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**Washington, D. C. 20549**
(202) 272-2650

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# ARE "COOKED BOOKS" A FAILURE OF CORPORATE GOVERNANCE?

James C. Treadway, Jr.
Commissioner

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

ARE "COOKED BOOKS" A FAILURE OF CORPORATE GOVERNANCE?

Good afternoon. It's a pleasure to appear before the Third Annual Southern Securities Institute.

Today, I would like to try to bring together two topics some might believe to be unrelated. The first is financial statement fraud, or "cooked books"; the second is corporate governance, a topic much discussed during the 1970's but a less fashionable topic for recent discussion

Let me start with a brief review of developments in the "cooked books" area. Financial statement frauds and outright falsifications of books and records are not new. But the problem is persistent, and the new cases are egregious. I previously have stated my belief that many of the new cases result from aggressive and arbitrary demands by top corporate management that subsidiaries and divisions achieve unrealistic profit goals, compounded by poor communications between corporate headquarters and divisions. The resulting atmosphere seemingly tolerates or encourages reporting profits, even if they do not exist. My criticism has a three-pronged foundation: (1) the pressure to achieve unrealistic goals; (2) poor internal communications; and (3) the failure or absence of adequate internal checks and balances in the corporate structure.

Recent cases of "cooked books" have involved major, blue chip companies. Employees who participated in "cooking the books" apparently believed that the manner in which they acted was in the best interests of the company. In some cases, it was an admitted feeling of "team effort" rather than an effort to realize immediate personal gain, such as from theft, kickbacks, bribes, or diversion of assets.

Another noteworthy aspect of these cases is the lack of creativity in "cooking the books." The methods are simple: pre-recognize revenue; falsify inventory; ship without invoices or issue invoices without shipping; and play games with a variety of expenses. Sometimes inventory figures have been total concoctions. Sometimes third parties, such as suppliers, have been enlisted to defer or redate invoices. But creativity has been almost totally missing. Indeed, the methods have been so crude that I wonder why the participants thought their activities would remain undetected for any length of time.

The third feature of these cases, which may be the single most significant factor, is the organizational structure of the companies involved. I refer to a decentralized corporate structure, with autonomous divisional management. Such a structure is intended to encourage responsibility, productivity, and therefore profits -- all entirely laudable

objectives. But the unfortunate corollary has been a lack of accountability. The situation has been exacerbated when central headquarters has unilaterally set profit goals for a division or, without expressly stating goals, applied steady pressure for increased profits. Either way, the pressure has created an atmosphere in which falsification of books and records at middle and lower-levels became possible, even predictable. This atmosphere has caused middle and lower level management and entire divisions to adopt the attitude that the outright falsification of book and records on a regular, on-going, pervasive basis is an entirely appropriate way to achieve unrealistic profit objectives, as long as the falsifications get by the independent auditors, who are viewed as fair game to be deceived.

Some have attributed "cooked books" to difficult economic times, and hard times undoubtedly may play a role. But closer review reveals that "cooked books" have occurred during good years as well as lean. That suggests that we may have seen only the proverbial tip of the iceberg and that recent hard times may yield an increase in these cases. That is a distressing thought.

With that general background, let me very briefly discuss three cases: Heinz, McCormick and Ronson. In May, 1980, Heinz filed a Form 8-K Current Report, which detailed Heinz's Audit Committee's investigation of questionable accounting practices and restated financial statements previously filed with the Commission. The falsifications at Heinz occurred over a seven year period (which was relatively profitable) and shifted millions of dollars of income from year-to-year, sometimes increasing and sometimes decreasing reported income. For example, the falsifications increased 1979 reported income alone by $16 million. In late 1982 the Commission sought and by consent obtained an injunction against McCormick and the General Manager of McCormick's Grocery Products Division, barring them from further violations of Sections 13(a) (inaccurate filings) and 13(b)(2)(A) (inadequate books and records) of the Securities Exchange Act of 1934 (S.E.C. v. McCormick & Company Incorporated, et. al., Civil Action No. 82-3614, D.D.C. 1982). The falsifications at McCormick occurred over a four year period and involved an overstatement of revenues by $48 million and income by $4.1 million. Finally, in late 1982 the Commission concluded an administrative proceeding against Ronson Corporation, finding that falsifications occurring at Ronson over a four year period overstated revenues by $6.3 million (Admin. Proc. File No. 3-6191, Rel. No. 34-19212, November 4, 1982).

These three cases have some striking common characteristics:

1. The divisions and subsidiaries were autonomous, with

little or no oversight by headquarters, particularly in the areas of auditing, accounting, and internal controls.

2. Constant pressure was strongly exerted by distant top management on subsidiaries and divisions to achieve profit goals set unilaterally and arbitrarily by corporate headquarters.

3. Communications between divisions and headquarters about the practicability of reaching established profit goals ranged from limited to non-existent.

4. Headquarters and top management created an atmosphere in which sales and marketing functions in the divisions were viewed as more important than accounting and auditing.

5. That atmosphere caused divisional managers and personnel to believe that falsifying or "cooking the books" was the only way to achieve the profit demands, and that this was acceptable to headquarters. The divisional personnel engaged in the improper activities as part of an admitted "team effort." In some instances, divisional employees stated that they believed it a "mortal sin" not to meet the profit goals.

6. No employee involved received any direct personal benefit from theft, bribes, kickbacks, or diversion of assets.

7. The falsifications were large, simple, and direct. Expenses were improperly shifted from one accounting period to another. Goods ready for shipment, sometimes not even manufactured, were accounted for as sales in the current period, even though not actually shipped or manufactured until a succeeding period. False statements were made to auditors. Multiple sets of expense records were kept. Shipping invoices and bills were altered, with third parties sometimes enlisted to assist.

8. The falsifications were undetected by top management, not for brief periods of time, but for years and years. In short, the break-down was systemic.

In light of the number of parties involved in these efforts -- lower-level employees, mid-level managers, officers, directors, and sometimes third parties -- I could go on at length and draw many fine distinctions about the respective liabilities of the various parties. But such an exercise would serve little purpose unless it were to point out a more important problem -- a dysfunction or break-down in corporate structure. That is my focus today -- structure. If corporate managers believe that the corporate structure will tolerate their enhancing the company's reported profitability at the expense of the integrity of the company's

financial statements, "cooked books," a devastating kind of fraud, seems bound to occur in massive proportions.

Before addressing the structure problem further, let me elaborate on my characterization of "cooked books" as "devastating." First, look at the number of parties who ultimately are damaged by "cooked books."

1. Large and small market-place investors in both debt and equity securities of the issuer.

2. Management and directors of the issuer, regardless of the ultimate determination of their individual culpability.

3. Owners of large blocks of stock of an issuer, such as estates or family trusts. As exposure of the wrong-doing occurs, the value of such holdings may drop dramatically and become more illiquid than is normal.

4. Merger partners, who may have overpaid to acquire stock or assets of the issuer.

5. Underwriters who distributed securities for the issuer. Not only may they find themselves named defendants, they may be looked at as the "deep-pocket."

6. Market-makers and retail brokers effecting transactions in the issuer's securities.

7. Auditors for the company, who may find themselves a named defendant, or be the subject of an investigation, or lose a client.

8. Attorneys for the issuer, and perhaps for the under-writers.

9. Financial analysts who gave investment advice about the issuer and its securities relying upon the issuer's financial statements.

10. Employee-stockholders who purchased securities of the issuer directly or through employee benefit plans.

11. The wrongdoing mid- and lower-level employees who, perhaps mistakenly, thought they were following the company line but became scapegoats when exposure occurred.

12. Honest employees and managers who have been denied career opportunities and salary increases.

13. Banks and other institutions which made loans to the issuer on the strength of its financial statements.

14. Suppliers who extended credit to the issuer on the basis of its reported financial viability.

15. The issuer itself, in any number of ways.

16. General investor confidence.

Second, what is the impact of "cooked books" on our system of disclosure, which is largely based on voluntary compliance and minimal governmental interference? "Cooked books" cause false financial statements; if the financial statements are false, it is impossible for the narrative portion of any disclosure document to be accurate; and the entire disclosure process is therefore totally undermined.

So back to the $64 thousand question: what do "cooked books" have to do with corporate governance? Let's briefly describe corporate governance. Corporate governance is an approach to the management of public companies which has as its essential premise the idea that a corporation should institute and enforce adequate controls and procedures to assure that the corporation is operated solely for the benefit of stockholders. Sound corporate governance requires a corporate structure and procedures which will preclude or minimize undesirable activity prior to its occurrence. More specifically, it means independent oversight of management by a Board of Directors which includes independent directors, active and questioning participation in corporate affairs by qualified independent directors, and the use of whatever other mechanisms of oversight -- such as independent Audit and other Committees -- are necessary to assure that all corporate managers are properly sensitive to their paramount duty to stockholders. And the duty of managers to stockholders must surely include accurately accounting to them for the management of the corporate assets by not "cooking the books." To describe the opposite, corporate governance does not mean directors who, by active participation or by a wink of the eye, tolerate "cooked books" or an atmopshere where "cooked books" may occur, nor does it mean an "ignorance is bliss" attitude, nor an attitude that says " don't bother me as long as we're making money." In short, it does not mean directors who don't direct and managers who don't manage solely for the benefit of stockholders.

In the three cases I discussed, two structural problems

seem to exist which resulted in a failure of corporate governance. First, information about improper or illegal behavior failed to reach top management, or the Board of Directors, or the Audit Committee for years before the crises broke. The human tendency to avoid telling a superior what he does not wish to hear may be understandable, but that demonstrates a structural weakness, which is the inhibition against unfavorable information being communicated upward. Second, the Directors and senior management apparently failed to convey to others the need for accurate accounting, compliance with the securities laws, and the elimination of improper or questionable activities. Yet, common sense alone tells us that a decentralized corporate structure, where the burden of operational decision-making shifts from senior to middle level management and lower, is precisely the kind of structure where these two structural shortcomings are most likely to occur. Therefore, it is precisely the kind of structure where good internal controls and good communications assume the utmost importance. In other words, sound corporate governance is simply good business sense.

The 1970's sensitive payments cases seem to have arisen from many of the same circumstances which have caused "cooked books." These include competitive pressures, the inevitability of operating "close to the line" in some areas of the law, the difficulty of breaking with tradition and resisting long established operating practices, top management's isolation from operations, an inability or unwillingness of top management to monitor or scrutinize activities at these levels, and perhaps some insensitivity to signs of illegality. In both types of cases perhaps a general observation can be made that the Board of Directors -- and particularly the Audit Committee -- was not sufficiently active and questioning.

To conclude my answer to the question as to what corporate governance has to do with cooked books, I have three responses. First, corporate governance is another term for sound corporate management, or a back-to-basics approach emphasizing open lines of communication and adequate internal controls. Second, I question whether it can be said that a corporation is soundly managed or properly governed if "cooked books" occur year-after-year. Third, corporate governance need not always be associated with the exotic or with social objectives, as it perhaps was in the 1970's.

So what needs to be done? Can corporate governance be improved to prevent "cooked books"? If so, can it be done within the existing statutory and regulatory framework? Or are new procedures and tools needed?

Let's discuss some ideas about improving corporate

governance in a fashion which could reduce "cooked books."

1. As a general proposition, would corporate procedures and controls, and therefore corporate governance, be improved and enhanced if the accountability of individuals for violations of the securities laws were increased? Presently, alleging violations by individuals may require the construction of an aiding and abetting or other secondary liability theory. Would an increase in individual accountability cause individuals at all levels in the corporation to insist that the corporation institute and enforce controls and procedures which would cause the corporation to be governed in such a way as to preclude or minimize violations such as "cooked books"?

2. More specifically, Section 13 of the Exchange Act, the section requiring accurate and adequate annual and periodic reports, refers only to the issuer as having an obligation. Should Section 13 be amended to confer upon the Commission express authority to proceed directly against individuals who cause, aid and abet, or contribute significantly to an issuer's violation? If so, should this expanded prosecutorial power be available in lieu of naming the company as a defendant, on the theory that injunctions against issuers sometimes are cumbersome and may damage the corporate entity and therefore innocent stockholders? Or should it be merely an additional tool?

3. Should Sections 10(b) and 14 of the Exchange Act be similarly revised?

4. Should the Exchange Act be amended to add a provision similar to Section 9 of the Investment Company Act of 1940, which automatically bars a person who has been enjoined from violations of the federal securities laws from serving as an officer, director, or employee of a registered investment company. Do today's publicly-owned corporations have characteristics which make it appropriate to distinguish them from investment companies?

5. Rule 2(e) of the Commission's Rules of Practice authorizes the Commission to bar professionals from practicing before the Commission upon making certain findings. One of the predicate acts is the entry of an injunction against an individual for violations of the federal securities laws. If an individual is found to have violated the securities laws, such as by participating in "cooking the books," and is enjoined, should the Commission have additional authority to institute a Rule 2(e) - type administrative proceeding against such a wrongdoing individual with a view toward barring such person, totally or in part, from acting as an officer, director, or senior employee of a public corporation?

6. Section 15 of the Exchange Act establishes an elaborate scheme of supervisory responsibilities for registered broker-dealers and their employees with a view toward preventing violations of the federal securities laws. Should all publicly-owned companies be subject to a similar requirement, so that the Commission, after an administrative proceeding, could bar, suspend, or impose limits on the activities of individuals within a corporation who failed to discharge their supervisory duties?

7. Bank regulatory authorities now have the power, in summary fashion, to bar certain persons from serving as officers or directors of a bank. This can include those who have contributed to unsafe and unsound banking practices. Sometimes these bars can be entered immediately, prior to a hearing, with the aggrieved party having the right to a hearing afterwards. Should the Commission have any comparable authority, even if limited?

I have posed all of the above ideas with a focus on increasing the accountability of individuals within a corporate structure and thereby improving corporate governance and structure and dealing with the insidious problem of "cooked books." Granted, the adoption of such ideas also would represent expansions of the Commission's enforcement tools and capabilities. But the by-product could be a clear and resounding demand by such individuals that corporations be structured and governed in a way as to avoid violations and therefore individual liabilities. The criticism has been leveled that injunctions, particularly against corporations, can be a "meat-axe" approach, injuring innocent stockholders. If that criticism is valid, perhaps more refined, surgeon-like tools should be placed in the Commission's hands.

To be sure, there may be some arguments to the effect that the Commission should continue with the injunction as the primary tool, with the focus first and foremost on the issuer. In the interest of fairness, let me identify a few:

1. Although cumbersome, an injunction is a judicial process. It therefore is inherently fairer than an administrative proceeding. That argument undercuts broader powers to institute any type of administrative proceedings, whether against individuals or corporations.

2. In the case of injunctions, focusing upon the corporation as the primary offender represents a realistic recognition that individual responsibility within a corporation is often diffuse and the Commission cannot always identify with certainty and fairness the wrongdoing individuals.

3. Should the Commission attempt to ferret out all individual wrongdoers and determine who should be sued for what? Doesn't the imposition of primary responsibility at the corporate level force the corporation to police those under its institutional umbrella and therefore involve less governmental intrusion into internal corporate affairs in the long run?

4. If the Commission were to pursue wrong-doing individuals rather than the corporation, would not the company endure far longer and greater disruption while the Commission prolonged its investigations and continued to pour over corporate records and transactions for long periods of time?

5. If the concept of greater individual accountability were adopted, would that result in defendants who are less sophisticiated or are represented by less sophisticated counsel being sacrificed as scapegoats?

As I said, all of these ideas are enforcement-oriented, in that they would impose individual liability as a means of improving corporate procedures and governance. I will stop with that for today, other than to observe that structural approaches to corporate governance are likewise available.

I have attempted to deliver these remarks in a netural tone, without necessarily advocating any of the suggestions or taking sides on the debate about individual vs. corporate responsibility. But there is much debate today about the Commission's enforcement powers and tools. "Cooked book" cases are proliferating; we can expect to see more. I believe the time is ripe to consider the inter-related problems of "cooked books," corporate governance, and enforcement techniques.

With those thoughts in mind, I will close. I hope my comments will serve to prompt debate and discussion.

Thank you.