From: Stephen A. Zeff <sazeff@rice.edu>
Sent: Tuesday, June 6, 2023 10:10 PM
To: Vanich, Barbara <VanichB@pcaobus.org>
Subject: [EXT]: fair presentation

Dear Ms. Vanich,

In regard to the Board's proposal to clarify the meaning of "fair presentation," may I bring to your attention an article which I wrote in 1992, attached, which recounted the decision by Arthur Andersen & Co. between 1946 and 1962 to decouple the auditor's opinion on fair presentation into two opinions: one on fair presentation, and other on conformity with GAAP?

In another article which I published in 2007, "The Primacy of 'Present Fairly' in the Auditor's Report," also attached, the point is made that "fair presentation" and "not misleading" are not equivalent terms.

Kind regards,

Stephen Zeff

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Arthur Andersen & Co. and the two-part opinion in the auditor's report: 1946–1962*

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Abstract. This paper constitutes a historical study of the roots of the decision by Arthur Andersen & Co. in 1946 to adopt a two-part auditor's opinion for all of its engagements, and of its eventual decision in 1962 to return to the standard form of the auditor's report. The essence of the two-part opinion was to decouple the auditor's opinion on fairness of presentation from the opinion on conformity with generally accepted accounting principles. The paper also treats the factors that prompted the Canadian Institute of Chartered Accountants to adopt a two-part opinion, and the reasons why it opted to return to the single-opinion format in 1976.

Résumé. L'auteur retrace l'historique de la décision prise en 1946 par Arthur Andersen & Cie de présenter l'opinion du vérificateur en deux volets dans toutes ses missions, et de sa décision ultérieure, en 1962, de ramener le rapport du vérificateur à sa forme standard. Le choix de l'opinion en deux volets reposait sur l'intention de distinguer l'opinion du vérificateur quant à la fidélité avec laquelle est présentée l'information de l'opinion du vérificateur relative au respect des principes comptables généralement reconnus. L'auteur traite également des facteurs qui ont amené l'Institut Canadien des Comptables Agréés à adopter l'opinion en deux volets, et des raisons pour lesquelles il a choisi de rétablir l'opinion unique en 1976.

Introduction

Since 1939 in the United States, the standard form of the auditor's report has contained the phrasing, "present fairly... in conformity with generally accepted accounting principles...." In the last 25 years, the role of "present fairly" in relation to "in conformity with generally accepted accounting principles" in the auditor's report has been a controversial topic in North America (see Carmichael, 1974; Rosenfield and Lorensen, 1974; and Johnston, 1979). The Auditing Stan-

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dards Board of the American Institute of Certified Public Accountants (AICPA), seeking to implement a recommendation made by the Commission on Auditors' Responsibilities (1978, p. 14), proposed in 1980 that "fairly" be deleted altogether from the auditor's standard report because "the word is subjective and is interpreted differently by different users of the auditor's report" (AICPA, 1980, p. 6). The board's proposal provoked considerable debate and disagreement because it was not clear whether the deletion of "fairly" would contribute to, or lessen, the alleged confusion over the meaning of the auditor's report (see Carmichael and Winters, 1982, p. 18). In the end, the board's proposal was withdrawn.

In Canada, for a period in the 1960s and 1970s, the accounting profession supported a two-part opinion, in which separate opinions were to be given on "present fairly" and on "conformity with generally accepted accounting principles."

In addition, although it was not widely known, the accounting firm of Arthur Andersen & Co. used a two-part opinion in all of its engagements between 1946 and 1962.

It is the purpose of this article to suggest the reasons behind the firm's decision to adopt a dual-opinion format and, in the end, to return to the single-opinion format endorsed by the AICPA. In the first part of the paper, the Canadian experience with the two-part opinion will be reviewed because it may be instructive to compare the experience of a national accounting profession with that of a major accounting firm at odds with the leadership of its national accountancy body.

Canadian experience with the two-part opinion

In Canada, the auditing pronouncements of the Canadian Institute of Chartered Accountants (CICA) called for a two-part opinion between 1968 and 1976 (some would say from 1959 to 1976). The auditor was expected to express two opinions, one on whether the financial statements present fairly, the other on whether they were prepared in accordance with generally accepted accounting principles (GAAP) (see Eckel, 1973; and Johnston, 1979).

The CICA's Accounting and Auditing Research Committee, evidently more through inadvertence than design, created the impression in *Bulletin No. 25* (CICA, 1967) that it was recommending a two-part opinion. In fact, it appears that the committee had no such intention.[1] The purpose of *Bulletin No. 25* was to

1 Eckel (1973, p. 41), a close student of these developments, finds language in *Bulletin No. 25* that supports the concept of a two-part opinion, although the language used by the committee was less than explicit. Moreover, in a communication with the author, Gertrude Mulcahy, who was CICA research associate, then associate research director, and (from 1969 onward) research director during the 1970s, maintains that the two-part opinion was first introduced in *Bulletin No. 17*, issued in 1959, and was reiterated and clarified in *Bulletin No. 25*. Yet, in other communications with the author, R.M. Skinner, a member of the committee that drafted *Bulletin No. 17*, and G.K. Carr, the deputy chairman of the committee that drafted *Bulletin No. 25*, both affirm that there was no intention by their respective committees to call for a two-part opinion. (Letter, 1990, from Gertrude Mulcahy; letter, 1988, and telephone conversation (1990) with R.M. Skinner; letter 1990, from G.K. Carr.)

add a reference to the funds statement in the auditor's report. It also restated the auditor's obligations set forth in *Bulletin No. 17* (CICA, 1959). The principal object of the latter was to recommend the inclusion in the auditor's report of a reference to conformity with GAAP and consistency in their application. Another aim of *Bulletin No. 17* was to recommend the use of "present fairly" in the opinion paragraph of the auditor's report unless a different wording was required by statute. Prior thereto, the opinion to be given in the auditor's report was confined to whether (1) the financial statements "present fairly" the financial position and results of operations (for Ontario corporations) or (2) the financial statements "exhibit a true and correct view" (for corporations subject to the companies legislation of other jurisdictions). The purport of *Bulletin No. 17* was to favor the American-style opinion paragraph in the auditor's report.

Since *Bulletin No. 17* had introduced the auditor's obligation to comment on conformity with GAAP and consistency in addition to the previous obligation that the auditor give an opinion on "true and correct view" or "present fairly," the committee found it necessary to discuss how the *two* obligations were related to one another. Some drew the inference from the committee's discussion that two *opinions* were required. A similar discussion appeared in *Bulletin No. 25*. In 1967–1968, when the Accounting and Auditing Research Committee codified the previous bulletins and compiled the new *CICA Handbook*, the committee used language that was construed as constituting an *explicit requirement* for a two-part opinion (Sec. 2500.06) (see, e.g., Eckel, 1973, p. 41), even though the committee may not have had that intention.[2]

Since the CICA had switched to the American-style opinion paragraph, there was keen interest in Canada in the decision rendered in the Continental Vending case in 1969 by the U.S. Second Court of Appeals in which the court said that the "critical test" for determining the adequacy of financial statements was fair presentation. Compliance with GAAP, the court said, was persuasive but not necessarily conclusive. The case attracted comment in the Canadian accounting literature (see, e.g., Eckel 1973, p. 43; and Anderson, 1977, p. 484), and the Second Circuit's establishment of the primacy of fairness may have emboldened the CICA's leaders to support a two-part opinion in the auditor's report.

Indeed, in May 1972, the CICA research director wrote a letter on behalf

2 G.K. Carr, who served as 1967–1968 chairman of the Accounting and Auditing Research Committee, advises the author that the issue of a two-part opinion "did not come to the fore" in the committee's discussions. (Telephone conversation, 1991.) When the *CICA Handbook* was unveiled in December 1968, the research director reported that the committee had "made a number of wording changes in recommendations to eliminate ambiguities" (Mulcahy, 1968, p. 433), but the changes were not identified.

Eckel (1973, p. 42) has pointed out that the CICA's Accounting and Auditing Research Committee never actually added an "and" between "present fairly" and "in accordance with generally accepted accounting principles" to signify, unequivocally, the intention to call for two separate opinions. As will be seen below, when Arthur Andersen & Co. decided in the 1940s to express two opinions instead of one, the firm believed it was necessary to insert "and were prepared" between "present fairly" and "in conformity with generally accepted accounting principles."

of the Accounting and Auditing Research Committee to all CICA members to remind them of the dual obligation imposed by the requirement of a two-part opinion (see Eckel, 1973, p. 43). The CICA's letter of clarification had been provoked by concern over the 1971 annual report of Trizec Corporation, a Montreal-based real estate development company, in which the company boosted its reported net income by 60 percent by means of a decision to account for deferred income taxes on a discounted basis. The company's auditor, one of Canada's best-known firms, did not qualify its opinion on conformity with GAAP even though there was little, if any, support for this discounting practice in Canada. After some discussion, the Ontario Securities Commission eventually accepted a filing of the company's prospectus that incorporated the financial statements reflecting the disputed practice. Eventually, in connection with the issuance of Trizec's 1972 financial statements, the 1971 statements were restated to eliminate the discounting of deferred taxes, and two partners of the audit firm were censured by their professional institute (see Elliott, 1974).

One consequence of the Trizec affair was that questions began to be raised about the criteria that auditors should be expected to use when deciding whether a client's practices are in conformity with GAAP. Companies and securities legislation were silent on the point. Although CICA members were required to base their judgments on the *CICA Handbook*, the Trizec affair drew attention to the auditor's responsibility to determine the content of GAAP when there was a departure from the *Handbook* or, as in the case of Trizec, where the *Handbook* was silent.

In December 1972, the Canadian Provincial Securities Administrators declared in a national policy statement that GAAP, for purposes of yearly and half-yearly financial statements filed with them, would be defined by reference to the recommendations in the *CICA Handbook*. This action was, without doubt, precipitated by the embarrassment surrounding the questionable judgment used by the Trizec auditors in deciding what practices qualified as GAAP. The securities administrators preferred an objective source of authority rather than reliance on the judgments of individual auditors that could be based on largely undefined criteria. A similar provision was included in the 1975 Canada Business Corporations Act Regulations. Hence, the legal status accorded to the CICA's accounting recommendations as the arbiter of GAAP suggested to the CICA's Auditing Standards Committee that they should constitute the sole framework for judging fair presentation. The decision taken in 1976 by the CICA's committee to revert to a one-part opinion was, therefore, taken mainly to establish a generally understood framework for use by auditors when making this judgment (see Thomas, 1976, pp. 57–58).

Another more subtle factor may also have been influential in the committee's 1976 decision. In the 1950s and early 1960s, when accounting pronouncements were issued relatively infrequently and were concerned, in the main, with broader and less contentious questions, auditors may have found themselves in easier agreement with one another, and with their client companies, on matters of

judgment in the application of accounting principles. As the standard setters began to pronounce upon specific and controversial questions in the late 1960s and early 1970s, auditors were increasingly likely to find themselves disagreeing with their peers, and with their client companies, on such judgments. Companies wishing to avoid the adverse effects of disagreeable pronouncements on touchy subjects were likely to be questioning the wisdom of their auditors' judgment. The level of tension in such relationships must have been rising. By the mid-1970s, therefore, auditors themselves may have preferred to substitute the *CICA Handbook* for the broader exercise of professional judgment.

It is interesting to note that the CICA's Auditing Standards Committee, as part of its decision in 1976 to revert to the one-part opinion, included the suggestion that "the auditor must exercise his professional judgment as to the appropriateness of the selection and application of principles to the particular circumstances of an enterprise and as to the overall effect on the financial statements of separate decisions made in their preparation." This passage prompted one commentator to remark, "In effect, we still have a two-part opinion!" (Johnston, 1979, p. 53). Johnston's dictum may have been premature since the committee's suggestion was made as background discussion, but not as part of the formal recommendation. Eight years later, in 1984, the CICA's Auditing Standards Committee converted the "appropriateness test" from a suggestion to a formal recommendation (*CICA Handbook* para. 5400.13), to increase the emphasis on professional judgment in the audit function (see Jeffreys, 1984; and Gibbins, 1983).

Hence, although the dual (or two-part) opinion was mandatory in Canada for almost a decade, the auditor's standard report in the United States has, since the 1930s, joined fair presentation and conformity with GAAP in a single opinion.

Arthur Andersen & Co.: Rationale behind the decision in 1946

In 1934 in the United States there was "almost instant and widespread acceptance" (Staub, 1942, p. 76) of the standard form of the auditor's report (or certificate, as it was then called) recommended by the American Institute's Special Committee on Co-operation with Stock Exchanges and endorsed by the Committee on Stock List of the New York Stock Exchange and by the Committee on Stock Exchange Relations of the Controllers Institute of America. The opinion paragraph was as follows:

> In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 1933, and the results of its operations for the year (American Institute of Accountants, 1934, p. 47).

It was originally envisaged that "accepted principles of accounting" would be expressions of broad principles and would be few in number. The Special Committee suggested that a statement of such principles might be developed in consultation with "a small group of qualified persons, including corporate of-

ficials, lawyers and accountants" (AIA, 1934, pp. 13–14). Within the limits of these broad principles, corporations were to be free to choose accounting and reporting methods, and were expected to file a public statement of these methods with the New York Stock Exchange. In its report, the Special Committee proposed five broad principles, which were, together with a sixth, approved by the membership of the American Institute of Accountants (as the AICPA was then known). Yet neither the New York Stock Exchange nor the Securities and Exchange Commission (SEC) acted to require corporations to provide a publicly available list of the accounting and reporting methods they used. Storey writes: "The failure to adopt the limitations recommended by the special committee to accompany the freedom given management in the choice of accounting methods sowed the seeds of the subsequent proliferation of accepted methods" (Storey, 1964, p. 27). In 1939, the Institute's Committee on Auditing Procedure modified the opinion paragraph by transposing "present" and "fairly," replacing "in accordance" with "in conformity," and inserting "generally accepted accounting principles" in place of "accepted principles of accounting": "... present fairly ..., in conformity with generally accepted accounting principles ..." (AIA, 1939, p. 12). The term *generally accepted accounting principles* came to refer not only to broad principles but also to accounting methods. In 1939, the Institute's Committee on Accounting Procedure began issuing bulletins to provide the SEC with "substantial authoritative support" for the principles and methods comprehended by GAAP. In instances where alternative methods or practices commanded strong support within the Committee, the resulting bulletins allowed optional treatments, contributing to the proliferation cited by Storey.

As a firm, Arthur Andersen & Co. was concerned that questionable methods and practices had become justified under the imprimatur of GAAP, and the firm believed that the formal link between fair presentation and conformity with GAAP might preclude auditors from taking exception to the application of accounting principles (i.e., methods) of which they disapproved but which were nonetheless believed to be generally accepted. In an internal memorandum dated November 21, 1941, the firm indicated its uneasiness with the link between fairness and GAAP:

> The reputation and standing of the firm have been built upon a foursquare policy of honesty and forthrightness. If, after the most thorough investigation and careful consideration, we are convinced that a certain accounting policy is fundamentally unsound and that its application will result in financial statements that are materially misleading, we must take exception to the policy in our certificate; we will not avail ourselves of the technicality that the principles to which we object may be quite generally accepted.

This policy reflected the view of Arthur Andersen himself that the partners in the firm, no less than other members of the profession, should use their independent judgment when assessing the propriety of accounting principles, and should not unquestioningly subordinate their professional opinions to the rules and procedures approved by a committee of the Institute.

In 1944, the Institute's Committee on Accounting Procedure approved *Accounting Research Bulletin No. 23*, "Accounting for Income Taxes." The committee accepted interperiod tax allocation except "in the case of differences between the tax return and the income statement where there is a presumption that they will recur regularly over a comparatively long period of time" (AIA, 1944, p. 190). Arthur Andersen & Co., however, favored interperiod tax allocation for oil and gas companies that capitalized the drilling costs of productive wells for financial accounting purposes while deducting them immediately for tax purposes—a difference that could well persist for a considerable number of periods.

Finally, in 1946, the firm concluded that the auditor's standard report, with a single opinion, placed it in an indefensible position. The decision was made to decouple the opinion on fair presentation from that on conformity with GAAP.

In an internal memorandum dated July 2, 1946, the firm "reemphasized the established policy of the firm to take exception in our certificate to accounting principles or procedures of which we cannot approve, regardless of the fact that there may be a substantial weight of accounting authority or usage in support thereof." The 1946 memorandum continued:

A corollary of this policy is the proposition that the certifying paragraph expresses three separate and distinct opinions: (1) that the financial statements present fairly the financial position and results of operations, (2) that the statements have been prepared in conformity with generally accepted accounting principles and (3) that these principles have been consistently applied.

The fact that the certifying paragraph in its standard form is an expression of more than a single opinion may not have been uniformly understood in the past. Some of the misunderstanding, if any, may have resulted from a lack of clarity in the wording of the paragraph, and it is the purpose of this release to revise this wording so that it will hereafter more clearly convey the appropriate meaning of the paragraph. Insertion of the words "and are" just preceding the present reference to conformity with generally accepted accounting principles will accomplish this purpose. Therefore, in the future the standard certifying paragraph in our certificate will read as follows:

"In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the XYZ Company at ____ and the results of its operations for the year ended that date and are in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

Somewhat more than a year later, the firm replaced "are" with "were prepared," as an investment banker had suggested that this revised wording would improve the clarity. One supposes that the phraseology in *Accounting Series Release No. 4*, the SEC's basic statement of its administrative policy on accounting principles, commended the word "prepared" in the firm's opinion paragraph. *ASR No. 4* (1938) begins as follows:

In cases where financial statements filed with this Commission ... are *prepared* in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite dis-

closures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material (emphasis supplied).

Another motivation behind the firm's decision was to differentiate its services from those of other firms: to create the image that principle, not expediency, governed its actions and that the firm had the courage to break with tradition. Leonard Spacek, who was the firm's partner in charge of the Chicago office when the decision was made, subsequently said, "Of course a lot of our attraction to clients was the fact that we would do things if we thought they were right" (Spacek, 1985, p. 238). Moreover, in a conformist profession the firm was willing, even eager, to break ikons. Spacek recalls that Arthur Andersen himself "liked the idea of bucking a trend" (p. 231). In 1970, *Fortune* magazine wrote that "Arthur Andersen [& Co.] ... has long been regarded as the maverick of the profession, a role the firm obviously relishes" (Louis, 1970, p. 96). The decision to opt for a two-part opinion in the auditor's report was tailor-made to demonstrate these virtues.

In the mid-1940s, Arthur Andersen & Co. was known as "a small [public] utility firm" (Spacek, 1985, p. 8) and was based in the Middle West, when all of the country's major accounting firms had their headquarters in New York City. Shortly after Spacek became the firm's managing partner in 1947, following Andersen's death, he gave several speeches that ruffled the feathers of the profession's elders. Spacek was asked to meet with the heads of other firms at a prominent New York City club. All of the large firms were represented, as were a number of middle-sized firms. The session was chaired by George O. May, the retired senior partner of Price Waterhouse & Co. and the *éminence grise* of the profession. Spacek (1985, p. 55) recalls the encounter as follows:

I remember George O. May telling us, but looking me straight in the eye, and said that the leadership of the accounting profession must rest in the hands of the larger, successful firms and that the smaller firms can enjoy the success but must acknowledge that the leadership of the profession is in the hands of the larger firms. It had a terrific impression on me because I was just trying to work out our own leadership in the profession. But I said to myself, at that time, if it is bigness that it takes to have any say in the accounting profession, why then we will concentrate on first things first. We'll get big. That's when I really went out for promotion. I really–everything I did in one way or the other was to see that it eventually resulted in promotion.

One could easily imagine that this encounter with the Eastern establishment served only to redouble Spacek's determination to differentiate his firm from the others.[3]

3 Spacek's fiery personality and the dominant role that he played as unquestioned leader of Arthur Andersen & Co. from 1947 to 1963 combine to make this as much a study of Leonard Spacek as of his firm. Indeed, in his oral history, he takes credit for having made the decision in 1946 to shift to the two-part opinion (Spacek, 1985, p. 238). For a further discussion of Spacek and his role in the firm, see *A Vision of Grandeur* (1988, esp. pp. 107–112 and 118–122).

Amplification of the firm's rationale

On May 7, 1957, almost ten years after Arthur Andersen & Co. abandoned the single-opinion format of the auditor's report, Carman G. Blough, the Institute's full-time Director of Research and former SEC chief accountant, questioned the firm's practice in a letter to Richard S. Claire, an Andersen home-office partner. Blough, as it happened, had become a manager in the firm in 1938, following his departure from the SEC; he was admitted to the partnership in 1940 and left to join a federal government agency in 1942. (He had represented Arthur Andersen & Co. on the Institute's Committee on Accounting Procedure between 1938 and 1942.) Blough and Claire had discussed the firm's preferred format of the auditor's report during the April 1957 meeting of the Institute's Council. Claire replied to Blough in a lengthy letter dated May 15, 1957. In his letter, Claire (1957, p. 2) said that

> we view the distribution of significance to each of the three parts of the opinion paragraph in the standard certificate to be roughly 85% to the fair presentation of financial position and results of operations, 10% to generally accepted accounting principles, and 5% to consistency. Any exaggeration that there may be in the foregoing distribution of values is done just to make clearer what we consider to be a most important point. The reference to generally accepted accounting principles we regard as a statement of the objective standards by which the fairness of presentation is judged. We recognize also that the term "generally accepted accounting principles" as used in certificates today is applied both to principles and to practices. Improvements in accounting practices are continually in process. A practice generally accepted today may a few years from now not be generally accepted. During the interim period there may be two practices covering the same accounting matter, both of which may be said to be generally accepted. One, however, may clearly result in a better statement of net income.

Claire illustrated his argument with two cases. In the first, he compared the income statements of a small oil company on two different bases: successful-efforts costing and full costing. The latter practice, he said, was in accordance with GAAP, while the former had the support of "substantial precedent and authority." By adhering to the Institute's standard form of auditor's report, an accounting firm could, Claire argued, give an unqualified opinion for either practice. With respect to the financial statements prepared in accordance with the successful-efforts practice (of which the firm disapproved), Arthur Andersen & Co. would insert a middle paragraph in its auditor's report that would include the following sentence:

> While the practice of expensing such costs for financial reporting purposes was generally followed in the petroleum industry some years ago, the practice of capitalizing such costs and amortizing them over the productive lives of the properties is now more generally followed and, in our opinion, is preferable ... (Claire, 1957, p. 3).

Since, in Claire's factual case, the full-costing net income for the year was 10

times the successful-efforts costing net income, he said (1957, p. 3) that his firm would conclude with the following opinion paragraph:

Because of the significance of the matter referred to in the preceding paragraph, we are of the opinion that the accompanying balance sheet and statements of income and earned surplus do not fairly present the financial position of X Company as of ____, 195__, nor the results of its operations for the __ months then ended.

In his second illustrative case, Claire referred to the prevailing practice of auditors with respect to railroad clients. Since interperiod tax allocation was not required for railroads by the Interstate Commerce Commission, most auditors followed a practice of giving an opinion on railroads' financial statements "in accordance with accounting principles and practices prescribed or authorized by the Interstate Commerce Commission," rather than in accordance with GAAP. Arthur Andersen & Co.'s practice, wrote Claire, was to draw attention to, and quantify the effect of, the railroad's departure from GAAP, and to state the firm's opinion on what was the *proper* practice (which, in this instance, conformed to GAAP). The firm's opinion on fair presentation would be qualified in the light of the railroad's departure from proper practice (or, one assumes, an adverse opinion would be given if the effect of the departure were very significant).

In closing his letter, Claire contended that his firm believed that its form of the auditor's report "conforms more closely to Rule 202 [of SEC's Regulation S-X] that the accountant's certificate shall state clearly 'the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein' " (Claire, 1957, pp. 4–5). Claire reported to Blough that "we have never discussed [our form of the auditor's report] with the Securities and Exchange Commission . . ." (Claire, 1957, p. 4). One therefore infers that the SEC's accounting staff had never registered a formal objection to the use of Arthur Andersen & Co.'s dual-opinion format in the filings by its clients.

On May 8, 1958, two senior partners of Arthur Andersen & Co. met in Washington with Andrew Barr, the SEC's chief accountant, and three of his aides. The meeting had been requested the previous fall by the firm, owing apparently to Claire's letter to Blough. The firm sought to ascertain the accounting staff's reaction to the form of its audit opinion. According to the firm's report of the meeting, Barr said it was "unfortunate that [the firm] adopted this wording because it created dissension in the profession" (Arthur Andersen & Co., 1958, p. 1). Asked whether, in his view, the firm should not have adopted the two-part opinion, Barr avoided a direct reply and repeated his expression of disquiet about dissension in the profession (p. 1). Barr allowed the inference that the two-part opinion, while unfortunate and perhaps ill-advised, was not objectionable. This seems to have been the only recorded reaction of the SEC to the firm's practice of using a two-part opinion. There is no indication that the SEC ever declined to accept financial statements with the firm's two-part opinion attached.

Partners vote on returning to single opinion

By 1957, leading partners in the firm were troubled by the apparent conflict between the firm's espousal of price-level-adjusted depreciation and its practice of not expressing an exception in its auditor's report when clients did not follow this practice.

In 1954, Arthur Andersen & Co. had petitioned the SEC "to formally require disclosure of the effect on income of depreciation adjustments related to price level changes in financial statements filed for purposes of public record" (Spacěk, 1956, p. 5), but the petition was denied. Also in 1954, Garrett T. Burns, an Arthur Andersen & Co. partner, made a determined effort to persuade the Institute's Committee on Accounting Procedure, of which he was a member, to reverse its long-standing opposition to the recognition of price-level-adjusted depreciation in companies' financial statements. In Chapter 9A of *Accounting Research Bulletin No. 43*, issued in 1953, the Committee had once again reaffirmed its earlier position, but only by the narrowest majority. Burns' effort within the Committee failed, if only because of the SEC's known antipathy to departures from traditional historical cost.

Since 1954, Leonard Spacek, the firm's managing partner and an uncompromising advocate of the principles and standards in which he believed, had been promoting the cause of price-level depreciation in speeches before academics and professionals. Spacek's campaign for price-level depreciation further served to differentiate Arthur Andersen & Co. from other firms. Not only did price-level depreciation raise a central question about the meaningfulness of corporate financial statements, it would also have struck a responsive chord among companies who believed that the federal income tax was a levy upon capital, and among public utilities who questioned the fairness of a rate-base determination without considering the effect of changing prices (see, e.g., Chandler, 1953).

There was, some noticed, a discordance between Spacek's aggressive espousal of price-level depreciation and his firm's failure to take exception in the "present fairly" portion of its two-part opinion when clients did not accept the practice. In a widely reported speech in February 1957, Spacek gave his own answer to this apparent conflict (p. 21):

> Our clients have the right to prepare their financial statements on the same basis as the financial statements of the corporations with which they are competing. We cannot interfere with this right. We, as auditors, cannot impose upon our clients new principles of financial accountability when those principles are not accepted by the accounting profession and business generally, even though we are strongly convinced of their merit . . . . We will give each of our clients and their shareholders all the benefits accruing to them under "generally accepted accounting principles," except in those cases where we believe that such "principles" are at variance with the concepts for which there is, or has been, substantial acceptance.

In an internal memorandum dated February 19, 1957, the firm's partners were

asked whether the policy of giving a two-part opinion should be continued. The alternatives were laid before the partners. The firm could

1. Revert to the single-opinion format, continue to take exception to practices that do not "fairly present," but omit any exception in cases, like price-level depreciation, where the practice had not secured substantial acceptance.
2. Revert to a single-opinion format but omit an exception "in all cases in which the practice of a client, with which we disagree, has the support of the American Institute of Accountants or is supported by substantial precedent in actual practice."
3. "Retain our present form of certificate and continue to explain frankly (outside the certificate) why we do not believe we have a right to take exception to a failure to recognize price level depreciation or other practice [which we believe is sound and] for which there is no authoritative support or precedent in practice" (Arthur Andersen & Co., 1957, p. 5).

In the six-page memorandum, arguments were presented on both sides of the question of whether to retain the two-part opinion, but by far the longest and more impassioned argument was given in defense of continuing to give the two-part opinion. Spacek's views in his February 1957 speech (quoted above) were reflected in the latter argument. Among the points made in favor of retaining the two-part opinion were the following:

> To revert back to the other form at this time would mean an abandonment of a long-established policy which is just as sound today as it was twenty years ago. It would represent a departure from a policy based upon principles and the adoption of one justified only by considerations of expediency . . . .
>
> Rule 202 of the Securities and Exchange Commission states: "The accountants' certificate shall state clearly (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein." We *should* be advocating the universal adoption of a certificate that does that, but the adoption of the proposed revision would forever bar us from recommending such a change (pp. 3, 4).

Also in support of the argument for retaining the two-part opinion, it was stated that legal counsel had given the firm an opinion that a change to the single-opinion format would not lessen any liability of the firm, "but on the contrary might *jeopardize* our position because the change might be construed as a course of action designed to conceal rather than to disclose." (Arthur Andersen & Co., 1957, p. 4).

The principal argument in favor of making the change was given in the 1957 Arthur Andersen memo as follows:

> Admittedly this is a compromise, but since there is no satisfactory way out of our present dilemma, it represents a better policy than the one we now follow. Anyone who reads our present certificate could assume that we judge independently of generally accepted accounting principles as well as in conformity with them. This is not true at the present time in those cases involving price level depreciation (p. 2).

As these excerpts suggest, one side could claim principle, while the other was supported only by expediency.

At the partners' meeting in May 1957, the matter was discussed at length, and their decision was to retain the two-part opinion. No transcript was preserved, and the reasons that were considered the most persuasive were not recorded.

Public criticism by Carman G. Blough

Following the exchange of correspondence between Carman G. Blough and Richard S. Claire in May 1957, there was no indication that Blough intended to carry the matter further. It came as a surprise, therefore, when Blough devoted a portion of his "Accounting and Auditing Problems" department in the March 1958 issue of *The Journal of Accountancy* to a criticism of the dual-opinion format of the auditor's report. Without naming Arthur Andersen & Co., Blough wrote that "At least one accounting firm has, for some time, been using a variation of the standard form of auditor's report which apparently uses some other basis, which is not disclosed, for the judgment as to 'fairness'" (Blough, 1958a, p. 76). After stating "we feel that this is a most unfortunate practice," he added:

> If every accountant were to decide for himself what a "fair presentation" is, there would be no standards to go by. One person might consider that a certain presentation was fair while someone else might feel that it was unfair and that something very different was fair. Both might be very honest in their convictions yet be miles apart in their presentations. It is only if their judgments are reached within the framework of generally accepted principles of accounting, i.e., the recognized and widely accepted conventions and procedures, that there can be any test of the reasonableness, or even the honesty, of a particular representation.
>
> ... it seems to us the accountant puts himself in a dangerous position when he departs from established ground rules in determining the fairness of a financial presentation (Blough, 1958a, p. 76).

A reply to Blough's position appeared in the May 1958 issue of the *Journal*. It was written not by a partner of Arthur Andersen & Co. but by Maurice E. Peloubet, to whom Blough referred as "a well-known and highly regarded member of our profession, for whose views we have the highest respect" (Blough, 1958b, p. 73). Peloubet, in fact, had been one of the original members (1939–1941) of the Institute's Committee on Auditing Procedure and had been a long-time member (1941–1953) of the Committee of Accounting Procedure. He was a partner in a small firm, Pogson, Peloubet & Co., which merged into Price Waterhouse & Co. in 1963. In his reply, Peloubet criticized Blough for suggesting that "present fairly" means no more than "in conformity with GAAP." He argued (1958, p. 73) that

> Wherever choices are presented or where the exercise of judgment is required, either on the part of the management or the accountant, I do not think the full responsibility has been discharged by merely stating that the accounts have been prepared on the basis of generally accepted accounting principles.

If this is sufficient, why bother about "present fairly"? It seems to me that the phrase "present fairly in conformity with generally accepted accounting principles" means that the accounts are prepared in accordance with appropriate and applicable generally accepted accounting principles, and that where there are choices, and where alternative methods are permitted, the methods under which the accounts have been prepared are either the most appropriate under the circumstances, or are one of possibly several alternative methods, any of which, in the judgment of the accountant, are applicable.

Although Peloubet seems to dilute his argument by suggesting, at the close of the foregoing quotation, that applicability can be substituted for appropriateness, he added (1958, p. 74) that "in the vast majority of cases some one of the accepted principles or methods will be applicable, but the accountant will still be forced to decide on the propriety of the method used." Blough did not agree. He wrote (1958b, p. 75):

If there are two or more such alternatives, we agree that the auditor may use his influence to have management adopt his choice, but if the management chooses an accepted alternative that he agrees is appropriate, though not what he considers the best, we question whether he can properly deny its fairness in accordance with generally accepted accounting principles.

Blough contended that, until the accounting profession could get together and agree upon criteria for assessing appropriateness, the determination of "fairness" should be guided by generally accepted accounting principles that are applicable in the circumstances.

Yet the premise underlying Arthur Andersen & Co.'s decision in 1946 to adopt the two-part opinion was that the auditor has a professional responsibility to determine appropriateness when deciding whether the financial statements "present fairly." The issue of appropriateness was, in one sense, more serious in the 1940s and even in the 1950s than it is today. In the years prior to the establishment in 1959 of the Accounting Principles Board, the number of pronouncements was relatively few and there was resistance within the profession to narrowing the range of acceptable methods (see Zeff, 1984, pp. 458–459). In such controversial areas as inventory valuation, depreciation, tax allocation, goodwill amortization, pensions, leases, business combinations, and the treatment of unamortized discount, issue cost, and redemption premium on refunded bonds, the Institute's pronouncements either were silent or admitted of alternatives, usually with scant regard for differing circumstances.[4]

4 A profound difference in accounting ideology existed between Arthur Andersen & Co., a firm whose early development had been primarily in the regulated public utility field, and Price Waterhouse & Co. and Haskins & Sells, which had developed client bases composed heavily of major industrial corporations whose presidents were among the early captains of American industry. Companies in regulated industries were accustomed to uniform accounting systems imposed by governmental fiat, while unregulated businesses were disposed toward freedom of enterprise. Not surprisingly, Arthur Andersen & Co. urged a greater degree of company-to-company uniformity in financial reckonings (see, e.g., Spacek, 1961), while PW and H&S were defenders of flexibility (see, e.g., Grady, 1965, pp. 32–35; and Powell, 1965). Prior to

Leonard Spacek believed that, in such a permissive climate, it was incumbent on the auditor to make a judgment on the appropriateness of alternative methods. In an August 1957, speech, he reiterated that view and said that the profession would "at least put the teeth of responsibility into the present form of audit certificate" if it were to modify the opinion paragraph as follows:

> In our opinion (the statements) present fairly the financial position and results of operation in conformity with *those* generally accepted accounting principles *considered appropriate in the circumstances* and applied on a basis consistent with that of the preceding year (Spacek, 1958, p. 374, italics added).

In the same speech, Spacek proposed that the Institute establish "a court or professional tribunal of accounting principles" and charged the Institute with responsibility for "defining the criteria of accounting principles" (1958, p. 377).

According to Blough, the auditor's determination of appropriateness had to await the day when the profession could agree upon suitable criteria, and until then the auditor should not be basing judgments on his own personal opinion (1958b, p. 74). Spacek, ever the activist, was pressing the profession to develop criteria for evaluating appropriateness and, in the end, to eliminate alternative accounting principles.

The controversy over appropriateness flared anew in the 1970s, when the SEC proposed to charge auditors with the responsibility for determining whether a client company's switch from one accounting principle to another "is preferable under the circumstances." The SEC eventually lightened the burden by permitting the auditor to rely on the client's business judgment. Nonetheless, issues were raised about how an auditor might determine preferability in the absence of agreed-upon objectives and established criteria (see Revsine, 1977, and footnote 8, *infra*). It will be recalled that an appropriateness test currently exists as a formal recommendation in Canada, yet criteria for making such judgments seem to be lacking there as in the United States (see Gibbins and Mason, 1988, chap. 6).

Two-part opinions on price-level depreciation

As demonstrated by the firm's internal debate during 1957, its advocacy of price-level depreciation was testing the partners' depth of support for the two-part opinion. Evidently, it was not contemplated by the firm in the 1940s that it might one day espouse an accounting principle, such as price-level depreciation, for which there was no general acceptance, thus placing the firm in the unacceptable position of imposing on its clients "new principles of financial accountability," as Spacek termed it in his February 1957 speech.

In audit reports given to three of its clients who adopted price-level depre-

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the showdown in AICPA Council in 1964 (Zeff, 1972, pp. 180–183), the flexibility school was the dominant force in the AICPA committees that pronounced upon accounting principles. In this arena as well, Arthur Andersen & Co. was "bucking the trend."

ciation during the 1950s, Arthur Andersen & Co. used its two-part opinion to lend support to this departure from GAAP.[5]

Ayrshire Collieries Corporation, an Indianapolis client, reflected price-level depreciation in the Comparative Statement of Earnings included in its 1958 annual report as follows:

	Year Ended June 30, 1958	Year Ended June 30, 1957
Net income for the year	$2, 884, 256	$2, 904, 730
Provision for price-level depreciation (See note)	195, 429	143, 587
Balance of Net Income	$2, 688, 827	$2, 761, 143

After giving its usual two-part opinion on the company's financial statements, Arthur Andersen & Co. added the following paragraph as part of its auditor's report:

In our opinion, however, the net income for the year is more fairly presented after deducting the provision for price-level depreciation, since current price levels have been recognized in determining the current cost of property consumed in operations. Generally accepted principles of accounting for cost of property consumed in operations are based on historical costs and do not reflect the effect of price-level changes since dates of acquisition or construction of the companies' depreciable property.

In the 1957 annual report of Sacramento Municipal Utility District (SMUD), the Operating Expenses section of the Income Statement included the following breakdown:

Provision for depreciation—Computed on historical cost	$1,506,624
Additional provision to reflect increase in price level (Note 1)	665,000

In the auditor's report, the following two paragraphs were given after the scope paragraph:

As set forth in Note 1 to the accompanying financial statements, the statement of net revenue reflects an additional charge for depreciation of $665,000; this charge is equivalent to the amount by which depreciation computed on the cost of depreciable property adjusted to reflect current price levels exceeds depreciation computed on cost. Although this practice is not yet recognized as a generally accepted principle of accounting, it is our opinion that, for the District, it results in a fair statement of net revenue for the year, and we have approved its adoption. In other respects, the financial statements, in our opinion, were prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

5 Expanded treatment of these company disclosures and the resulting auditors' reports may be found in a news feature in *The Journal of Accountancy* ("Price-level Depreciation . . . ," 1959) and in Appendix D in *Accounting Research Study No. 6* (Staff of the Accounting Research Division, 1963, pp. 211–217).

In our opinion, the accompanying balance sheet and statement of net revenue present fairly the financial position of Sacramento Municipal Utility District as of December 31, 1957, and the results of its operations for the year then ended.

Iowa-Illinois Gas and Electric Company, which had been authorized by the Iowa Supreme Court to recover, through rates charged to customers, the fair value of the property used to provide customer service, also recognized fair value depreciation in its financial statements. In its 1958 annual report, the company included fair value depreciation in the operating expenses in its Statement of Income. Included in the middle paragraph of the auditor's report were the following two sentences:

We approve the practice adopted by the Company, since it results, in our opinion, in a fairer statement of income for the year than that resulting from the application of generally accepted accounting principles. In all other respects, the financial statements were prepared in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Arthur Andersen & Co. concluded its auditor's report with an opinion on fair presentation similar to the final paragraph in its auditor's report given to SMUD.

Both Ayrshire and Iowa-Illinois were subject to SEC jurisdiction, and the Commission's accounting staff took exception to the treatment of price-level depreciation as an expense. As a result of the SEC's objection, the companies amended their presentation to show price-level depreciation as an appropriation of earned surplus (i.e., retained earnings).

The auditors' report in these three instances illustrate Arthur Andersen & Co.'s use of its two-part opinion to express approval of companies' use of price-level depreciation. The dilemma that faced the firm, however, was the inconsistency between these opinions and those given to companies whose financial statements reflected traditional historical cost depreciation.

The firm reverts to the single-opinion format

Spacek's despair in 1957 was that the Institute's Committee on Accounting Procedure was making no progress toward reducing the number of alternative accounting principles, and that no one in the Institute's hierarchy seemed interested in actively developing criteria for judging appropriateness when alternatives were available. In that climate, his firm had decided to continue its policy of giving two-part opinions.

During 1957, the stridency of Spacek's public criticisms of the accounting profession's record in improving financial reporting accelerated, and the Institute appointed a special committee to investigate Spacek's charge that an Institute committee had yielded to industry pressure. The committee, composed of Institute leaders, found his claims to be unsupported by the facts (see Zeff, 1984, p. 461). The firm's strong view that it should base its auditor's opinion on only

those accounting principles that it believed were proper led to the loss of some of its railroad clients (Spacek, 1985, pp. 248–249).

In October 1957, changes began to occur that, for the first time, gave Spacek and his firm some basis for believing that progress might soon be made on both fronts. Institute President Alvin R. Jennings, a senior partner in Lybrand, Ross Bros. & Montgomery (as the U.S. firm of Coopers & Lybrand was then known), delivered a major address in which he responded to criticisms (including Spacek's) of the performance of the Committee on Accounting Procedure. Jennings (1958) proposed the creation of an independent research organization that would be more attuned to the changing economic and financial times.

In December 1957, Jennings appointed a blue-ribbon Special Committee on Research Program "to consider a new approach to the means whereby accounting research should be undertaken, accounting principles should be promulgated, and adherence to them should be secured" (Report to Council of the Special Committee on Research Program, 1958, p. 62). The committee's charge was broad and dealt with fundamental issues. Spacek was among those invited to serve, and he accepted. Other members of the special committee included Carman Blough, Paul Grady, William W. Werntz, Andrew Barr, and Weldon Powell—all leaders of the profession. Werntz was chairman of the Institute's Committee on Accounting Procedure, and Barr was the SEC's chief accountant. Blough and Werntz were former chief accountants.

In its historic report issued in September 1958, the special committee unanimously recommended a major reform in the Institute's accounting principles program, which included the following points:

- the Committee on Accounting Procedure be replaced by an Accounting Principles Board (APB),
- an accounting research division be created within the Institute to serve the Board,
- two initial research projects be directed at identifying the basic accounting postulates and broad accounting principles, and
- the Board use these and subsequent research studies as a basis for its accounting pronouncements.

As Spacek saw it, the high priority given to the two research projects on postulates and broad principles inspired hope that the Institute would finally develop criteria for assessing appropriateness and that, as a consequence, the Board's pronouncements would lead to a reduction in the number of alternative accounting principles. This was Spacek's first service on an Institute committee, and one may infer from his unqualified assent to the special committee's report that he believed that the profession's leaders were of a mind to make real progress toward solving the problems of which he had been complaining. The Institute swiftly approved the special committee's recommendations and established the

APB and its accounting research division in 1959. One year later, after resolving some initial concerns, Spacek accepted an appointment to the Board.[6]

In his address to the Institute's 1960 Annual Meeting, Spacek voiced support for the goals implicit in the special committee's report. He referred to two publications recently issued by his firm that supplied agenda material for the newly formed Accounting Principles Board. One, a 127-page booklet, *Accounting and Reporting Problems of the Accounting Profession* (Arthur Andersen & Co., 1960a), was a critical analysis of alternative accounting principles in 20 major problem areas. The second of the two publications, a 43-page booklet on "the basic postulate of accounting," discussed his firm's views on the Board's research project on basic accounting postulates (Arthur Andersen & Co., 1960b).

Spacek's avowed endorsement of the aims of the APB, coupled with his firm's emerging policy of publishing technical booklets dealing with matters coming before the Board, created a climate in which the firm could consider abandoning its departure from the Institute's standard form of the auditor's report and instead channel its efforts at achieving accounting reform through the Institute's new accounting principles program.

In an internal memorandum dated October 2, 1962, a proposed revision of the firm's dual-opinion auditor's report was again placed before the partners for a vote. Only the argument in favor of reverting to the single-opinion format was presented, and it was stated that Spacek, the firm's managing partner, concurred with that argument. The memorandum drew attention to the booklets in which the firm took issue with settled practice in a number of problem areas. The memorandum (Arthur Andersen & Co., 1962, p. 2) added:

> In some of these areas where the effect is very substantial, we have qualified and would currently qualify our opinions on financial statements, and in some of the other areas we have not qualified and ordinarily would not qualify our opinions.
>
> In articles, speeches and other communications, as well as in our booklets, we have emphasized to businessmen and accountants that "fairness" in financial reporting is not being achieved through some of the present accounting practices. The continued use of our present form of opinion, in the light of the position we have taken publicly on many of these practices and the general recognition by the profession that these problems do exist, could easily create the impression that we are being hypocritical or intellectually dishonest.

6 The Institute's executive committee had insisted that, apart from Weldon Powell (who was to be the chairman), all representatives on the APB from the Big Eight firms must be their firm-wide managing partners. Spacek balked at this requirement, believing that his firm's senior technical partner should represent the firm. William M. Black, the managing partner of Peat, Marwick, Mitchell & Co., held the same view. Consequently, only six of the Big Eight firms were represented on the APB during 1959–1960, its inaugural year. J.S. Seidman, the Institute's 1959–1960 President, believed it was essential to the success of the APB for all of the Big Eight firms to be represented. A close professional acquaintance of Spacek's, Seidman succeeded in persuading Spacek and Black to join the APB in 1960, when its size was increased from 18 to 21 to accommodate the new members. Seidman was also instrumental in arranging for Spacek, whose aggressive manner and outspoken criticism had irritated many members of the profession's establishment, to deliver a major address at the Institute's 1960 Annual Meeting.

By the early 1960s, price-level depreciation was not the only subject on which the firm was recommending a practice that was not generally accepted. In October 1962, when the memorandum was issued, the Accounting Principles Board was embroiled in a controversy over accounting for the investment credit, and Arthur Andersen & Co. had announced its position in favor of deferral.[7] Since the investment credit was without precedent, neither the flow-through nor the deferral approach to accounting for the credit could be said to enjoy general acceptance. Perhaps the firm sensed that, in the event that the Board were to support only the flow-through approach, it would find itself (as with price-level depreciation) in opposition to the only practice that was generally accepted. It may not have been entirely an accident in timing that the memorandum was issued in the thick of the controversy over accounting for the investment credit. Furthermore, if the firm's managing partner was serving on a board that would have a large hand in determining GAAP, it might have seemed incongruous if the firm were to continue giving opinions on fairness of presentation not predicated on GAAP.

The vote of the partners was not recorded, but on October 25, 1962, the firm issued an internal accounting release in which the single-opinion auditor's report was presented as firm policy.

The reversion decision: Some major influences

What had happened since 1957? For one thing, the firm had adopted a strategy of publicly venting its views on a wide range of financial reporting issues. The number of problem areas in which the firm took issue with generally accepted accounting principles was considerable. Prior to 1957, by contrast, the firm had focused its public criticism on the unwillingness of the profession and the SEC to approve price-level depreciation as an accepted principle. The inconsistency between the firm's public advocacy of price-level depreciation and its policy of giving clean "fairness" opinions to companies not adopting price-level depreciation had troubled many of the partners at the time of the reconsideration of the two-part opinion in 1957. Owing to the firm's outspokenness on the entire agenda of issues coming before the APB, the number and variety of potential inconsistencies between what it said and what it did multiplied between 1957 and 1962. The firm's internal memorandum of October 2, 1962, stated the dilemma as follows:

> If we retain our present form of opinion, we would be continuing to state that, in our opinion, the financial statements "present fairly," while at the same time we are saying publicly in booklets, articles, addresses, etc. (in order to obtain corrective action by the accounting profession), that some of the practices on the basis of which we give unqualified opinions do not result in financial reporting that meets the test of "fairness."

7 For a discussion of the controversy over the investment credit in 1962, see Moonitz (1966).

It was awkward, to say the least, for the firm to be giving an unqualified opinion on the "fairness" of financial statements that reflected the use of accounting principles that the firm publicly criticized.

Second, the firm's practice of championing price-level depreciation in some of its auditors' reports, as illustrated in the previous section, had drawn even further attention to the inconsistency dilemma. In 1957, a problem that concerned the firm was the juxtaposition of Spacek's public utterances on price-level depreciation as against the firm's policy of giving clean "fairness" opinions to companies not adopting the practice. In 1958, as reported above, the firm began to carry its advocacy of price-level depreciation into its reports on the financial statements of companies that had adopted the practice. Yet the firm continued, as it knew it must, to give clean opinions to nonadopters.[8]

Third, the Institute in the 1960s seemed to be committed to abandoning its earlier tolerance of alternative accounting principles, and the firm, as suggested above, believed that its advocacy in the form of publications, speeches, and articles might gain support within the APB for a reduction in the number of alternatives. To Spacek's disappointment (1962a), the Board's research studies on postulates and principles did not become the building blocks for later pronouncements, and the Board itself disavowed the two studies in June 1962. By mid-1962, the APB still had not been tested on a major accounting pronouncement, yet Spacek continued to believe in the Board. In July 1962, he said, "I do believe that our Accounting Principles Board will eventually succeed in coming to the right answer" (1962b, p. 205).

Fourth, the firm's policy of tackling controversies in its auditors' report was not working. The policy was having no perceptible impact on practice or on the literature. No other firms had followed suit even though the SEC's accounting staff did not object to the practice, and no evidence has come to light that it influenced companies in their choice of accounting principles. Apart from Blough's 1958 column in *The Journal of Accountancy*, and some discussion in one of the firm's publications (Arthur Andersen & Co., 1960a, pp. 4–5), nary a reference to Arthur Andersen & Co.'s two-part opinion can be found in the academic or professional accounting literature, or even in the minutes of the

8 A somewhat similar problem involving the preferability dilemma (see discussion on p. 457, *supra*) arose in the mid-1970s, when Arthur Andersen & Co. challenged the SEC's *Accounting Series Release No. 177* (1975). The SEC required that, when a registrant company seeks to change an accounting principle, "a letter from the registrant's independent accountants shall be filed as an exhibit indicating whether or not the change is to an accounting principle which in his judgment is preferable under the circumstances . . . ." In response, the firm wrote: "A letter from our firm stating that a particular principle is preferable for one client could adversely affect many other clients not participating in such a decision and could adversely affect the reputation and credibility not only of such clients but also of our firm in giving reports on the financial statements of those other clients, whether or not they ever make accounting changes, and thus open our clients and our firm to potential costly litigation" (Arthur Andersen & Co., 1976, p. 8). The threat of litigation, while considered in the firm's 1957 internal debate and perhaps also in the decision to abandon the two-part opinion in 1962, had become a significantly more serious issue in the 1970s.

Institute's Committee on Auditing Procedure. The firm's practice had attracted virtually no notice.

Fifth—and perhaps the pivotal factor—was Spacek's interest in taking over a long-time client from Price Waterhouse & Co. Superior Oil Co. had been a Price Waterhouse client since 1933, and the company's management wished to change auditors. If only because of George O. May's condescending manner in the meeting with Spacek in the late 1940s, the prospect of acquiring a Price Waterhouse client must have been irresistible. Moreover, Superior Oil was thinking of moving its headquarters from Los Angeles to Houston, where Arthur Andersen & Co.'s major oil and gas audit work was based. But there was a problem. Superior Oil, with conservative management, followed the minority but accepted practice of expensing not only the cost of unsuccessful wells but also the cost of successful wells. Arthur Andersen & Co. had been very critical of this practice and did not have any clients following it. The firm was an avowed advocate of capitalizing the costs of both successful and unsuccessful wells. Before accepting the engagement, Spacek asked SEC Chief Accountant Andrew Barr, "If we took over an oil company who was charging all their drilling cost to expenses, including the good wells, I mean the successful wells as well as the dry holes, and we qualified it, would [you] stand behind us and require the capitalization of the successful wells?" (Spacek, 1985, p. 239). Barr responded that, in his view, the company's practice was "generally accepted." It therefore became necessary for the firm to endorse what was "generally accepted" in this regard if it wanted to obtain the new client. As Spacek later said, "That triggered [the firm's decision to revert to the one-part opinion] because the accounting profession always said 'You preach all these things but you don't follow them.' I just said okay, [from] now on we will follow generally accepted accounting principles [in our auditor's report] but nobody will stand in our way in our efforts to improve them" (Spacek, 1985, p. 239). Arthur Andersen & Co. acquired the audit of Superior Oil in 1962, and the firm's report issued in 1963 in the one-part format was not qualified.[9]

The Superior Oil incident was the last straw. In a permissive climate, when other major firms were willing to give unqualified opinions on a wide range of alternative accounting principles, Arthur Andersen & Co. ran the risk of offending newly acquired clients that were accustomed to the flexibility of their previous auditors. The advocacy of the firm's views through the medium of its auditor's report had become too costly. It was thought wiser to promote the firm's views on accounting principles through its publications and the speaking and writing activities of its partners.

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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]

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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.

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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