no way inconsistent with generally accepted accounting principles.

After a jury conviction the appeals court was asked to overturn this charge and declined to do so. The court said, "We think the judge was right in refusing to make expert testimony so nearly a complete defense," and they added: "We do not think the jury was required to accept the expert's evaluation whether a given fact was material to over-all fair presentation, at least not when the expert testimony was not based on specific rules or prohibitions to which they could point."

In looking at this case there are a number of key factors that should be pointed out about the decision. In the first place the court felt that it was appropriate for a lay jury to determine fairness in their judgment, at least in the absence of specific rules to the contrary. While this approach has been attacked as exposing professionals to the judgments of persons unqualified to appraise professional performance, it seems to me this overlooks the fact that in any jury trial the jury devotes a substantial amount of time to being educated in the accounting approach by counsel on both sides. Thus, this is not a casual appraisal of fairness but one based on education in a trial.

Second, the appeals court emphasized the concept of over-all fair presentation which suggests that the impression left by the financial statements taken as a whole was of great importance.

Finally, it should be pointed out that the court did not suggest that the presence of rules would necessarily overcome the fairness test, although they might under some actual circumstances. Judge Friendly indicated that where there were no rules, a defendant could not bring in experts to testify to the absence of such rules and thereby conclusively establish that the statements met the fairness test. He said that the jury was not required to accept the experts' evaluation whether a given fact was material to an over-all fair presentation, "at least not when the experts' testimony was not based on specific rules or prohibitions to which they could point." The decision implies that were there rules, a court might accept them, although the wording is ambiguous in this regard.

In the most recent criminal case against accountants in which two accountants employed by Peat, Marwick, Mitchell & Co. were convicted, Judge Tyler, in his charge, seemed to reiterate the principles set forth in the Continental Vending case. Judge Tyler charged the jury that:

> "The fact that a given defendant's conduct was in accord with (generally accepted auditing and accounting) standards and principles does not necessarily or automatically constitute a complete defense to this charge.
>
> "The weight and credibility to be extended by you to such proof must depend among other things on how authoritative you find the precedents and teachings relied upon by the parties or the extent to which they contemplate or deal with the circumstances found in the documents and evidence here and on the weight you give to expert opinion evidence offered by various witnesses." (6)

Judge Tyler then went on to say:

> "Perhaps the critical issue in this case therefore can be summarized as follows: Were the quoted earnings figures and footnotes set forth in count 2 fairly set out; that is to say, did they fairly present the revenue and earnings picture for NSMC for the fiscal year 1968 and the first nine months unaudited of fiscal 1969." (7)

This charge appears consistent with that of the principles set forth in the Continental Vending case while at the same time indicating even more specifically that standards were not an absolute defense. A recent civil case, *Herzfeld v. Laventhol, Krekstein, Horwath and Horwath*, has also resulted in some judicial attention to the concept of fairness. Judge MacMahon in his opinion offered the following observations:

> "Much has been said by the parties about generally accepted accounting principles and the proper way for an accountant to report real estate transactions. We think this misses the point. Our inquiry is properly focused not on whether Laventhol's report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly

> presents the true financial position of Firestone, as of November 30, 1969, to the untutored eye of an ordinary investor.
>
> "The policy underlying the securities law of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company. In those cases where application of generally accepted accounting principles fulfills the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately." (8)

This opinion offers a number of additional tests in regard to fairness, some of which are wise and some of which are troubling. In the first place the judge believes that the financial statements must meet the test of portraying "the actual financial condition of the company. Second, he suggests that the report must present the true financial position "to the untutored eye of an ordinary investor."

And, finally, he suggests that the report must "lay bare all the facts needed by investors to interpret the financial statements accurately." These are significant tests which create some problems and certainly extend the obligation of accountants.

In the first place the requirement for portraying the "actual financial position" suggests that there is some "financial reality" against which a statement can be tested. This presents some practical problems, since "financial position" is not an absolute which has been precisely defined or is readily apparent. The test suggested, therefore, requires some agreement on a framework for presentation of financial position.

In addition 'the judge applies the test of "the untutored eye of an ordinary investor" while at the same time suggesting that the statements "lay bare all the facts needed by investors to interpret the financial statements accurately. " Some suggest that these are fundamentally conflicting requirements. At a minimum the tests certainly suggest a dual approach since the combination of "all the facts" and the interpretive role implied by the second test may not be completely consistent with "the untutored eye of an ordinary investor." These are some of the problems which the Commission has attempted to solve by the development of its concept of differential disclosure which suggests more detailed analytical disclosure for some and better summarization for the "ordinary investor."

Finally, this opinion appears to place upon the preparer and auditor of financial statements an interpretive role previously assigned to the user since in order to understand what facts must be laid bare so that investors can interpret the statements accurately, it will be necessary for the preparer to place himself in the user's position and perform some analysis. This is not an unreasonable test, although it cannot be said that accountants have always regarded such analysis as part of their role. With the increasing emphasis on user needs it is certainly appropriate to expect preparers and auditors of statements to take this approach.

In addition to these court decisions the Securities and Exchange Commission for many years has taken the position that fairness connotes something beyond conformity with generally accepted accounting principles. The Commission's first statement in this regard came in the Associated Gas and Electric Company case in 1942 where the Commission said:

> "We think, moreover, that too much attention to the question whether the financial statements formally complied with principles, practices and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements performed the function of enlightenment, which is their only reason for existence. Each of the accountants' certificates in question contained the opinion that, subject to various qualifications therein, the financial statements fairly presented the

> financial condition of the registrant, in accordance with generally accepted accounting principles. If that basic representation was not accurate as to the financial statements as a whole, no weight of precedent or practice with respect to the minutiae of the statements could justify the accountants' certificates." (9)

This opinion emphasizes the idea of financial statements as a vehicle for communication and the view that financial statements must be taken as a whole, although it does not specifically indicate that the audience for the statements or the accountant's report is the average investor.

This emphasis was reiterated in the Commission staff s report on the Penn Central case where the emphasis on the over-all impression left by the financial statements was once again stressed:

> "In addition to the analysis of various individual transactions, the over-all impression left by the financial statements is part of the responsibility of the public accountants. Statements cannot simply be the accumulation of data relating to individual transactions viewed in isolation." (10)

In sending this report to the Congress, Chairman William Casey added a covering letter which dealt with other factors. While this letter was not a formal Commission statement, it was approved by the Commission. He said, in part:

> "The whole pattern of income management which emerges here is made up of some practices which, standing alone, could perhaps be justified as supported by generally accepted accounting practices, and other practices which could be so supported with great difficulty, if at all. But certainly the aggregate of these practices produced highly misleading results . . . . It is essential that the end result of applying accounting principles be a realistic reflection of the true situation of the company on which a report is prepared. Here, there was no adequate presentation of the fundamental reality that reported income was not of a character to make a contribution to the pressing debt maturities or liquidity needs of Penn Central, nor was it of the sort that might reasonably be expected to be evidence of continuing earning power." (11)

In this letter Casey raised a number of additional issues such as the existence of a pattern of income management which for the first time suggested a motivation to mislead. In addition he applied a test of "a realistic reflection of the true situation of the company" raising the same issues as suggested in judicial decisions above. He also suggested that failure to make disclosure of the liquidity contribution made by income was a deficiency. This comment emphasizes the need for clear disclosure when income bears no relationship to cash but does not appear to suggest that income should be measured on a cash basis. Finally, he added for the first time explicitly the idea that financial statements had some implication in regard to investor forecasts. The Chairman's statement that there was no adequate presentation of the fundamental reality that reported income was not of the sort that might reasonably be expected to be evidence of continuing earning power was the key phrase in this respect.

Most recently, the Commission's views on fairness were expressed to the accounting profession in responding to an exposure draft on the subject of reports on audited financial statements. This draft proposed to add a sentence that would define fairness in terms of conformity with GAAP. The Commission's response indicated that the Commission was "deeply troubled" by this sentence and recommended its deletion. The Commission authorized the Chief Accountant to submit the following comments on this sentence:

> "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. We are concerned by the impression the sentence gives that AudSEC is determined to deal summarily with the problem. We believe that issues such as the objectives of financial statements and the function of independent auditors have an important bearing on the

> meaning of "present fairly" when used by auditors in relation to financial statements. This phrase is the focus of rising public expectations. We recognize that AudSEC cannot deal with all of these issues in a Statement on Auditing Standards, and it seems important that they avoid the appearance of having closed their minds on these issues."

In response to this comment the Auditing Standards Executive Committee removed the sentence from the final draft on auditors' reports and began the process of developing the separate statement recently exposed for comment.

In looking at these various cases and statements it appears that four general conclusions can be drawn. First, fairness seems to be related in some fashion to "truth" which has some meaning beyond generally accepted accounting principles. Second, the courts seem to view generally accepted accounting principles as a set of defined rules and conventions, and they believe that following these rules does not give complete absolution from the possibility of either civil or criminal liability. Third, the overall impression left by the financial statements must be considered in appraising fairness, and finally, the courts at least seem to view fairness as something that can be interpreted by the layman as well as the sophisticate.

The authoritative literature of accounting also speaks to the subject of fairness. Accounting Principles Board Statement No. 4 indicated that fair presentation was "the subjective benchmark against which independent accountants judge the propriety of the financial accounting information communicated" and set forth four conditions necessary to conclude that a fairness test had been met. These conditions were, first, that the generally accepted accounting principles applicable in the circumstances have been applied; second, that changes in accounting principles from period to period have been adequately disclosed; third, that the information in underlying records has been properly reflected in conformity with generally accepted accounting principles; and finally, that the statements represent an appropriate balance between the need for disclosure on the one hand and for summarization on the other.

In addition Rule 203 of the Code of Ethics of the AICPA seems to indicate that a fairness test should be applied, at least on a negative basis. In the official interpretation of the specific rule the Committee on Ethics indicates that "the proper accounting treatment is that which will render financial statements not misleading. " (12) This, at a minimum, indicates that there is a test beyond conformity with generally accepted accounting principles articulated by professional bodies that must be met in the preparation of financial statements. While auditors' opinions making use of the exception spelled out in Rule 203 have been rare, they do exist. In such cases the general practice has been to give an unqualified opinion paragraph where a statement is made in the middle paragraph of the auditor's report that to follow authoritative pronouncements under the circumstances would result in misleading financial statements.

Since this survey of cases and literature indicates that a variety of views of fairness currently exist, it does not seem inappropriate for another personal view to be expressed as part of the discussion which may lead to an accepted definition.

In the first place it seems apparent to me that fairness means more than following a set of specific rules, standards, and guidelines. Accounting cannot be viewed as a mechanistic process and remain either professional or communicative.

Second, fairness cannot be evaluated in terms of an absolute standard without a frame of reference. It seems to me, therefore, that when one speaks of fairness in a financial statement context, one must be referring to fairness within the framework of "the accounting model," not in absolute terms. Financial statements are inherently a vehicle for communication, and if effective communication is to take place, there must be a joint frame of reference on the part of the communicator and the communicatee.

Someone starting without any background might well conclude that economic activities should be measured in a totally different way than has been generally developed and agreed upon. For example, it would be reasonable enough to believe that all assets should be reported on the basis of current values or that the net worth of a firm should be determined by the market value of its shares. A good case could also be made for measuring income on the basis of the change in expectations for the future as innovations are made. It could logically be said that income is generated from technological innovation, not from the subsequent sale of goods resulting from that innovation. If one looks at much of the literature of economic theory on the measurement of income, for example, one finds measurements suggested which are totally different from those which an accountant would view as acceptable. Economic models are not constrained by the needs for practical recordkeeping devices, objectivity, and other factors which affect the selection of an accounting approach. The accounting model has grown up in practice over a period of many years based on what might be called common business sense and a series of practical decisions made over time. It may lack measurement purity, but in general it has the benefit of being understood.

There have been many attempts to define "the accounting model," and it is unlikely that any specific articulation will win universal approval. Nevertheless, since it is a significant element in the determination of fairness, it seems desirable to attempt to present a simplified statement of my view of the accounting model today.

Five parameters provide a reasonable definition of this model. First, business results are presented in a set of articulated financial statements of which the income statement has primacy. Second, income is measured by an averaging approach (called matching) which is designed to show the long-run average net cash inflow at the current level of activity. Third, the current level of activity is measured by recognizing revenue on the basis of work done and the legitimization of the value of that work by an arms' length transaction with an outside party. Fourth, asset valuations are generally based on historical monetary costs incurred in arms' length transactions. Increases in value are recognized only when a transaction occurs, while decreases are recognized when there is a reduction in the value of assets for the purposes for which they are held. Finally, business substance rather than legal form must predominate in the analysis of transactions and the determination of the accounting to be followed for them.

This basic model is not static and may change over time based on a changing concensus of business realities, upon a Financial Accounting Standards Board study of the conceptual framework for financial reporting, or even upon devine revelation, if that is different from an FASB study.

Within the framework of this accounting model, fairness seems to me to have three essential elements when applied to the financial reporting process. First, the financial statements taken as a whole must present business results in a fashion such that users who have a general familiarity with the accounting model will be able to understand what happened to the reporting entity in a business sense. A detailed knowledge of accounting should not be required of users to achieve this result, even though general familiarity with the model is necessary. The user should not be required to be familiar with Judge MacMahon's "esoteric accounting norms comprehensible only to the initiate." The basic impression given by the financial statements should coincide with the business reality; in other words, the message must be readily receivable.

In meeting this first test subjective determinations as to the appropriateness of accounting principles followed in the circumstances are inevitably required. It is not appropriate for the company accountant or the independent auditor to deny the need for such subjective determinations. The independent accountant is a measurer by profession, and he should be best able to appraise the desirability of alternative methods in communicating a factual situation to a user of financial statements.

The statement by the Auditing Standards Executive Committee in an exposure draft that "the auditor cannot appraise the choice among alternative established accounting principles" in the absence of promulgated criteria for selection seems to me to be an abdication of the fundamental responsibilities of a professional. Procedures for making such determinations within a public accounting firm are a fundamental part of the firm's responsibility. To admit that there is subjectivity in the process is not to say that every individual partner and staff man should make up his own mind as to what is the best measurement in each circumstance, but rather that there should be a procedure within a firm to compare business facts with the accounting model and decide how these facts can best be communicated. We have observed a number of recent cases where firms have taken positions as firms on particular current problems, and in my judgment this has resulted in improved reporting.

A second essential element which seems to me to be a necessary part of fairness is that the financial statements presented do not lead users to a forecast or other conclusions which preparers and auditors know to be unlikely or incorrect. This is a negative criterion. It does not say that financial statements must lead to the correct forecast or conclusions, but rather that they should not lead to a forecast or conclusions which are known to be incorrect. It is recognized that forecasting is a precarious business and that users of financial statements cannot be assumed to be uniformly perceptive. Nevertheless, if the financial statements do not meet this test, it seems to me that they fail in their ultimate objective. The Trueblood Report emphasizes the user and the predictive orientation of financial statements, and I believe that this cannot be ignored. While statements are not forecasts, they may not mislead as to the future in terms of the current knowledge of the preparer and auditor and still meet the test of fairness.

What are the practical implications of this criterion? It seems to me to require a more analytical approach to an income statement. It may also lead to more situations where an auditor may have to conclude that following authoritative principles will be misleading. It is fairly easy to cite extreme examples but much more difficult to deal with marginal cases.

For example, if substantially all sales made during a year were made under a contract subsequently cancelled, it seems apparent that the face of the income statement must show this fact. Similarly, if a major portion of profits arise from the liquidation of a low cost LIFO inventory, this must be shown separately in the financial statements. Where there are material gains or losses on unusual transactions, these should be separately reflected.

More difficult questions might arise under conditions where a very substantial year-end sales campaign pushes out a large quantity of goods through the use of unusual selling terms. Here it is likely that this test of fairness would require full disclosure of this fact where it appeared that the effect of this approach was simply to borrow normal sales from a subsequent year and place them in the current year. On the other hand a sales effort alone which led to higher sales would not seem to require the same type of disclosure. It may be difficult to determine which is which. Subjective judgments must be made.

The final criterion for fairness is that disclosure is sufficient to enable the sophisticated user to understand the basis for recording transactions. Any deviations from normal accounting procedures should be set forth and justified. Accounting Principles Board Statement No. 4 provides that "adequate disclosure relates particularly to the objectives of relevance, neutrality, completeness, and understandability. Information should be presented in a way that facilitates understanding." This seems to sum up disclosure obligations rather well.

If an independent public accountant is not satisfied that financial statements meet these tests of fairness, he should not give an unqualified opinion on them.

This approach to fairness seems to have a number of different implications. In the first place it means that professionals who have the responsibility for preparing and auditing financial statements must put themselves in the position of users. Accountants cannot view their role as talking primarily to other accountants. They must be aware of how users work with financial information. At the same time this definition places an obligation on users of financial statements to develop their understanding of the strengths and weaknesses of the basic accounting model so that they can receive accounting communications more effectively. I think it is fair to say that one of the consistent complaints I hear from financial executives and accountants is that analysts are generally not adequately trained to receive accounting communications effectively, and this is an area where substantial additional effort needs to be placed by the financial analysts' profession.

It is important that management, accountants, and analysts all study the possibility of making improvements in the communication process. We do not have good information on how data can be made more understandable. Considerable research into the needs of users and the factors that determine the value of enterprises is needed as well as some study of behavioral and psychological theory to consider the ways in which communication can be improved.

This definition of fairness also should encourage the development of criteria wherever possible for the selection of measurement principles to be used. It is not reasonable to think that every circumstance can be contemplated, and accordingly subjectivity will inevitably remain.

The need for subjective judgments in determining fairness seems to me also to emphasize the importance of an independent and unbiased measurer. This may require a rearticulation of the role of the independent public accountant in public financial reporting. Traditionally the auditor has attested to management's financial statements. This has implied that management should make the basic reporting decisions, and the auditor's role was to attest to the fact that the statements fell within acceptable limits. As the subjectivity inherent in fair presentation is recognized, it may be considered inappropriate to put the primary responsibility on management for making financial reporting decisions. At a minimum it would seem that the independent accountant should take on a joint responsibility with management for fair presentation so as to avoid the suspicion that management may have some bias in reporting on its own activities.

Joint responsibility would imply that management and independent accountants would have to agree on the various subjective judgments involved in determining what constitutes the best communication of business results to the investing public. If agreement could not be reached, both parties would have the obligation to report differences in view.

It is plausible to suggest that an independent accountant's function should move even further to the point where he would have the responsibility of a public financial reporter, although it seems unlikely that this approach is likely to be adopted in the near future. This would have the effect of pushing independence one step back from attestation to reporting. The analogy to the role of a newspaper reporter may be apt. Management would have the responsibility for maintaining basic financial records and controls, and for continuing consultations with independent accountants about the progress of the business, while the accountants would have the responsibility of determining how business results should be reported and what disclosures should be made.

There is evidence today that the accounting profession is recognizing the demands for greater fairness in financial reporting and the need to examine their changing role. The Statement of the Auditing Standards Executive Committee on the subject of fairness is a significant step forward. Similarly, the appointment of the Audit Commission under former SEC Chairman Manuel Cohen to explore auditor expectations is a positive step. The President of the American Institute of CPAs, Wallace Olson, in a recent speech (13) suggested that the role of the auditor might increasingly contemplate interpretation of financial results as well as simple attestation to their conformity with generally accepted accounting principles. All of these are encouraging signs. If the profession is prepared to recognize its responsibilities and to expand them, its contribution to investor confidence and knowledge and, hence, to the capital markets of the future will be substantial. The opportunity is present and the Commission stands ready to lend its enthusiastic support.

(1) Report quoted in Carmichael, D.R., *The Auditor's Reporting Obligation*, AICPA, 1972, p. 14.

(2) *Ibid*., p. 13.

(3) CICA Handbook, Section 5500.08

(4) James, David, "Professional Responsibility of Accountants," an unpublished speech delivered at SEC Regional Enforcement Conference, Los Angeles, California, February 14, 1975.

(5) *United States v. Simon*, F. 2d, CCH Fed. Sec. L. Rep. ¶92,511 (2nd Cir. 1969).

(6) *United States v. Anthony M. Natelli and Joseph Scansaroli*, 74 Cr. 43, Charge of the Court, Transcript p. 2366.

(7) *Ibid*., p. 2369.

(8) *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (1974).

(9) In the Matter of Associated Gas and Electric Company, 11 SEC 1058, August 4, 1942.

(10) "The Financial Collapse of the Penn Central Company," Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, U.S. Gov't. Printing Office, 1972, p. 77.

(11) *Ibid*., p. x.

(12) *AlCPA Professional Standards, Ethics, Bylaws,* Section 203.

(13) Olson, Wallace, - A Look at the Responsibility Gap," *Journal of Accountancy*, January 1975.

SELECTED QUESTIONS AND ANSWERS

Mr. Burton:
If anyone has any questions about fair presentation, or presumably about anything else, I would be only too pleased to answer them.

I went to an FEI luncheon meeting the other day and before my talk I said, "Last year I went to an FEI luncheon, and I explained what was going to be done in a year, and I asked if there were questions. There were no questions, and I took that as a vote of confidence, and we went ahead and did it." Then I said, "I'm looking forward to the question period at the end of this talk." At the end of that talk there were seventeen hands up in the air ready to respond.

Question:
In the last part of your suggestion for fairness you said that the accountant should take more part in the preparation of financial statements. Doesn't that seem to be in obvious conflict with the need for independence?

Mr. Burton:
No I don't think so, just as I don't think a reporter has an independence problem when he is analyzing data and presenting it. There may be some cases where you can argue that a reporter is biased. But I don't think the problem would be any greater than it is in terms of independence as it exists today. I don't see it as a major problem because it seems to me management would have the responsibility for maintaining the records and maintaining good systems of internal control, that is, for presenting the raw data which is going to be used to describe results. Instead of having management describe results using the principles they choose, with the auditor coming in and attesting, it's arguable, it seems to me, that you would get better reporting if an independent person made the selection of the principles rather than merely attesting. Now I think that if the concept of fairness develops sufficiently, in effect, you will have a joint activity anyway. I think as a practical matter you have a joint activity today. But I would not be troubled in this regard, although there are certainly a number of people who will be troubled by

that difficulty. But perhaps as we look to the future it may be that, given the fact there are subjective determinations to be made, it is important to have these subjective determinations made independently rather than simply to have them reviewed. I think you might get better reporting. It's at least arguable.

Question:
Many accounting firms have done violence to your suggestion that they submit statements that present fairly, and many of these firms have found themselves guilty of criminal offenses, and more often they have found themselves guilty of civil offenses. Now among the duties of the SEC is discipline, and yet I'm always disturbed when a poor schnook from the Midwest who commits an infraction has the book thrown at him while these large firms are merely slapped on the wrist. My question is: why?

Mr. Burton:
Well, there are differences in perception. There are some large firms that at least claim they are going around with their wrist hanging down uselessly. In the first place there is a difference between a small one-man firm or two-man firm and a major national firm. There is a difference between a firm where one or two partners are found to be defective and a firm where there are 800 partners involved, and there is a question whether you should assign the sins of one partner to all for purposes of deciding whether or not they are fit to practice before the Commission. Now we have in the last two and a half years attempted, in a number of cases dealing with large firms, to assure that the firms develop improved standards of control internally. While we don't view ourselves as being totally successful in this regard, this has been one of the intentions of our sanction. As a practical matter, it would be very difficult in terms of equity to justify putting a major public accounting firm out of business, for example. We have tried to work on sanctions which will help them to improve their practice and will be remedial rather than strictly punitive, but I think the firms involved feel it's more a left to the chops than a pat on the wrist. I admit that it may not be perceived the same way by all, and one is always trying to appraise the relative impact. I think it's fair to say that in addition to what the SEC has done, the plantiffs' bar has imposed some very substantial costs on defective professional work. It can be argued, and I guess I would say in some cases it has gotten a little beyond what I think represents a sound burden for the accountant to bear. But nevertheless that certainly has had a very substantial impact on public accounting firms. So I don't think the major public accounting firm is getting away scot free today for defective practice where the small firm is being strung up. I don't think it's a sound analysis of the facts as they exist.

Question:
I'm not unmindful of your burdens and the Commission's burdens, but yet, fair is fair. When we look, for example, at the slap on the wrist given to Arthur Andersen in connection with Whittaker, we find that they immediately came out with a statement saying, "We don't admit any kind of guilt here really in the consent decree, and we want to get the madmen off our backs." You read that long statement in their Executive News Briefs. We are also familiar with the Accounting Series Release of the firm out in Wichita that fouled its nest in connection with the audit of brokers' statements. We here in New York know of a prestigious firm that was rather less than optimally involved in the audits of, for example, Francis 1. DuPont, Dempsey Tegler, Orvis Brothers, Hayden Stone, and I suppose a few others could come to mind, and yet we don't even see them mentioned in litigation. Yes, they made a token concession to the New York Stock Exchange, and again I'm not unmindful of what you said, but what's happening is that you can find individual guilt but yet corporate innocence, and this does violence to those of us who sometimes empathize with the poor schnooks.

Mr. Burton:
Well I emphathize with the poor schnooks. There are some accountants who view themselves in that category today, but I guess that all that can be said is that in cases where broker-dealers have problems or in cases where registrants have problems, the Division of Enforcement of the Commission looks with care at the role of the accountant in those problems. I think you must look at the order of magnitude, if you will, of the deficient performance of auditors in applying the standards of their profession, rather than the amount of money people may have lost in a case. I think an examination of these cases would

indicate in the Wichita case, the person so appeared to lack the most rudimentary knowledge of the standards of the profession that it was of a different order of magnitude in terms of professional deficiency than some of the others. Now in many of the other cases you mentioned, the SEC investigated the audit work performed, and I think it's fair to say, in many cases it was less than we would have hoped. The question that has to be tested is whether or not the audit work was so substantially professionally deficient that we should bring an enforcement action and a related proceeding in regard to ability to practice before the Commission. And in some of those cases at least, we concluded that it was not and this was not a decision taken lightly. It was a decision based upon a careful review of the evidence and the working papers of the auditing firm, the evidence gathered in some cases in outside suits, and a look at what it was that the Commission was trying to achieve with its enforcement actions and its enforcement procedures. And I think it is fair to say, just as in fair presentation, any area that requires subjective appraisal is subject to legitimate disagreement, and I think these are probably areas that are. However, I do think that it is fair to say that the accounting profession in the last few years has not felt unscathed in terms of Commission actions in regard to both large and small firms.

Question:
I appreciate your position that subjective judgments could perhaps be made by the independent auditors. What effect do you think this would have on the independence of the independent auditor when he comes back the subsequent year and finds out that his subjective judgment may not have been too accurate?

Mr. Burton:
Well, I guess I don't think it would be much different than it is now when he comes back and finds that the financial statements are such that he might not certify them or report on them again the same way as he did. I don't personally see a big problem in regard to independence here because it's a question as to where independence is applied. When you audit, you do associate yourself with those financial statements, and it seems to me independence-wise you're as much associated with them as if you prepared them. I don't think there is a big difference because in terms of liability you're in bed with the company, once things go badly. There are all sorts of problems that exist. And I don't think having the auditor as a reporter would accentuate those problems to any substantial degree. I might be wrong. I'm sure there are those who disagree with me; in fact, I know there are those who disagree with me. But I personally feel that if the independence is applied one step back in the process, at the point of selecting the measurement principles and approach by professional measurers whose public responsibility is to measure properly within the framework of the accounting model, then I think you would get better reporting, and that, in the final analysis, is what we're looking for. So in many cases you give up a little independence to get better reporting. Now of course you can go to the extreme and say you might get more accurate books if the auditors kept them. You could go down this line, and the question is where you're going to draw a line. I guess I believe that data collection, data processing, and internal control systems are part of management's responsibility. It is possible to say that, at that point, the auditor has a responsibility to audit as an outsider the adequacy of the systems and then to take the output of the systems and decide how the results should be reported to the public. I'm not saying this is something that the Commission is on its way to adopting in the next few months; it really isn't. But I guess what I am saying is that I think conceptually it is arguable that such an approach would give rise to better reporting.

Question:
You suggested that auditors be more user-oriented and also that they get more involved in interpretation. What, in your opinion, is the implication for accounting education in this?

Mr. Burton:
I think there are significant implications for accounting education. It seems to me that accounting education has to look at the uses of financial statements. While it has done this to some extent, I think this would have to be accentuated. It may be, for example, that the accountant of the future will require

training in security analysis and financial statement analysis. He will be required to look at the investment decision-making models that people are using and see where financial statements fit into them. I think today most good accounting students have some exposure to this. The student who has 62 hours of accounting and nothing else is not likely to be the good accountant of the future. And I think that in looking at curricula, it probably implies a greater dose of finance and particularly a greater dose of security analysis so that the student could put himself in the position of the investor more reasonably.

Question:
Speaking of Chairman Casey's letter of transmittal with the Penn Central report, you suggested the possibility of an invasion into the field of forecasting. Was that really so? Or was he really trying to say that any kind of extraordinary transaction should be so reported that its likelihood of repetition in the future should be made known?

Mr. Burton:
Well, I guess what he said was that the income statement as presented did not reflect the continuing earning power of the business. I think he wasn't saying that there should never be an unusual item. He was saying that as you look at that income statement, it appeared as though the company was doing well, and it was not apparent that they were recording as income the receipt of an undivided 50 percent interest in a station which previously was held by a subsidiary that was 50 percent owned by the parent company. It implied that there was earning power when there wasn't earning power. It wasn't a continuing earning power. I think what Casey said was not that the statements have to forecast, per se, but rather that they have to be helpful in the framework of trying to understand the past so that you can make some reasonable projections of the future.

Question:
In connection with the earlier question about accounting education, don't you think that there are some implications for education of the analysts, who do not really understand thoroughly the basis on which accounting statements are prepared, so that when they read the technical language, the notes, and the report, they really understand what they are reading?

Mr. Burton:
I agree. Amen.

Question:
Didn't Mr. Casey imply in his comment on the Penn Central Income Statement that the reported income had no relation to cash flow -- that there was a tremendous disparity and that cash income must be taken into account?

Mr. Burton:
He did in his report, and I didn't in quoting him. I omitted those remarks regarding cash implications not because I did not think they had some significance but rather because I thought they weren't focused on fairness to the same extent. I think he spoke in terms such that some accountants were offended because they said: "Well, doesn't he know income isn't cash?" But he did not say that income should be cash. He said that there should be enough disclosure so a reader could tell that the income wasn't cash. That's really what he was saying In that transmittal letter, and I agree that that's an additional factor.

Question:
What are the possibilities of cutting down the number of principles which accountants and managements can choose from?

Mr. Burton:
Well, I agree that it is desirable to do this, and certainly the Commission has been working, as has the Financial Accounting Standards Board, to try to cut down the alternatives. There are strongly held views about certain alternatives, and it is difficult in some cases to decide among them. I believe that there is no really good reason why, for example, the company should be able to use LIFO, FIFO, and

average cost in accounting for inventories. No good reason, that is, except that to change that practice would have tax implications and would create such noise and concern that people are a little nervous about it. In the oil industry, you have the same sort of thing. There are lots of cases where I think the accounting profession must gradually move to change alternatives. However, suppose you think you have eliminated alternatives in a given area. There are still many different ways of viewing a transaction. So the question of what principle you select goes to how you view the transaction. In other words, if you view something as a purchase commitment, you don't book it; if you view it as a purchase, you do book it. Then you have to took at the facts and say, "How do you appraise which this is?" A large number of so-called accounting problems that cross my desk are problems of perception of the facts. If you grant the fact, the accounting follows. It's just that there is such an incredible conception of the facts in some cases. In other cases it's arguable. I had one friend who used to be a very rigorously logical arguer. I always had to stop him at the first step, because once I granted him that I loved my mother, I moved right down the line to some ridiculous conclusions, and I would have to say, "Well, let's define terms, Marty. What do you mean mother, and what do you mean love?" After I did that he usually got tired of the game after a certain length of time. In accounting there is no question that assets should be carried at cost-but what are assets? But problems aside I agree that fundamentally it is of great importance that the profession moves in the direction of limiting the areas where the same economic phenomena can be accounted for differently.

Question:
This is a three-part question. First, does the SEC in your office have the authority to promulgate auditing procedures and establish accounting principles? And if so, from whence does this authority flow? And third, has this authority ever been challenged?

Mr. Burton:
I think that the answer to all of your questions is yes. We have the authority under statutes, specifically the Securities Act of 1933 and the Securities Exchange Act of 1934, to prescribe accounting principles. The right to prescribe auditing standards is less clear, but the opinion of the counsel of the Commission is that we do have that right because the form and content of the auditor's report is part of our preview. And by directing the auditor to report certain things, in effect, we are in a position to define his auditing standards. Neither of these rights have in fact been tested. The only court test of the Commission's right was one procedural argument which a large accounting firm had with us as to whether or not we had followed the procedures set forth in the Administrative Procedures Act. And they sued us saying we hadn't, and we thought we had, but just so that we wouldn't argue, because we're nice people, we followed the Procedures Act in such a way that we were able to go ahead. But nevertheless there has never been a test of the Commission's right to set accounting principles or auditing standards. We have addressed ourselves to both in various circumstances, more frequently to accounting than to auditing. It is also well known that we have in a very substantial way concluded that it is better to allow the accounting profession and the private sector to deal with these principles and procedures, and we think this has worked well. We have worked cooperatively, and I think it is fair to say, because of our statutory powers we have been able to encourage the accounting profession to take steps that otherwise they might not have taken. And I think these are steps in the public interest. Again, there are a few who might disagree with that.

Question:
What would your reaction be if you saw in an accountant's report a reference to something you had prescribed which wasn't in accordance with generally-accepted accounting principles?

Mr. Burton:
Well, we have had such reports. And in some circumstances we have taken them. We had an argument a few years ago with Occidental Petroleum, for example, where there was such a report. We would look at this on an ad hoc basis. There would be some circumstances where I think we would feel it was inappropriate. I think if we concluded a particular proposed presentation was inappropriate, then of course it would be up to the auditor to conclude what he would do and to the registrant to conclude what

he would do, and I think after a sober reflection upon the alternatives, they might conclude that they could find some other way of venting their spleen. But we have taken it in some circumstances.

Question:
The direction you are moving in having the income statement disclose LIFO liquidations, year-end unusual sales, and unusual transactions is a total reversal of APB Opinion No. 30 which specifically limited the amount of extraordinary items. The FASB also came out recently, I think at your suggestion, that the one time gain on early liquidation of debt must also be shown as an extraordinary item. Is that a general move away from APB Opinion No. 30?

Mr. Burton:
No, I don't think what I'm suggesting is that there should be an extensive use of a special category called extraordinary items. I think what I'm suggesting is that an income statement should be more analytical in form so that it would show these items separately even if it didn't classify them as extraordinary, per se. The extraordinary item category, which was created by APB Opinion No. 9, was used by a number of companies in a fashion which could reasonably be said to constitute an abuse. There seemed to be a large number of losses that were extraordinary and far fewer credits that seemed to be extraordinary. Now some people say it's a tribute to American management-credits are expected whereas losses are almost unheard of. But nevertheless, I think we perceived an abuse which grew out of essentially a two-line income statement which shows income before extraordinary items and net income. And let's not forget that abomination called cumulative effect of accounting changes, which is also part of that income. But, nonetheless, as one looks at this, we had sort of a two-part classification system, and I don't think that's sufficient. I think we're really talking about a more analytical income statement. And in some cases, rather than in the face of the income statement, it's possible that a note will disclose some of it in a satisfactory fashion, even though it seems to me that we should not mend with a note a basic deficiency in the income statement. But to answer this specific question, I do not view the FASB exposure draft, which, it is true, was a result of consultation with us, as the breakdown of APB Opinion No. 30 within what might be called the two-part income statement. On the other hand, if you ask if it is an indication of our concern that an income statement on the whole be more analytical and break these things out, not necessarily in a caption called extraordinary items, but break them out-sure, we do believe that.

Question: But if you do have them broken out, then ordinary and extraordinary will be almost meaningless classifications because those that are listed are sort of extraordinary items.

Mr. Burton:
But not under APB Opinion No. 30. Someone said that if the chemist who owned the formula was eaten by a tiger in India, that would not be extraordinary because after all there are lots of tigers in India. APB Opinion No. 30 is a fairly tightly-written opinion designed to prevent an abuse. In my own view, as long as we have these separate captions, we have a problem of preventing abuse. An APB Opinion No. 30 dealt with this. My own view is that in the long run we would want not just two captions, but an analytical type of income statement.

Question:
Couldn't you in effect do that by just extending the supplementary P&L information?

Mr. Burton:
Well we could, and we have in some cases. We expanded disclosure of tax expense along just those lines. And we have increased from time to time the supplemental P&L information. I guess what I'm saying, however, is that some of these things are difficult to spell out in a rule, and it is better to adopt an approach which accountants know is being followed rather than a rule. For example, it would be hard to write a rule requiring disclosure if you have a lot of sales in the last two weeks of the year. Someone will say, "Well does that mean fifteen days?" Then you would have someone say, "What's a lot of sales? Is 10 percent a lot?" I've played this game with many people, particularly attorneys, who say, "Just tell

us what the rules are -- tell us what they mean. Once we know what they mean, by golly, we're great fellows, and we're going to do just what you want." And by the time you finish defining what you mean, you don't know what you mean. So rule writing is a terribly complicated business.

Question:
Since the creation of the FASB, are you personally satisfied with the rate of progress it has achieved?

Mr. Burton:
I believe I'm hard to please, but nevertheless I think that the FASB has moved at a reasonable rate. I think if one looks at the output of the Board in the course of about two years, it is substantial. I think the real test is in the year ahead where we're going to see what they do in terms of really major problems, with highly controversial solutions, whichever way they come out. In a year from now, if there isn't a final opinion on business combinations, and there isn't a final opinion on business segments, and there isn't a final opinion on leases, and there isn't a final opinion on contingencies, I won't feel very satisfied. But right now I think it is reasonable.