Remarks by

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The SEC's View on Government and Enforcement Activities

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Institute of Internal Auditors Business Issues and Audit Conference - Exploring the Role of the Audit Committee in a Changing Environment - The SEC's View on Government and Enforcement Activities - Michael J. Kigin

In the interest of full disclosure, and I know you are all aware that the SEC is a full disclosure agency of the federal government, anything I say today is my own view and does not necessarily reflect the views of the SEC or other members of its staff.

You've all heard the old adage - I'm from the government and I'm here to help you - well, today I believe that is true, except perhaps for those very few of you who might start feeling guilty and squirm in your chairs during my remarks. Although the SEC was established by Congress as a law enforcement agency, most of the activities of the Office of the Chief Accountant, and most of the activities of the Division of Corporation Finance, are organized to help registrants report properly and timely using appropriate accounting and disclosure policies.

Three out of four of the Chief Accountant's Office's main functions are help-type functions. Our accounting profession oversight function and our rule-making function are designed to assist in establishing and overseeing the establishment of the accounting principles, auditing standards, disclosure rules and regulations which establish a basis for full disclosure. When a registrant has trouble interpreting those accounting principles or disclosure requirements, our office assists through its review and comment process function.

Our fourth major function is enforcement and that is primarily what I want to speak about today. I've been working in the Office of the Chief Accountant's enforcement program for over 10 years. Basically, my office gets involved with all recommendations that the Division of Enforcement makes to the Commission that involve accounting, auditing, financial disclosure, internal control or

books and records allegations. We advise the Division of Enforcement and the Commission concerning the technical aspects of the alleged accounting and auditing failures. We also assist the General Counsel's office in litigating Rule 2(e) administrative proceedings against accountants who have violated the federal securities laws or who have engaged in improper professional conduct by departing from GAAP, GAAS or the independence rules of the Commission.

Before I get into specific Enforcement activities, let me leave you a word of caution concerning the Corporation Finance review process.

I'd like to put to rest a myth that needs to die. The myth is that the Division of Corporation Finance is in business to do due-diligence reviews for registrants. Obviously, when Corp Fin speaks, registrants listen. But I must warn you, and please pass this on to your financial reporting people, when Corp Fin doesn't speak, your company shouldn't take any comfort in its silence. Corp Fin does not have time to "baby-sit" every filing and jawbone every accounting issue to reflect the best GAAP. If your company has transactions or situations that raise valid questions as to how they should be accounted for, the staffs of both Corp Fin and our office are always willing to listen and provide your company with guidance, when asked, and before a transaction is publicly reported. But if we're not asked and we're expected to bird dog every questionable GAAP or disclosure situation, your financial reporting people may be sadly mistaken. Floating something in with perhaps the hope that the staff won't catch it will not do; your company may be referred directly to Enforcement rather than completing the Corp Fin review process.

Often the question is asked, where do Enforcement cases come from. I've just mentioned perhaps the primary source, referrals from Corp Fin. Other sources of cases are informants - often

former or current employees, customers or shareholders who notice something is not quite right. Enforcement also reads the newspapers and may pick up a case from a financial news writer's critical analysis of a company or from a lawsuit filed by aggrieved shareholders or customers. Change of accountants Form 8-Ks and SECPS Practice Section letters from former independent accountants are closely scrutinized by the Enforcement Division for indications of "opinion shopping" or financial reporting problems and this process has resulted in a number of enforcement actions.

The Commission considers financial fraud to be a top priority. Last year over 50 cases were brought against registrants and their management for financial fraud or disclosure violations. An additional 16 disciplinary administrative proceedings were brought against accounting firms or their partners or employees and 8 disciplinary administrative proceedings were brought against financial or accounting officers of companies following injunctive or cease and desist actions by the Commission. Over 200 cases currently being investigated included allegations of financial fraud, improper accounting practices or internal control problems. The Division of Enforcement's staff of accountants has more than doubled to 20 in the past 2 years (and I must tell you, the average accountant hired by the Division of Enforcement has 8-12 years experience with a Big 6 accounting firm as a manager and knows his or her way around the corporate reporting and auditing processes). Additionally, the enforcement accounting staff in the Commission's 5 regional and 7 district offices has increased by 50% over the same period.

You might say to yourself: there's no way my company is going to get involved in an enforcement proceeding. I'm going to discuss 2 recent cases where it did happen to companies whose top management was basically unaware of what was occurring under their noses and then one recent case where an alleged fraud was fully orchestrated by management. As I review these cases you might

consider how you, as the internal auditor, would have been conducting internal audits or periodic analytical reviews of these companies that would have prevented or detected the alleged illegal conduct. Also, as I review these cases, please keep in mind that they were settled by defendants or respondents who neither admitted nor denied the SEC's allegations.

The first case, which was brought by the Commission about a year ago, involved a subsidiary of Union Corporation, an SEC registrant, and the subsidiary's controller and its CEO. Alberte Barrette and Michael Strauss were the controller and CEO of the subsidiary, Capital Credit Corporation. Barrette and Strauss settled an injunctive action brought by the Commission. The complaint filed with the court by the Commission alleged that management of Union Corp, which wasn't named as a defendant in the SEC action, established budgeted goals for Capital's monthly revenues. The complaint stated that in 1990, when Capital failed to meet its budgeted goals early in the year, Barette and Strauss caused <u>false</u> reports to be made to Union to show that Capital <u>had</u> met its goals. Later in the fiscal year, when things improved, Barette and Strauss allegedly under-reported revenues to Union so that the annual audit would not catch the fraud. All three 10-Qs were false and misleading. When Barette and Strauss realized in early 1991 that revenues once again were falling short of budget, they again allegedly caused false reports to be made to Union which again caused Union's 10-Q's to be materially misstated. According to the complaint, Barette and Strauss were in the process of again <u>understating</u> revenues in late 1991 when Union discovered the fraud, required an investigation by Union's independent auditor and restated the 1990 and 1991 quarterly financial statements. The Commission decided not to charge Union with filing false 10-Qs, but rather charged the two officers at the subsidiary with fraud and with aiding and abetting filing and books and records violations. More importantly, the misconduct cost the two individuals in their pocketbooks. Strauss, the CEO, agreed to pay a $50,000 civil money

penalty and Barrette, the CFO, agreed to pay a $10,000 civil money penalty pursuant to the Securities Enforcement Remedies Act of 1990, which gave the Commission authority to seek such penalties in a number of situations.

The next case involving unaware management was brought by the Commission about six months ago and involved the American Express Co. and Larry Leslie. The case involved Mr. Leslie's conduct as the Director of Credit Operations at a subsidiary of American Express. He allegedly engaged in conduct that, although reprehensible, and involving an over $30 million profit overstatement, did not result in American Express filing materially erroneous financial statements. The Commission alleged that Leslie circumvented established accounting policies and thus prevented the write off on a timely basis of delinquent accounts receivable in order to meet certain budgeted figures established by the subsidiary's management at the beginning of the year. The Commission asserted that Leslie's conduct violated Section 13(b)(5) of the Securities Exchange Act of 1934, which prohibits the knowing circumvention of a system of internal controls. This is the first time Section 13(b)(5) was used in a Commission Enforcement action, but I'm sure it won't be the last. Section 13(b)(5) was added by the Securities Enforcement Remedies Act of 1990. Leslie consented to pay a $10,000 civil money penalty pursuant to that same act.

The third case, and this is one in which most of the company's executive officers allegedly were involved in a huge fraud, was settled by the Commission about a year ago with the defendants and respondents. You may have heard this case referred to as the "tin men" case, named after a Danny Devito film called The Tin Men, because it involved a company that Sears subcontracted much of its aluminum siding contracts through in the 1980's. The company was Amre and the Commission alleged that shortly after Amre went public in 1987 it began to engage in creative accounting (some would call

it cooked books and others just plain fraud). According to the Commission's allegations, the tricks engaged in included the:

Improper deferral of current period expenses

Improper application of the percentage of completion method of accounting by recording revenues prior to any labor being applied to contracts

Improper capitalization or deferral of advertizing costs by inflating the number of advertizing leads

Improper inflation of inventory at period end

Improper inclusion of marketing costs in the percentage of completion equation in 1988 and as deferred costs under the completed contract method in 1989

These accounting frauds allegedly continued over a period from late 1987 to mid 1989. The participants in the scheme involved the Chairman of the Board, the Chief Operating Officer, the Chief Financial Officer, the Comptroller, the Assistant Comptroller, the VP of Data Processing, and a few other unnamed lower-level participants. The Commission filed a cease and desist proceeding against Amre, against the VP of data processing, and against the chief financial officer. You might ask why only a C&D against the CFO? He wasn't hired until the scheme was almost over, but according to the Commission's complaint, did assist the company in hiding the scheme from its independent auditors in 1989. A complaint for injunctive action was filed by the Commission and settled by the Chairman of the Board, the Chief Operating Officer, the Chief Accounting Officer and the Assistant Comptroller. The Chief Operating Officer agreed to pay $1.8 million as part of his settlement of insider trading charges and the Chief Accounting

Officer agreed to pay $16,000 as part of his settlement of insider trading charges.

As long as we are talking about conduct that costs defendants money, let me point out that the Commission has begun to strongly enforce the reporting requirements of Section 16(a) of the 34 Act. Section 16(a) and the rules promulgated thereunder require that insiders (defined broadly as officers, directors and 10% owners of a company's stock) insiders must file forms 3, 4 and 5 to report acquisitions or dispositions of the issuer's securities. The issuer is required, pursuant to Item 405 of Regulation S-K, to report the names of any late or non-filers of these forms. I assume that many of you are charged with monitoring compliance with these rules. Violations of Section 16(a) can be subject to substantial penalties pursuant to the Securities Enforcement Remedies Act of 1990, the same act that gave the Commission authority to issue cease and desist orders and to seek civil money penalties. Just recently the Commission approved an action pursuant to Section 16(a) in which an individual consented to the entry of a cease and desist order and to the payment of a $75,000 civil money penalty and in which 3 companies controlled by the individual consented to cease and desist orders, all for failure to file the appropriate forms 3, 4 and 5. This appears to me to be an area where the internal auditor could be involved in assessing the reliability of a company's system for notifying employees of the requirements and monitoring compliance with the company's procedures.

On another topic, insider trading is still a priority of the Commission. Although the huge dollar insider trading cases against Levine, Boesky and Milken are now history, the Commission continues to investigate and prosecute insider trading cases using former Chairman Shad's infamous "hob-nailed boots" which he was gracious enough to leave behind when he left the Commission. Some cases still involve multimillion dollar alleged profits, but many cases have been brought where the damages were only in the $10,000 -

20,000 range. It is incumbent upon corporate executives and employees to maintain the moral and legal high road and to refrain from trading on inside information. And here is the only black mark I am aware of concerning the conduct of internal auditors. In late 1990 and early 1991, the Supervisor of Internal Audit at the Vista Chemical Company got greedy and began buying "out of the money" call options when he learned various bits of inside information during the course of his duties. Edward Ruggiero, the Supervisor of Internal Audit, was a certified public accountant and former audit staff member for a Big 6 accounting firm, who along with a friend whom he tipped, made almost $900,000 of illegal profits. They settled a Commission injunctive action in April 1992 and disgorged over $900,000 in profits and interest. But even worse, both were criminally convicted of insider trading in June 1993, and were recently sentenced to 30 months and 18 months in jail, respectively. As Mr. Ruggiero found out, breaking the rules could cost you a lot of money and may even result in jail time. It just isn't worth it.

Another area of concern that I want to talk to you about today is the importance of the confirmation process to the conduct of an independent audit. I want to bring up this subject because in many cases someone from your company is the provider or signer of the confirmation. Confirmations are responded to by people in your company, perhaps by people who work for you, or by yourselves. It is important for the integrity of the audit process to assure that your customer's or supplier's auditor is receiving accurate and truthful information, just as you would desire that your company's auditor be responded to in an accurate manner during your company's audit, or you would expect when you send confirmations as part of an internal audit. There have been a number of enforcement cases filed against employees of customers and suppliers for sending false confirmations to auditors or providing false invoices to be used by a registrant to mislead its auditor. Additionally, we have found in a number of investigations that inaccurate information

inadvertently supplied to an auditor in response to a confirmation request gave that auditor comfort when he really should have had a red-flag waved in his face by a properly answered confirmation. So please, in your future internal audit projects, take a look and see if your company's system for responding to audit confirmations will always give the auditor a complete and accurate answer.

When I told George Diacont, the Chief Accountant of the Division of Enforcement, that I was going to speak to you, he said to tell you to keep your eyes open for things that bother him a lot. I've already covered some of those things, but to give you a complete list, I repeat myself:

-- First, as mentioned previously, accommodation arrangements by customers on behalf of registrants, including falsifying receivable and inventory confirmations, or parking securities at year end, or accepting inventory on consignment but allowing the registrant to reflect it as a sale are all unacceptable and illegal practices.

-- Secondly, along the same lines, officers and directors are often charged with lying to the auditors. Not only is making false statements to the auditors illegal, so is making false statements to internal accountants preparing reports that are filed with the Commission. Additionally, the omission to tell an auditor a material fact is also a basis for charging an officer or director of a registrant.

-- Third, most financial fraud cases also involve books and records and internal control violations. <u>And</u>, although it is infrequent, the Commission has brought actions solely on the basis of failure to maintain accurate books and records or adequate internal controls.

-- Another area of Commission interest and concern is the integrity of the quarterly reporting process. As illustrated in the Union Corp case discussed above, enforcement actions are taken frequently for quarterly misstatements of financial information. Additionally, large fourth quarter adjustments

are closely scrutinized by the staff and enforcement action may be taken if it is clear that those adjustments should have been booked in prior periods. (See eg. In the Matter of Excel Bancorp, Inc., AAER No. 316, September 11, 1991)

-- Lastly, proper recording and disclosure of significant contingencies that may affect future periods are looked at closely. This includes environmental contingencies, product liability, and litigation risks, as well as loan loss reserves and reserves for doubtful accounts receivable. Disclosures in the Managements Discussion and Analysis are also examined by the staff in this regard. For some guidance on the staff's views in this area, you might want to read Staff Accounting Bulletin No. 92, issued in June of this year, entitled "Accounting and Disclosures Relating to Loss Contingencies".

Let me close with some suggestions that I believe will assist you as internal auditors, if you are not already doing these things, to do your job better:

-- First, write a charter for your internal audit function that can be adopted by the board of directors and management so that there is no question about who you report to and what your duties are.

-- Second, assure that your reporting chain in the company is through an independent audit committee or an independent member of the board of directors.

-- Third, develop a good working relationship with the external auditor - stay in contact through the year, not just at audit time - read carefully the auditor's management letters and address and resolve the problems cited through the internal audit process, where appropriate.

-- Fourth, encourage the adoption and application of conservative accounting principles. Don't allow your company to be on the leading edge of "creative or cute accounting" for your industry. Know what accounting principles your competitors are using and encourage uniformity in reporting results of

operations in the industry. Question management when it stretches GAAP or goes over the line.

-- Fifth, and last, keep handy, and provide to each of your auditors, a phone list that contains the phone numbers of the Director of Internal Audit, the audit committee chairman and members of the committee, the partner and manager in charge of the company's external audit, and the Director of the Division of Enforcement at the SEC (202-272-2900). (By the way, Bill McLucas is the Director of the Division of Enforcement, and his phone number, once again, is 202-272-2900.) Let management know that you have such a directory and use it if necessary.

I want this audience to realize that, in spite of the fact that Enforcement cases get a lot of publicity and involve a substantial amount of time spent by persons in our office, that we believe these cases, and others you read about in the press, are aberrations from the norm. We continue to believe that the overwhelming majority of all of corporate America is honest, that the capital markets are, on the whole, fair, that the system of enterprise in this country is the best in the world, and that the financial and accounting professionals in this country are, for the most part, honest and competent. And we also believe that you, as honest auditors and professional accountants, are well served by having these aberrations addressed and made public so that you can (1) know that someone does care enough to punish those who might give the rest of you a bad name, and (2) you can profit from knowing where others fall short and design your internal control systems and internal audit functions to avoid similar problems. And with that more positive comment I will conclude. Thank you for your attention. If there is time, I will be happy to try and answer any questions you might have.