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

News Release

Address to

The SEC Institute
ANNUAL SEC REPORTING FORUM

Sheraton Grand Hotel
Washington, D.C.

December 9, 1985

ENFORCEMENT AND THE IN-HOUSE PROFESSIONAL

David N. Powers
Counsel to Commissioner Aulana L. Peters

The views expressed herein are those of Mr. Powers and do not necessarily represent those of the Commission or other members of the staff.

ENFORCEMENT AND THE IN-HOUSE PROFESSIONAL

Before I begin, I would like to pass along Commissioner Peters' regrets that she cannot be here to speak to you today. I can assure you that neither the SEC Institute nor Commissioner Peters nor I got you to this conference with a "bait and switch" tactic, promising a luncheon speech by an SEC Commissioner and delivering instead a speech by one of her assistants. To those of you who think you've been short-changed, I would ask you to look on the brighter side, which is that you are about to hear something that hasn't been heard in Washington for many years -- that is a speech given by the person who prepared it!

My remarks today cover a relatively narrow, but nevertheless very important topic: which is the responsibility of corporate officials to maintain a high level of professionalism and thereby ensure that financial disclosures fairly reflect their companies' financial condition and results. My remarks are directed specifically at those who have substantial responsibility for financial disclosures within a company, but who may nevertheless not be at the highest levels of management.

In most public companies, the responsibilities for financial reporting and disclosure are now distinctly segregated between management and the independent auditor. Direct responsibility for the preparation of financial statements rests with management. Thus, management must be prepared to support the accounting measurements used in connection with those statements. On the other hand, the auditor challenges and evaluates management's basis for those measurements. While the Commission has continuously stressed the importance of the independent audit to the

financial reporting process, it has by no means intended to minimize the significant, indeed the primary, role played by management, especially CFO's and other managerial accountants who have firsthand knowledge of the factual basis for the financial statements. The Commission insists therefore, and reasonably I believe, that management apply the method of accounting that most appropriately reports the substance of a particular transaction. Unlike the independent auditors who necessarily must rely on sampling techniques and materiality factors as the basis for their opinions, management should ensure that each and every transaction is accounted for properly according to its substance.

Nevertheless, the pressures on executives and in-house accountants are quite different from the pressures on independent auditors. An independent auditor who displeases a client may lose just that -- a client -- whereas the in-house professional who displeases his employer may lose his job. The in-house professional is under pressure to be a team player and not "rock the boat." A February 1985 article in Management Accounting 1/ captured the essence of the problems facing company accountants in the following quote, but these thoughts apply also to middle-level company executives dealing with more senior management:

1/ Morgan, Soroosh and Woelfel, "Are Ethics Dangerous to Your Job?", Management Accounting, February 1985, at 25.

> Each day management accountants face issues testing their ethical responsibilities. How should [a company accountant] react when told that the business wants to show a certain profit and it is in his job to juggle the books so that a profit figure can be reported? What is his duty in this situation?"

I can assure you that although there is sympathy and understanding at the Commission for executives and in-house accountants subject to those pressures, the Commission expects all company executives and in-house accountants to act ethically and lawfully, and to strive toward high standards of professionalism.

Let me digress a minute to try to convince you that what I have just said is not idle posturing on my part. It is my personal opinion that when bringing financial fraud cases, the Commission now is more willing than it has been to name not just the company, or perhaps one executive in its complaint or order. Instead, the Commission now is quite willing to name all of those who aid and abet the misconduct, even if the impetus for that misconduct comes from others. For example, in the recent Pepsico case 2/, which involved among other things "cooked books" by one of Pepsico's subsidiaries, the Commission named five of the subsidiary's employees who participated in falsifying the subsidiary's financial statements, even though one vice president was clearly the driving force behind the misconduct.

How then should such professionals react to demands by others to set aside good judgment in favor of creativity in preparing

---

2/ SEC v. Pepsico, Inc., Litigation Release No. 10807 (July 1, 1985); Accounting and Auditing Enforcement Release No. 65 (July 1, 1985).

financial statements? The answer is easy. The answer is that company executives and accountants must remain independent and refuse to do so.

All in-house professionals have a responsibility, first to themselves, but also to the company's shareholders and the investing public to resist complying with improper suggestions or orders. The Commission realizes, of course, that the fair presentation of financial information is often a question of judgment and that is why we have Generally Accepted Accounting Principles rather than hard and fast rules. However, there are limits to the flexibility allowed. When an executive is setting those limits in the face of resistance by his superior, he can be guided by the Standards for Ethical Conduct for Management Accountants, as adopted by the National Association of Accountants. The standards impose upon management accountants a responsibility (1) to be objective, (2) to disclose fully all relevant information to the user of financial information and (3) to communicate favorable, as well as unfavorable, information and professional judgments. If everyone adheres to these standards, the risk of not being independent should be substantially reduced. After all, a company is not likely to bid an employee adieu if it expects his successor to support his opinion.

This leads me to my next topic relating to professionalism -- opinion shopping. Last year, 523 publicly held companies changed auditors, which is 9% more than the number of companies that changed auditors in 1983 and 75% more than the number that

changed auditors in 1981. Of course, the great majority of the changes probably result from ever increasing competitive pressures within the accounting profession, rather than from any sinister motive, such as trying to find an auditor unquestioningly amenable to management's views. There is no question that companies today are more willing to change auditors because they are finding better services and lower costs elsewhere, and there is no question also that the accounting firms are becoming more entrepreneurial as mergers reduce the number of potential clients. Let me assure you that there is widespread awareness at the Commission of the factors that drive publicly held companies to switch auditors. Nevertheless, there is also, I believe, a widespread feeling at the Commission that opinion shopping is too often the reason that companies change auditors.

Let's look quickly at two recent SEC enforcement cases involving opinion shopping. Last April, the Commission settled a Section 15(c)(4) administrative proceeding with Broadview Financial Corporation, 3/ a large savings and loan holding company. The case involved the overstatement of revenue and net income in reports filed with the Commission. Broadview included in revenue a $4 million fee that it received in connection with the sale of an undeveloped tract of land. Broadview provided a loan to finance the purchase of land and the $4 million

---

3/ In the Matter of Broadview Financial Corp., Securities Exchange Act Release No. 21949, (April 17, 1985).

fee came directly from the loan proceeds. When Broadview informed its auditors of the transaction, it failed to disclose the true source of the $4 million fee. Not surprisingly, after the facts became known, the auditors indicated that a restatement was in order. Broadview resisted and "shopped" four other "Big Eight" accounting firms in search of a favorable opinion concerning its desired accounting treatment for the transaction. The search ended, needless to say, on the doorstep of a firm that was willing to endorse Broadview's desired accounting treatment.

The second case I would like to discuss is the Stephen O. Wade case, a 2(e) proceeding against three individual accountants. 4/ In the Wade case, two S&L's dismissed their auditors after a dispute over an accounting treatment for GNMA certificates. The Commission disciplined the accountants who were retained as a result of the "shopping" after concluding that the S&L's accounting treatment was not in accordance with GAAP. The egregiousness of the case was highlighted by the fact that the successor auditors never inquired as to why their predecessors disagreed with the S&L's accounting treatment.

As many of you know, the Commission's regulations require registrants to report any change in auditors on Form 8-K and in certain proxy statements. You can rest assured that the Commission's staff actively monitors all disclosures about changes in auditors, and investigates those that appear to indicate possible problems.

4/ In the Matter of Stephen O. Wade, Ralph H. Newton, Jr., and Clark C. Burritt, Jr., Securities Exchange Act Release No. 21095 (June 25, 1984).

Why has opinion shopping been targeted as an important part of the Commission's regulatory effort? Why shouldn't publicly held companies be able to change their auditors at will, regardless of the reasons for doing so? I'll be succinct in my answer. (1) Objectivity. (2) Integrity. (3) Perception. As the Commission noted recently, these three principles are the "cornerstones" of the accounting profession, each of which is necessary to ensure that a review of a client's accounting treatment is accepted as being fair and impartial. 5/ If the manner in which a company changes its auditors restricts the independence of the new auditors or calls into question their objectivity, the public's belief in the integrity of (1) the financial markets, (2) the issuer's financial statements and (3) the auditor's independence -- will be eroded.

How then, should the Commission deal with the problem of opinion shopping, aside from enforcement actions and the present 8-K disclosure requirement? The Commission's staff currently is considering a number of initiatives that are aimed at curbing the effects of opinion shopping through disclosure, and we welcome and seek your input into that process. 6/ One option is an expansion of the 8-K disclosure requirement to include disagreements occurring during the two years prior to an initial public offering. Another option is increasing the required disclosure about situa-

---

5/ Id.

6/ Request for Comments on "Opinion Shopping," Securities Act Release No. 33-6594; Securities Exchange Act Release No. 34-22197 (July 1, 1985).

tions in which accountants are asked to give opinions on accounting issues outside the normal course of an audit.

The private sector is focusing on opinion shopping as well. The Auditing Standards Board is considering the need for guidance where an auditor is asked to provide "generic letters" to parties that are not audit clients. Also, the SEC Practice Section has a task force on professionalism to study ways in which peer review or other membership requirements could be made more responsive to the concerns raised by opinion shopping. I applaud these initiatives, but I would point out that the first line of defense against opinion shopping is in the companies themselves that are doing the "shopping," and especially in the ranks of company executives and in-house accountants who deal directly with the independent auditors.

Let me conclude by saying that I believe the Commission through its disclosure requirements and enforcement actions is insisting upon integrity and independence on the part of all company executives and accountants. Nevertheless, the Commission cannot force those qualities upon company executives and accountants who are not committed to them. I hope all of you leave this program not only with a greater knowledge of the latest developments in the SEC's regulations, but also with a greater appreciation for the underlying purposes of fair and accurate financial disclosure. With those underlying purposes in mind, I hope you will leave this program with a renewed commitment, whatever your personal role may be, to maintaining the integrity of our financial disclosure system.

Thank you for your attention.