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The Accounting FUNCTION

... Under The Spotlight

and

Under Pressure

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Commissioner

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

The Spotlight

A bright spotlight shines today on the accounting function. Note that I said the accounting function, not the accounting profession. That does not mean that the profession is not under a spotlight -- it is. But the spotlight is also on others -- issuers, officers and employees of issuers who are involved in financial reporting matters, Boards of Directors, Audit Committees, and investment bankers. Even we regulators share the spotlight.

Who turned on this spotlight? How revealing is its glare? Listen to a few indications.

1. A recent BusinessWeek article discussing Commission enforcement actions in the financial reporting area was entitled "The SEC Turns Up The Heat On Cooked Books." 1/ An article in the Economist, talking of Commission accounting-related enforcement cases, characterized the Chairman of our Commission as a "crusader." 2/

2. The Wall Street Journal has reported that the chairman of a large accounting firm "seriously questions" (anonymously, I should add) whether the Financial Accounting Standards Board "is going to make it." 3/

3. Reporting recently on the possible merger of Price Waterhouse and Deloitte Haskins & Sells, the New York Times described the combination as "a common response to the wave of change and rampant competition that has swept public accounting in recent years." The Times added: "It is unlikely to be the last." 4/

4. The number of enforcement actions brought by the Commission during fiscal year 1984 based upon accounting irregularities was four times the number of insider trading cases. From 1983 to 1984 the number of accounting cases increased by approximately one-third. It is a rare week when some accounting matter does not come before the Commission in an enforcement context.

5. Concern is widespread about the adequacy of loan loss reserves of depository institutions. Witness an article in this past Wednesday's Wall Street Journal, "Bank Results for 3rd Period

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1/ Bus. Wk., Sept. 3, 1984, at 63.

2/ Economist, June 30, 1984, at 67.

3/ Wall St. J., April 30, 1984, at 1, col. 6.

4/ N.Y. Times, Oct. 3, 1984, at D1, col. 3.

Reflect Boosts in Reserves for Loan Losses." 5/ The Commission has demonstrated less reservations than in the past about bringing accounting-based enforcement actions against depository institutions.

6. Donald J. Kirk, Chairman of the Financial Accounting Standards Board, is concerned that the credibility of our entire system of corporate governance is at stake: "The long-run interests of those who believe in our economic system require recognition that responsible, credible financial reporting is inseparable from responsible corporate performance." 6/

7. Amidst all this, along with some highly publicized audit failures, the Supreme Court only a few months ago described the special role of the accounting profession in the loftiest of terms:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to [the] investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations. 7/

8. A Congressional Committee will hold public hearings on accounting in late 1984 or early 1985. These hearings will be the most farreaching and searching since the Moss-Metcalf hearings of the 1970's.

I could go on and on, but these examples make my point -- the accounting function is undergoing a microscopic examination with a critical focus. At the outset you might ask why a Commissioner who is a lawyer travels almost across the country to talk about accounting to an audience composed mostly of lawyers? I cannot think of any subject that ought to receive greater attention by the Commission and by anyone else involved in the the disclosure process. Financial statements are the foundation of our disclosure

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5/ Wall St. J., Oct. 17, 1984, at 4, col. 1.

6/ Address by Donald J. Kirk, "Standards and Other Requisites of Professionalism" (April 26, 1984).

7/ United States v. Arthur Young & Co., No. 82-687, slip op. at 11 (March 21, 1984) (emphasis added).

system -- in the words of the Supreme Court "one of the primary sources of information available to guide the decisions of the investing public." 8/ If their integrity is undermined, for whatever reason, the entire disclosure process is corrupted.

Sources of Pressure and Some Recent Commission Accounting Enforcement Actions

The spotlight has revealed that many complex pressures affect -- and therefore potentially may undermine -- the accounting function. The pressures include:

Issuers whose corporate structure and environment quietly or aggressively encourages a corporate attitude that auditors are adversaries and fair game to be deceived;

Corporate managers who allow management-by-objective, or unchecked ego, or more venal reasons to compromise accurate financial reporting;

Boards of Directors and Audit Committees that are not sufficiently diligent, or sufficiently sensitive, to detect the warning signs of institutional flaws and pressures and even outright cooked books;

Investment bankers and financial advisers who aggressively market transactions known to be at the outer edge of accounting acceptability, taking the attitude that accounting standards are made to be avoided -- even the most minute difference is enough to justify the desired accounting treatment -- regardless of the spirit and general intent of the standard, as long as the deal gets done and the fee collected;

Multiple regulatory bodies that take conflicting approaches to accounting matters, and individual regulatory bodies that sometimes take internally inconsistent positions; and

Congress itself, when it adopts laws like the banking laws, which embody a protectionist philosophy that inevitably is bound to result in slowness to recognize losses and other accounting liberalities for fear of loss of public confidence.

At this point, perhaps I should acknowledge that our Commission is partly responsible for the current spotlight. Among other things, Commission enforcement actions involving financial reporting over the past two years have been widely publicized. My focus today is much broader, but a few recent cases deserve brief comment.

8/ Id. at 4.

Especially Insidious Activities

The first two cases are noteworthy because the activity involved exerts an especially insidious pressure on the accounting function.

Opinion Shopping. The first case involves "opinion shopping." The mere fact that opinion shopping occurs encourages to some extent a belief among issuers and disgruntled executives that this form of pressure is an effective, legal, and acceptable way to bludgeon accountants into submission on disputed accounting issues. If the public were even to perceive that opinion shopping is widespread -- regardless of whether it achieves the end result sought by those who engage in such activity -- public confidence would be severely damaged. Think back to the Arthur Young decision, which also said:

> It is therefore not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. 9/

Let's consider a specific instance of opinion shopping and the outcome. In October, 1983 two North Carolina savings and loan associations purchased certain GMNA certificates and "hedged" their positions by selling futures contracts for U.S. Treasury bonds. A sharp decline in interest rates slightly increased the value of the GMNA certificates, but caused a relatively large decline in the value of the Treasury bond futures. In closing out their positions so as to be able to reinvest in other GNMA certificates, both associations stood to suffer significant net losses.

Seeking to avoid immediately recognizing the loss by adding it to the basis of the new GNMA certificates being purchased and amortizing it over time, the two associations talked to their respective independent auditors about the appropriate accounting treatment. Each received the same ultimate answer -- based on industry practice and the accounting literature, the loss was required to be recognized immediately rather than being deferred and amortized.

Immediate recognition of the net loss would have had a material adverse impact on each association's financial statements. 10/ The

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9/ *Id.* at 13 n.15.

10/ For its fiscal year ended December 31, 1982 one association reported net income of $248,149; if it had recognized its full losses rather than deferring them, it would have reported a net loss of $1,934,940. The other association, in its quarterly reports for the three and six months ended December 31, 1982, reported net income of $166,522 and $193,450, respectively; if it had recognized its full losses rather than deferring them, it would have reported net losses of $1,179,134 and $1,152,206, respectively.

associations responded by shopping, and eventually found an accounting firm that would concur in the desired treatment. Each association dismissed its existing auditors and retained this firm, which in turn issued an unqualified opinion allowing the deferral and amortization of the losses.

The Commission first instituted an enforcement proceeding against the two associations, obtaining a restatement of their financial statements which immediately recognized the full loss. 11/ In June, 1984 the Commission instituted a Rule 2(e) proceeding against three individual accountants who were partners in the successor accounting firm. 12/ The Commission's order concluding this proceeding found that the three partners involved had engaged in improper professional conduct. The order effectively bars two of the individual accountants from being involved, for three years, in any audit engagement of any company whose financial statements are reasonably expected to be filed with the Commission. The third partner was not barred, but only because he had represented that he is not, and does not intend to be, involved in consulting on engagements involving public entities. The Commission censured all three for improper professional conduct.

The Commission's order stressed an accountant's obligation to maintain integrity, objectivity, and independence -- the "cornerstones" of professionalism. The Commission stated:

> It is even more important that these fundamental qualities be maintained with respect to prospective clients to avoid the appearance of "opinion shopping." Before being engaged, and knowing that two other firms of independent auditors had been replaced when they failed to accept the savings and loans' futures accounting treatment, the [accounting firm's] partners informed the savings and loans that they would support the proposal of the savings and loans to defer the futures losses. Once retained, the [accounting firm's] partners caused the issuance of the unqualified opinion and review report on financial statements which improperly deferred material futures losses and thus were not presented in accordance with GAAP. Knowingly rendering an unqualified opinion on such financial statements constitutes improper professional conduct under any circumstances.

11/ See *In the Matter of Accounting for Gains and Losses Incurred in Connection with Certain Securities Transactions*, Securities Exchange Act Release No. 20266 (Oct. 6, 1983).

12/ *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). The defendants consented to the entry of the order without admitting or denying the Commission's allegations.

And then there is this final sentence:

> Such conduct is especially egregious when it occurs in the context of a change in independent auditors.

Third Party Collusion. The second especially insidious activity is third party collusion. In June, 1984 the Commission sued The Barden Corporation and one of its vice-presidents for aiding and abetting violations by United States Surgical Corporation 13/ of the anti-fraud, reporting, and accounting provisions of the Securities Exchange Act of 1934 ("Exchange Act"). 14/ The Commission alleged that during 1981 and 1982, Barden, a supplier to Surgical, 15/ and Barden's vice-president, acting on instructions from Surgical, substantially assisted Surgical in engaging in accounting shenanigans which materially overstated Surgical's earnings and financial condition. The Commission alleged that Barden and the vice president

- °° caused Barden to submit invoices to Surgical that falsely stated that over $1 million of stapling instruments was instead attributable to the cost of certain capital equipment, namely dies;
- °° provided false information to Surgical's auditors about the invoices; and
- °° falsely confirmed in writing to Surgical's auditors that charges for stapling instruments were, as Surgical falsely claimed, charges for capital items.

At first blush, some might view it as harsh for the Commission to bring an enforcement action against a third party whose own financial statements were accurate and who did not profit from the misdeeds. I will state the opposite view -- such collusion and deception by a supposedly independent third party, such as a supplier, is particularly devastating. The auditor of

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13/ See SEC v. United States Surgical Corporation, Litigation Release No. 10293 (Feb. 27, 1984).

14/ SEC v. The Barden Corporation and Robert P. More, Litigation Release No. 10433 (June 26, 1984). The defendants consented to the entry of the injunction without admitting or denying the allegations in the Commission's complaint.

15/ Barden manufactured surgical staples and dies for Surgical. The Commission alleged that during 1980, 1981 and 1982 Surgical accounted for approximately 40% of the revenues of one Barden division and a greater percentage of the division's profits. During the same period, the division accounted for approximately 15% of Barden's revenue.

one company cannot be a guarantor of the honesty of third parties with whom the audit client deals; it is sufficiently difficult for auditors to detect skillful, deliberate fraud by their own audit clients. Enforcement proceedings against all who participate in such activity is wholly warranted.

Pressures From Improper Revenue Recognition Techniques

Improperly accelerated revenue recognition is a recurring activity which puts substantial pressure on the accounting function. Sometimes the schemes are mundane -- merely treating unshipped and unordered products as having been sold. Some of the techniques are more complex, as shown by two recent cases.

In October, 1984 the Commission alleged that Chronar Corp. improperly recognized revenue 16/ from two transactions. In one transaction, Chronar recognized $1.8 million in revenue, about 81% of total reported revenue, from the purported sale of a technology manual to a Swiss corporation. This revenue recognition violated generally accepted accounting principles because (1) the contract in substance actually related to a prospective sale of machinery and equipment, thus the transaction was a disguised present sale of technology, (2) there were substantial uncertainties with respect to collection, and (3) there were doubts about Chronar's ability to satisfy certain performance guarantees relating to the equipment. These uncertainties prevented the earnings process from being complete.

Chronar also had recognized revenue of $858,869 for the nine months ended December 31, 1983, representing approximately 62% of total reported revenue, from sales made to a joint venture composed of Chronar and a glass manufacturer. The revenue recognition was premature for essentially the same reason -- the earnings process was not substantially complete. Among other things, Chronar (1) had agreed to purchase all output of the joint venture, (2) had guaranteed certain performance levels of the plant, and (3) gave the glass manufacturer the option to require Chronar to assume all debts and obligations of the joint venture and of the glass manufacturer with respect to a $5,000,000 issue of bonds which financed the construction of the plan. Even though Chronar's revenue recognition violated generally accepted accounting principles, the transactions were more creative than merely counting as sold equipment still in the factory, an activity we have seen frequently.

In August, 1984 the Commission charged that Stauffer Chemical Co. 17/ overstated its 1982 net earnings by $31.1 million,

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16/ SEC v. Chronar Corp., Litigation Release No. 10552 (Oct. 3, 1984). The offering has not taken place. The company consented to the entry of an injunction without admitting or denying the allegations in the Commission's complaint.

17/ SEC v. Stauffer Chemical Company, Litigation Release No. 10493 (Aug. 13, 1984). Stauffer consented to the entry of an injunction without admitting or denying the allegations in the Commission's complaint.

representing 25% of reported net earnings, through improper revenue recognition. Certain of the activities related to Stauffer's use of the LIFO method to value domestic inventory. 18/ Until 1982 Stauffer divided its LIFO inventory into eight "pools." In early 1982 the inventory pools were realigned into 280 smaller product categories, colorfully called "puddles." The separation of pools into puddles allowed the more rapid liquidation of lower-cost inventory and thus increased reported earnings artifically. Various presentations to company personnel explained ways to realign the LIFO "pools" into "puddles" to maximize the likelihood and magnitude of LIFO liquidations. Company personnel were urged to use the "puddle strategy" to maximize the positive earnings impact. The overall effect was a $3.3 million overstatement of net earnings for 1982.

The Commission also alleged that one division of Stauffer which did not use LIFO accepted inventory shipments from another division which used LIFO. These shipments were not based on firm customer orders and were above levels that the receiving division normally would have taken in one year (based on their sales forecast for the forthcoming year). The Commission alleged that Stauffer moved the inventory to create LIFO liquidations, and thus increase 1982 earnings (by approximately $2.6 million), but failed to eliminate in consolidation the earnings resulting from the liquidation.

18/ The Commission also alleged that Stauffer prematurely recognized $72 million of revenue by treating product shipments that were tantamount to consignments as completed sales, despite uncertainties about the volume of returns. For several years, Stauffer had made product sales under an "Early Order Program." Distributors ordered and received product during the fourth quarter of one year for resale to their customers during the following year. Until 1982, invoices were sent to distributors and payments were received by Stauffer during the first quarter of the next fiscal year. Stauffer reevaluated and modified the Early Order Program when sales for its 1982-83 season appeared in decline. Products shipped were invoiced on an accelerated basis in the fourth quarter of 1982 rather than in the first quarter of 1983. Stauffer in turn recognized revenue of $72 million in the fourth quarter of 1982 that otherwise would have been recognized in 1983. The Commission alleged that this revenue recognition violated generally accepted accounting principles, since the $72 million in sales were tantamount to consignments and not completed sales. Uncertanties as to the amount of returns from the consignments prevented the earnings process from being complete, which is required under generally accepted accounting principles for revenue recognition.

Financial Institutions and Sham Transactions

One additional enforcement case merits brief discussion, because it involves a distressed industry and shows the extremes to which some may go in structuring sham transactions which undermine accurate financial reporting.

In August, 1984 the Commission and the Comptroller of the Currency jointly sued Charles D. Fraser, the former chief executive officer of the First National Bank of Midland, Texas, 19/ alleging that the bank's financial statements for the nine months ended September 30, 1982 contained material overstatements due to inadequate loan loss reserves and failed adequately to disclose risks associated with loans outstanding. Those items are not new; the Commission has been focusing on those areas. But the bank also recognized a $35.6 million gain on the sale-leaseback of its main facilities. As payment, the bank received two letters of credit from the newly created limited partnership purchaser -- composed primarily of bank customers -- and personal notes from the limited partners. No cash whatsoever was paid. The bank recognized gain based upon a sales price of $75 million, which exceeded the market price of the properties. In turn, the bank agreed to pay rent to the limited partnership in excess of the fair market rental value of the property. Such revenue recognition violated generally accepted accounting principles because (1) the terms of the transaction were not sufficiently determined; (2) the collectability of the sales price was not reasonably assured, due in part to the over-valuation of the properties; (3) the risks and rewards of ownership were not sufficiently transferred to the partnership; and (4) the limited partnership did not make an adequate initial investment. In other words, this was a sham transaction.

Conclusion and Some Thoughts About Professionalism

That is enough about specific enforcement cases -- this is not really an enforcement speech. I began by talking about pressures on the accounting function. I have suggested that the function is being pressured from many quarters. Some pressures are intentionally issuer-generated; some pressures occur because of management stubbornness or adherence to unrealistic goals; some occur because of Boards of Directors and Audit Committees who do not exercise proper care or have adequate sensitivity; and some pressures flow from aggressive marketers of innovative financing techniques which test the outer limits of accounting acceptability. It is crystal-clear that

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19/ SEC and Office of the Comptroller of the Currency v. Charles D. Fraser, Litigation Release No. 10512 (Aug. 30, 1984). Mr. Fraser consented to the entry of an injunction without admitting or denying the allegations in the Commission's complaint.

non-accountants in various ways apply significant, subtle pressures on the accounting function.

To some extent, the enforcement cases I have discussed -- and others -- reflect those pressures. There is, however, another pressure which is more general and potentially more damaging. Price competition has come to the accounting world, and with a vengeance. One accounting professor asserts: "The audit today is as much a commodity as a gallon of gasoline." 20/ That is not exactly how the Supreme Court described it. Companies and executives do not necessarily view a more expensive or thorough audit as a recognized benefit. One accounting firm is not viewed as magic; fully a dozen or more nationally-recognized firms may be acceptable to executives, financiers, and investors; it's all a matter of cost.

Competition is a bit like the flag; we automatically salute. But competition is a negative force if it erodes the quality of audits -- if it causes the auditors to forego certain tests, to reduce the samples tested, to skimp on certain controls, or to ignore red flags. This pressure strikes me as especially insidious. First, it may be generalized, almost an environmental or cultural pressure, not one which can be directly confronted. Even if it is intentionally generated by the client, it may take subtle and amorphous forms. And finally, clients simply may not care in the short run.

But what if a major audit failure occurs, caused even partly because a firm cut corners to meet competitive pressures. I have no particular case in mind, only a gnawing concern. But that would make pale all our past problems. Isolated audit failures, even standing alone and even if they can be demonstrated to be isolated "people problems," damage the entire profession. What would it be like if we were looking at an audit failure clearly attributable to competitive pressures?

Is there an answer to all these pressures? Donald J. Kirk, the Chairman of the Financial Accounting Standards Board, has said that the only ultimate answer is professionalism, which he defines as a voluntary commitment to achieve excellence and as objectivity and integrity. Mr. Kirk notes concerns that commercialism may be overtaking professionalism in public accounting and wonders whether a tendency has developed to overlook the spirit of accounting standards as long as it can be argued that a transaction is technically covered by the standard. He calls for a return to higher standards.

This call places the issue of professionalism squarely before all of us. Public concerns about the FASB, the Commis-

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20/ N.Y. Times, Oct. 3, 1984, at D1, Col. 3.

sion's enforcement program, the Supreme Court's declarations in Arthur Young, and the forthcoming Congressional hearings all in some way involve the issue of professionalism. But professionalism of the accounting profession standing alone is far from adequate. Responsibility cannot be laid solely at the feet of the accounting profession. Professionalism is required of others. That includes issuers, their executives and directors, and professionals other than accountants who advise issuers. Issuers and their advisers are constantly and successfully striving to develop new financing techniques, and they may stretch current accounting concepts. There is nothing inherently evil in that. But if exotic and aggressive revenue recognition practices and artificially contrived transactions that lack economic substance become totally acceptable means to meet short term goals, professionalism -- which I would define as objectivity and a commitment to the integrity of financial statements -- has been compromised. I doubt that anyone here would quarrel if I stated the proposition that corporate officers and directors stand in a fiduciary relationship to shareholders. Assuming you accept that proposition, is it not the most fundamental and highest obligation of a fiduciary that he should truthfully account to his beneficiaries for management of their assets?

In short, the long term consequences of a lack of professionalism -- a commitment to objectivity, excellence, and integrity -- on the part of issuers and those associated with them may be stark indeed. Does the issuer community really wish to see the government set accounting standards? Does the issuer community really want to negotiate accounting issues in good faith with independent accountants with the federal government even more directly interjected into such negotiations? Does the issuer community wish the good faith judgmental flexibility of accountants to be replaced with more rigid, governmentally imposed controls?

I expect the answer is no. To that end, issuers, audit committees, individual officers and directors, and third party advisers should support the professionalism of which Don Kirk speaks. If professionalism on the part of all parties is not forthcoming, I fear that the Commission's enforcement statistics will mount, to no one's great satisfaction, the spotlight on all will continue to be bright and harsh, and calls for dramatic change and more governmental intrusion into the corporate structure will become more shrill.

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