U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Address to

American Accounting Association

Northeast Regional Meeting

Syracuse University

Syracuse, New York

April 19, 1985

FAIR PRESENTATION

Clarence Sampson
Chief Accountant
Securities and Exchange Commission

FAIR PRESENTATION

1985 promises to be a year of soul searching, reflection, and self-evaluation with the increased Congressional oversight of the accounting function -- a term that encompasses not only the independent auditors, but also financial management, audit committees and other professional advisors to entities whose securities are publicly traded. We are, all of us, going to have to review the various processes, programs and policies that have been established to maintain the accuracy and credibility of financial reporting to ensure that they remain relevant and adequate in today's environment.

I want to talk to you about one critical ingredient of accurate and credible financial reporting, the concept of fair presentation. Fair presentation is hard to define, but you know it when you see it. And I know that the determination as to whether financial statements are presented fairly has to be made from the perspective of the user, that is the stockholder, the creditor, or analyst.

I also know something of what it is not. Fair presentation is <u>not</u> determined based on whether it is "fair" to the company to disclose bad news. It is also not "fair" to account for a transaction in a manner which presents it in the best light for the company, regardless of the realities of the circumstances. It is not "fair" for a company to structure transactions to report desirable results, thereby artificially disguising its real financial results.

Accountants usually refer only to the financial statements as a whole (including the footnotes), when talking about fair presentation. But from the company's standpoint, Management's Discussion and Analysis ("MD&A") presents another opportunity for management to identify and address those key variables, trends and uncertainties, and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of their company. Management knows more about the company than investors or creditors, and can often increase the usefulness of financial statements by identifying certain events and circumstances and explaining their financial effect on the company.

The discussion and disclosures in MD&A, however, cannot substitute for appropriate accounting and fair presentation in the financial statements in the first place. So I will concentrate my remarks on the accounting.

Fair presentation as a basic concept of financial reporting, relies on two other basic concepts: (1) substance over form -- that the financial statements represent faithfully the economics of the transactions presented in them, and (2) decision usefulness -- that the information presented is relevant and reliable.

The economist will tell you that the value of financial statements is in making economic decisions, for allocating resources. A primary purpose of financial statements is to provide an objective, neutral measure of performance, whether that performance is "good" or "bad." That purpose stems from the fact that investors and creditors often lack the ability to demand the information they want and must rely on information that management gives them. Financial statements are a tool to provide that information. They aid in evaluating past decisions and in determining future decisions. Accounting standards and the financial statements utilizing them exist, therefore, to fill a need, to improve financial communication. That communication aids in making economic decisions, which aid in the effective allocation of scarce resources. If the users of the financial statements no longer perceive them as being fairly presented, they will lose their value. They will no longer be relevant or reliable for any purpose.

To retain user confidence, the accounting principles adopted by a company, and the methods of applying those principles, must be those judged by management to be the <u>most appropriate in the circumstances</u> to present fairly financial position and results of operations. And the auditors must independently evaluate management's decisions, because events have shown that the public relies on the auditors.

While most accounting transactions are straightforward, and applying standards is relatively easy, some standards, like SFAS No. 52 on foreign currency translation, require considerable judgment to implement. And some events and transactions (some created by innovative investment bankers or aggressive and/or desperate management and some just a consequence of a complex and changing business environment) raise accounting questions for which we do not find definitive answers in published standards or practice. That is when the issues of fair presentation and representational faithfulness become very important.

That's the theory, but what does it mean in the everyday world of business and finance?

While the staff at the SEC recognizes that the vast majority of registrants and accountants act in a prudent and professional manner, a few companies do play games with their financial statements. We've noticed a dramatic change in the business and accounting environment within the last few years. We've noticed in isolated instances a shift away from the fairest presentation to "acceptable" methods of accounting. We see transactions structured to fit the gaps in GAAP. Too often we see situations where the company and its auditors say to us "There's nothing in the literature that clearly says we can't account for a particular transaction in the way we want." Not surprisingly, the way they have chosen always seems to show the company in the most favorable light. These companies and auditors, as few as they may be, arouse public indignation that stirs up government intervention. Their failure to exercise good professional judgment, in my view, invites the SEC to step in to provide that judgment.

Even more importantly, questionable reporting practices shift the focus of accounting standard setting from areas like measuring income and economic performance to preventing income manipulation. Standards are written narrowly to prevent abuse, rather than broadly to encourage the use of professional judgment. Resources are shifted from considering emerging accounting and auditing issues to enforcement. And in the long (and short) run, the apparent lack or misuse of professional judgment threatens self-regulation.

What is to be done?

I believe neither the SEC nor Congress can adopt rules or laws that will, by themselves, cure the problems of today's environment -- many of which are the result of commercial competition.

While a major part of the cure must come from the profession itself, the courts may also have something to say. In United States v. Arthur Young & Co. the Supreme Court noted the necessity for financial statements to be perceived as accurate. The Court also stated that public faith in the reliability of the corporation's financial statements depends on the public perception of the outside auditor as an independent professional. While I certainly believe that it is still the company's responsibility to select accounting policies that present fairly their financial results, the auditor must independently evaluate the choices.

CPAs argue that the exercise of judgment must never be taken out of accounting and auditing standards. They assert that the loss of the ability to exercise judgment will be the end of the profession. But the role of judgment in financial accounting must be to determine the real substance of transactions and to choose the appropriate standards to present those transactions in the financial statements in a way that is fair ("representationally faithful"), relevant and reliable, and not to be overlooked, comprehensible to the user with a reasonable understanding of business and economic activity.

Day to day implementation of standards must rely on the professional judgment of the responsible officers who prepare the financial statements of a company, as well as on the professional judgment of the independent accountant who evaluates management's decisions. Professional judgment must focus on the overall fairness of the presentation of the financial statements <u>to the user</u>, rather than on technical rule interpretations and avoidance. Further, if we are to avoid "Gresham's Law" in accounting and auditing, judgment must be exercised objectively, with integrity and, for the auditors, with a healthy skepticism, when management has on its rose-colored glasses. Anything less undermines the credibility of the financial reporting process.

Accounting standards that allow for the flexibility of judgment can adapt better to a changing economic environment; but if, and only if, that judgment is professionally exercised. If auditors are committed to upholding standards, the role of standards can be to provide <u>direction</u> for the exercise of judgment, not to provide a rule book to cover all circumstances. We at the Commission have said many times over, that in cases where the accounting literature is subject to interpretation, or does not seem to provide guidance, companies do not have a license to use any accounting method that gives a desired, but inappropriate or distorted, result. A company and its accountants <u>must</u> choose an accounting policy that <u>fairly presents</u> financial position and results of operations. And the requirement for fair presentation is not just a consideration of whether a transaction is in accordance with the letter of a standard, but is a basic principle of the spirit of GAAP. In this context the accounting profession has provided the independent accountant with a tool to use when in his professional judgment literal compliance with a standard does not result in a fair presentation -- Ethics Rule 203. Perhaps we should be seeing more Rule 203 opinions in today's environment.

We at the Commission are able to deal with, have dealt with, and will continue to deal with registrants who engage in outright abuses of accounting standards. We will deal with "shoppers" and the unprofessional "shoppees." This area is currently a top priority in our enforcement program. Perhaps a more serious long-run concern, in my mind, is the slippery slope of LAAP, least acceptable accounting principles, which is threatening the credibility of financial reporting. More and more people seem to believe that it is OK to interpret accounting standards like income tax regulations. But, bending the rules, pushing the standards to the extreme, misapplication of standards is short-sighted and harmful.

As I have said on other occasions, the Commission has had a historical policy of looking to the private sector to establish and improve professional standards. In my view, this policy has served investors well. I believe it will continue to serve investors well if the accounting profession takes a leadership role to enhance professionalism.

What I would hope to see from the academic community is a heightened awareness of the kinds of issues we are wrestling with. Students must be taught, from the beginning of their academic careers, the difference between rote application of a standard and a consideration of the overall fair presentation of financial statements. Potential auditors must be made aware of the very real pressures they will face. They must be prepared to stand up to a partner when they believe GAAP or GAAS have not been complied with, even to the extreme length of losing a job. They must understand the difference between their job and their career, and their career and their profession. It is encouraging that, in many cases where we question the quality of an audit, the staff on the job has brought up the very same questions that we have. It's just too bad they were ignored or overridden by a supervisor.

On a more positive note, I am hopeful that the Emerging Issues Task Force will eliminate some of the problem. This group presents the accounting profession with the opportunity to discuss the accounting for new transactions not specifically covered by the accounting literature. If they are able to reach a consensus on the appropriate accounting, diversity in practice should be considerably narrowed. If there is a divergence in views, this may indicate a need for FASB (or SEC) action. The results so far have been encouraging. However, it is far from clear that this effort will succeed. If it does not, it will not be for lack of trying. But companies and their accountants are going to have to support the task force's efforts; they are going to have to bring matters to the task force, and be willing to <u>work</u> at achieving a consensus with the ultimate objective of fair financial presentation. Frankly I am convinced that something like the Emerging Issues Task Force is necessary in today's environment as an antidote to some of the problems of commercial competition. If the FASB's initiative flounders, I believe we will have to consider how the SEC might have to deal with those problems.

To close, I'd like to repeat again how important I believe the concept of fair presentation is to the investing public. The implementation of standards, assuring a fair presentation of the financial statements, is as important, if not more important, than the standards, if we are to maintain the value of the financial statements to those users.

Thank you for the opportunity to present my views.