4-29-1964

Summary of Counsel's Reasons for the Three Provisos at the End of Proposed Amended Rule 2.02(e), April 29, 1964

Fontaine C, Bradley

April 29, 1964

SUMMARY OF COUNSEL'S REASONS FOR THE THREE PROVISOS AT THE END OF PROPOSED AMENDED RULE 2.02(e)

Provisos (i) and (ii)

The amended Rule and standard provide that APB pronouncements embraced thereby shall be the only generally accepted accounting principles in the subject areas covered for the purpose of expressing an opinion on financial statements. For convenience, such APB pronouncements are called "effective pronouncements".

In the case of Rule 2.02(e), which requires disclosure of material departures from generally accepted accounting principles when an auditor expresses an opinion on financial statements, the above language means that a member's audit report must disclose a material departure from an effective APB pronouncement.

In the case of the first standard of reporting, which requires that the auditor's report state whether the financial statements conform with generally accepted principles of accounting, the above language requires the auditor to qualify his statement in regard to such conformity in respect of any material departure from an effective APB pronouncement.

In my opinion, insofar as the amendments to the Rule and standard have these results, they are justified in view of the fact that the proposal has the broad objective of narrowing, over a period of time, the areas of difference in accounting principles underlying financial reports.

However, care should be taken so as to avoid interference with the right of a professional man to express his honestly held professional views as to fairness of presentation. Unless his right to express his honestly held professional view as to fairness is preserved, the Rule may not be enforceable and the Institute may incur liability to an organization adversely affected by an APB pronouncement.

From the legal point of view, restricting an auditor's freedom to express his honest professional opinion on fairness of presentation creates a very different issue from restricting the significance he is permitted to ascribe to a technical term such as "generally accepted accounting principles". Provisos (i) and (ii) are designed to make it clear that the auditor's right to express his honestly held professional view as to fairness or unfairness of presentation is not interfered with, and thus avoid both the possibility that the Rule would be considered unenforceable and the risk of liability for the Institute.

Illustrations follow which point up the necessity for Provisos (i) and (ii).

<u>Proviso (i)</u>. It is conceivable that financial statements conforming in all pertinent respects with effective pronouncements of the Board could result in a misleading presentation. Proviso (i) makes it clear that, in such a case, an auditor is not required to give an unqualified opinion that the statements are fairly presented.

Also as to Proviso (i), assume that transactions are reflected by a client's financial statements in conformity with a principle which has been approved by the APB. Assume further that the auditor disagrees with such principle. He should be free to state that, even though there is such conformity, in his judgment the application of the APB principle requires him to give a qualified or adverse opinion on over-all fairness of presentation.

Proviso (ii). Assume that a principle which the client follows, and for which there is substantial authoritative support, is disapproved by the APB. In such a case, the auditor should not be prevented by the Institute from expressing his opinion that the principles followed by the client fairly present the financial condition, despite a departure from the APB pronouncement, provided such departure is disclosed and an appropriate statement is made as to nonconformity with generally accepted accounting principles.

The necessity for this proviso is pointed up very sharply by the Appalachian Power Company litigation, in which the Institute was a defendant. That was an injunction suit brought by a public utility company which claimed that it would be damaged by an impending pronouncement of the Committee on Accounting Procedure. Implicit in that case was a damage claim against the Institute running into millions. The plaintiff claimed that the issuance of the pronouncement (in the form of an interpretive letter which was only advisory) would, among other things, seriously damage the plaintiff's borrowing capacity. The Institute won in that case.

In the proposed amendments we have a compulsory disclosure of a departure from what the APB, with the acquiescence of the Council, determines to be the only generally accepted accounting principles in the subject area covered. Without Proviso (ii), it would not be clear that the auditor is free to express his honestly held professional opinion as to fairness of presentation in regard to statements not conforming to APB pronouncements.

In the Appalachian Power Company case, the court emphasized, in a different context, the public obligation of a professional society for unfettered expression of an honestly held professional opinion.

In my opinion, the Institute would incur a serious risk of substantial liability should it adopt the proposed Rule without Proviso (ii).

Proviso (iii)

The reasons for Proviso (iii) are different from those for Provisos (i) and (ii).

The amended Rule would state that a pronouncement of the APB designated by it as embraced by the Rule shall be considered as constituting the only generally accepted accounting principle or principles in the subject area covered for the purpose of expressing an opinion on financial statements. If this broad language were not limited by Proviso (iii), the Rule could mean that members are forbidden from assigning any other meaning to the term "generally accepted accounting principles" in any context whatever.

If open to this sweeping interpretation, probably the Rule would be invalid and unenforceable and may lead to serious liability.

Assume that a loan agreement provides that the failure of the financial condition of the borrower to meet certain minimum requirements in conformity with "generally accepted accounting principles" constitutes an event of default Assume further that this loan agreement specifically defines the term in a manner to have a meaning which is different from a subsequent pronouncement of the APB. Or assume that, absent a specific definition, it is clear from the financial statements submitted at the time of the making of the loan, and other material data, that the parties contemplated the phrase to mean something quite different from what the APB subsequent pronouncement states.

If the Rule required the auditor to disregard the meaning assigned the phrase in the agreement, in this manner, probably the Rule would be unenforceable. Also, the auditor might, by following such an unlimited requirement, incur liability for expressing an adverse opinion to the damage of the borrower. Moreover, the Institute might incur liability to the audited organization for having arrogated to itself the right to state the meaning of the phrase in all contexts.

Assume that a Governmental agency regulation provides that the principles set out in the regulation in regard to organizations within its jurisdiction must be regarded as the only generally accepted accounting principles within the subject area covered for the purpose of expressing an opinion on financial statements filed with it. Assume further that there are conflicts between the principles prescribed by the agency and those approved by the APB. Presumably, the Institute could not sustain disciplinary action against members of the Institute for giving an opinion that statements conform to such prescribed agency accounting regulation.

However, in my judgment, the Institute can require, as does this proviso, that there be a disclosure of a departure from what the Institute considers to be generally accepted accounting principles.

This proviso is not intended to affect the current practice, recommended by the Committee on Auditing Procedure, of expressing a conventional qualified or adverse opinion covering material departures from generally accepted accounting principles in statements of regulated companies.

Fontaine C. Bradley