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Accountants and the Full Disclosure System

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

I thank you for inviting me to appear at this meeting of the United States partners of Coopers and Lybrand. Both the accounting profession and the Securities and Exchange Commission exercise important public responsibilities affecting our securities markets and I welcome this opportunity to touch upon some points of mutual interest. The work of accountants auditing corporate financial statements is indispensable to the Commission. Without an independent and professional accounting and auditing capability in the financial structure of our Nation, the Commission would surely find it not possible to fulfill its mandates of investor protection and the maintenance of fair and orderly markets.

The reliability of financial statements is a linchpin of the full disclosure system provided by the securities laws. If financial statements materially misrepresent a company's financial condition, the market for the security will be distorted and investor confidence will suffer. The Commission's job is to administer its statutes to foster a financial environment where material misrepresentations do not occur. It has an array of powers provided by the Congress to accomplish its task. It has used its powers consistently over many years, and its message is clear. Financial fraud, whether by falsification of books and records or misapplication of accounting principles, are practices which will call forth Commission action because they cannot be tolerated by markets whose viability is premised on reliable financial information.

The Senate Banking Committee stated the proposition clearly in its report adopting Section 13(b)(2) of the securities laws, requiring maintenance of reasonably detailed books and records and internal management controls designed to assure that management maintains accountability for corporate assets and provides financial statements in accordance with generally acceptable accounting principles. The Committee said: "The purpose of Section 13(b)(2) is to strengthen the accuracy of corporate books and records and the reliability of the audit process which constitutes the foundations of our system of corporate disclosure. Management has a responsibility to furnish shareholders and potential investors with reliable financial information on a timely basis." Financial statements and the auditor's role with respect to these statements are crucial to the market.

Under the federal scheme of corporate disclosure, investor confidence depends on the financial statements prepared by public companies and filed with the Commission. As you know better than I, financial statements filed with the

Commission must be audited by an independent public accountant. Commission regulations require auditors to conduct audits in accordance with generally accepted auditing standards. Examination of a company's books and records is designed to reveal to the accountant whether the proposed financial statements may be said to have been prepared in accordance with generally accepted accounting principles. If they are, an opinion is then issued to that effect and the public takes comfort that the statements fairly reflect the company's financial results.

The public nature of the role of independent auditors was described recently by the Supreme Court as follows:

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.

The independent auditor has an important role in preventing financial fraud. By necessity, the Commission relies heavily on the accounting profession. The Commission's 1983 Annual Report states that there were 65,550 full disclosure filings in fiscal 1983. Filings that required detailed review increased significantly--first time Securities Act registration statements increased 41 percent, merger proxies increased 29 percent and Form S-18 registrations increased 135 percent. The Commission brought approximately 34 enforcement cases involving financial disclosure issues in 1983, and approximately 36 such cases have been brought thus far in fiscal 1984. Even though there has been an increase in the number of financial disclosure cases brought, the number is small in relation to total filings. In my judgment, this reflects three things. First, there appears to be on the face of it a high degree of compliance with the accounting requirements of full disclosure and financial fraud is the exception rather than the rule. Second, the system of audits in accordance with generally accepted auditing standards and application of generally accepted accounting principles works in the marketplace to provide the investor with appropriate information on which to base investment decisions. And, finally, the Commission continues its long-term commitment to provide the resources to combat financial fraud and to ensure the integrity of the system.

The system works because the Commission plays such a significant role in enforcing the disclosure laws by using its statutory powers to require adherence to those laws, whether by reviewing financial statements for aberrations or commencing enforcement actions against issuers or their auditors where appropriate standards of behavior are broken. But the system also works because the accounting profession is willing to adapt to changing circumstances in the marketplace that require updating of standards both for auditing and the application of accounting principles. An important aspect is, of course, industry self-regulation which I believe is an important and unique dimension of securities markets generally.

Having stated how crucial the role of the accountant is in relation to confidence in financial markets I should point out that the accountant's role is limited and is not one of a guarantor. The auditor's responsibility itself is not without limitation. It is possible for an auditor to give a clean opinion on statements that ultimately turn out to be fraudulent in some respect, and yet for that auditor to be blameless. The auditor's duties are to act in good faith and with reasonable care in the discharge of his professional undertakings. Auditors form opinions on the basis of selective testing. Thus, there is always a risk that misstatements in financial statements may not be uncovered even when the audit has been conducted in complete compliance with acceptable standards. So, the mere fact that a clean opinion is given on financials that ultimately turn out to be deficient in some respect does not in and of itself indicate improper professional conduct. It is also the case that even where there has been a departure from acceptable standards, not every such departure constitutes improper professional conduct.

However, the auditor must be on the alert for material irregularities or material errors, approaching the task with the independence of mind referred to by the Supreme Court and the auditing standards of the profession which state that:

the auditor should plan and perform his examination with an attitude of professional skepticism, recognizing that the application of his auditing procedures may produce evidential matter indicating the possibility of errors or irregularities. The scope of the auditor's examination would be affected by his consideration of internal accounting control, by the results of his substantive tests, and by circumstances that raise questions concerning the integrity of management.

What then, is the standard of an auditor's responsibilities? While this question is not susceptible to an easy answer, I think in general the standard may be phrased as one of a reasoned and reasonable adherence to generally accepted auditing standards and generally accepted accounting principles. When an accountant substantially or recklessly fails to perform properly the professional's role in either conducting the audit or in applying accounting principles that materially affect financial statements, then I believe it is fair to say that the auditor has not conducted himself or herself properly.

Accounting cases brought by the Commission appear to involve, generally, deliberate falsification of books and records to enhance profitability and misapplication of accounting principles by issuers or auditors.

Falsification of books and records may take a variety of forms. Some of the more common include: recognition of income before it is realized; treating operating leases as if they are sales; improper inventory calculations including misapplication of LIFO; capitalization or improper deferral of expenses; and creation of fraudulent transactions to boost earnings. Falsification of books and records generally involves no new tricks--the methods are predictable and involve outright cheating. "Cooking the books" is an apt description of these practices. For whatever reason, be it a desire to retain a client or failure to ascertain whether the facts fit the principle selected, auditors sometimes become parties to financial fraud. Unfortunately, accounting firms sometimes also become a party to shading applicable accounting principles to fit the needs of the client. In this regard, the Commission's activities in bringing actions based on a misapplication of principles represents evidence of a basic commitment by the Commission to require accountants to adhere in a professional manner to generally accepted accounting principles.

With these thoughts, let me turn to some recent Commission actions involving accounting, from the standpoint of both corporate misconduct and auditor misconduct.

The financial services industry is characterized by a highly volatile and changing business and regulatory climate. Both factors necessitate that financial statements reflecting the true financial condition of the institution be made available to investors. Domestic and worldwide economic changes can have an important impact on the value of an institution's assets and its capital structure. Adequate reserves for loan losses must be established so income is not inflated. With deregulation, many institutions will, for the

first time, be regulated in a market environment, and for a complex of reasons the public in the future will have to rely more on market discipline rather than direct government regulation to achieve a safe and sound financial system.

Loan loss reserves established by financial institutions have received Commission attention. I think there is an accurate perception that irregularities in the calculations of loan loss reserves has been more than an isolated problem in the industry. One case in particular comes to mind. In this case the Commission alleged that earnings were materially overstated due to inadequate provision for loan loss reserves.

Loan loss reserves were set in a manner inconsistent with the explicit policy set out in public filings with the Commission. The Commission alleged that the bank holding company falsely disclosed that its allowance, composed in large part of its largest subsidiary bank's allowance, was "based upon reviews of portfolios for potential losses therein and historical loss ratios to outstanding balances." The statistical disclosure portion of the 10-K stated:

Annual provisions for loan and lease losses charged to operating expense are based upon continual reviews of loan and lease portfolios for potential losses therein. In making such reviews, management gives particular attention to loans classified by Company and regulatory examiners as especially mentioned, substandard and doubtful and to its knowledge of individual borrowers and the local economy.

The complaint alleged that the institution set its allowance in a very different manner than stated, merely by adding the allowances of each of its subsidiaries. The allowance of its largest subsidiary was set merely by multiplying the subsidiary's total outstanding loans and leases by a percentage based primarily on the average percentage used by about 90 other banks. This was done despite materially adverse information known to the bank holding company and its subsidiary about the condition of the subsidiary's portfolio. As a result of these improper calculations, the bank holding company's income was materially overstated.

I think this case raises important issues. Every insured financial institution is periodically examined by one of the financial institutions regulatory agencies. An examination report is prepared which rates the asset portfolio of the institutions and places specific loans into various categories of risk. Examination reports have historically been held

confidential. The theory has been that confidence in financial institutions required a different regulatory scheme than one characterized as disciplined by the market.

I believe changing conditions emphasize that public financial statements must make accurate disclosure to investors of the condition of the asset portfolio and the adequacy of set asides for reserves on potential loan losses. The examination report should at a minimum be available to accountants in every audit leading to the issuance of financial statements by financial institutions coming within the jurisdiction of the Commission. It appears to me that an auditor can more properly perform his duties, which to some extent duplicates the examination function, with the data contained in the examination reports. Similarly, it would appear to me that examination reports should also be available to the Commission in the exercise of its tasks of ensuring full disclosure to the market.

Recent Commission actions regarding financial institutions I think are clear in their message. Regulated institutions that put a premium on growth will have to subject themselves to the discipline of the marketplace. Accountants should know that there is no exception for financial institutions with regard to compliance with generally accepted accounting principles.

Commission actions also show that management must give investors the bad news as well as the good news. Examples of negative trends that should be disclosed are loss of a major customer, loss of market share, and curtailment of operations.

One action taken by the Commission recently is instructive. The Commission alleged that certain of the company's annual and periodic reports were materially misleading due to certain omissions in the Management's Discussion and Analysis. Its 10-K and two then-recent 10-Q's failed to disclose that its largest customer had shut down those parts of its operation that required purchases from the company and was unlikely to resume purchases in the future. The customer accounted for about one-third of the company's earnings from continuing operations before income tax. Under the terms of settlement, the company was ordered to amend its disclosures to include this crucial economic information.

There is hardly a substitute for an honest corporate environment to achieve reliable reporting. The Commission has taken action against companies and their managements that

have sought to pay lip service to proper accounting requirements but whose structure and operations undermine accurate financial reporting.

In one case that comes to mind the Commission alleged serious misrepresentations, through practices such as arbitrary adjustments to profits, inflation of revenues and earnings and failure to record transactions properly.

As a result of these practices, the corporation's financial statements seriously overstated results of operations, shareholder's equity and assets, understated liabilities and misstated its statements of changes in financial condition. Notes to the consolidated financials were allegedly fraudulent concerning accounting policy, interim results of operations, unusual income, acquisitions, bank loans, long-term debt and the income and financial condition of a subsidiary.

The fraud was widespread--it appears that most operating divisions were involved. For an idea of the corporate personality we're dealing with, listen to these passages from the complaint:

[the company] had a decentralized management structure with divisions having primary responsibility for sourcing, managing and marketing their products. [It] managed its operations through a system referred to as "management by objectives." Pursuant to this system, prior to the start of each fiscal year, [the company] would require its divisions to prepare operating budgets which included detailed performance objectives for the fiscal year with respect to, among other things, sales and results of operations. [The company] would then perform extensive reviews of the operating budgets and often would require upward adjustments in the performance objectives, primarily with respect to projected sales and operating results.

. . . During the course of the 1980 fiscal year, [the company's] financial position deteriorated, and its management then applied increasing pressure on the divisions to meet performance goals. Such pressure consisted of, among other means, threatened dismissals, actual dismissals and ad hominem attacks on certain of the divisions' senior management. This pressure was, in turn, applied by the divisions' senior management to middle management. These pressures were motivated, in part, by the desire of [the company] to have a public offering of its securities in the Fall of 1980, and the belief that a pre-tax profits of \$10 to \$12 million for the 1980 fiscal year was necessary in order to proceed with the offering.

During the 1980 fiscal year, in response to the pressure applied by [the company], various divisions of [the company] engaged in wide-spread and pervasive accounting irregularities as discussed herein in order to present results of operations which conformed to budgeted performance objectives. Throughout the 1980 fiscal year, [the company's] corporate headquarters learned of many instances of accounting irregularities employed by its divisions. Despite this knowledge, [the company] continued to pressure its divisions to meet projected operating results.

I cannot stress my belief too strongly that it is the duty of management to provide an honest environment for accounting transactions and an adequate system of accounting controls. Where that is not the case, and the result is accounting fraud, the Commission has shown that it has the will to take decisive action to correct the deficient conditions.

In one settlement, the company was ordered to appoint two new unaffiliated directors to serve on the Board of Directors' Audit Committee. The Audit Committee was required to retain an accounting firm for at least three years to assist the Committee in fulfilling its responsibilities, which under the terms of the Order include a review of the company's financial statements and filings with the Commission. And, the company was ordered to enlist its independent auditors in a review of the Company's past and present accounting practices and controls and to make whatever adjustments were appropriate.

While falsification of books and records usually involves puffing of sales and revenues, misapplication of accounting principles often involves an attempt to downplay losses. The ultimate effect is the same--financials that do not fairly present the economic position of the company.

In every case of financial fraud that becomes evident, the Commission takes a very close look at the role played by the auditor. The Commission may proceed against the auditor to determine if restrictions should be placed on an auditor's privilege of practicing before the Commission. The public demands Commission action in appropriate situations.

A recent survey commissioned by a Big Eight accounting firm contains some interesting data. The survey was commissioned in late 1983 to assess the perceptions of a variety of people as to the quality of the auditing work done by the

public accounting profession. The survey questioned business leaders, members of the financial community, the media, the legal profession, regulators, stockholders, congressional aides and professors of accounting. One question asked was whether auditors sometimes "bend the rules." Let me quote how the survey summarizes the responses:

The severest criticism of the profession came in response to a question asking whether accounting firms give in too easily to pressure to 'bend the rules' in their clients' favor. Overall, 39 percent agreed either 'strongly' or 'somewhat' that the profession yielded too easily to client pressure. Criticism was in the general area of 35 percent among five of the groups surveyed--executives, lawyers, stockholders, congressional aides, and the media. For example, 34 percent of corporate executives surveyed thought auditors possibly 'bent the rules'. This belief was strongest among security analysts (64 percent), and substantial among portfolio managers (49 percent), regulatory officials (48 percent), and accounting professors (43 percent).

The statistics cited in this report deserve reflection by an independent profession with the kind of public responsibilities it exercises. Continued examination and updating of self-regulatory mechanisms is a necessity if public confidence in the independence and integrity of the profession is to be maintained.

A recent Commission proceeding against an auditing firm is a good example of the type of departure from accounting standards that will prompt the Commission to take action against an auditor. The particular action to which I refer arose from the audits of the financial statements of three different corporations. In one case, the Commission alleged that the company and its officers intentionally falsified books and records to inflate earnings through the creation of non-existent inventories totalling approximately \$75 million. Another case involved allegedly non-existent revenues from non-existent operations totalling approximately \$5 million in 1981 and \$13.5 million in 1982. In another case, approximately \$900,000 in corporate funds were diverted to the personal use of a corporate officer and the company's financials were doctored to disguise the transactions.

Action was taken against the auditor because significant audit deficiencies became apparent in the course of the investigations. The Commission's complaint alleged that the audits were not conducted in accordance with acceptable

auditing principles and that the statements of the companies did not present their financial operations in conformity with acceptable accounting principles. Specifically, (1) the audits were too limited in scope, (2) the auditors failed to follow up on red flags that called for an expansion of audit procedures, (3) the audits were not adequately planned and supervised, (4) the auditors failed to obtain evidence sufficient to support their opinions, and (5) the auditors failed to exercise professional due care in conducting the audits. As part of the settlements, the Commission ordered the auditor to (1) provide a Special Review Committee to study its audit practices concerning SEC reporting companies, and to implement any recommendations; (2) audit existing SEC clients in accordance with GAAS and not to accept new SEC clients until it has implemented all recommendations of the committee; (3) notify the Commission staff when all committee recommendations are implemented; and (4) perform a supplemental review one year later and report to the Commission and the court concerning implementation of all committee recommendations.

Proceedings were instituted against three former partners of another firm that involved a bending of the rules in a situation where there had been a change in independent auditors. The proceedings arose from the auditors' work in connection with the financials of two financial institutions. In October, 1983, the Commission instituted administrative proceedings against the associations, alleging improper deferral of net losses on the sale of Ginnie Mae certificates.

The Commission's Order states that unqualified audit opinions and review reports were issued even though generally accepted accounting principles did not permit such deferral, advisory guidelines issued by the AICPA did not allow such deferral, the auditor's own firm policy prohibited such deferral, and the financial institution's prior auditors had concluded that deferral was not proper.

The conclusion of the Commission's Order states:

The Concepts of Professional Ethics of the AICPA provides that '[a] certified public accountant should maintain his integrity and objectivity and, when engaged in the practice of public accounting, be independent of those he serves.' These qualities are the cornerstone of the accounting profession and are fundamental to reliance on independent auditors. The Commission, too, has recognized the need for independent auditors to retain a 'healthy skepticism' to ensure that a review of a client's accounting treatment is fair and impartial. In the Matter of Touche Ross & Co., Exchange Act Release No. 20364 (November 14, 1983). When circumstances so

indicate, independent accountants must opine that financial statements are not presented fairly in accordance with GAAP, even if such an opinion does not comply with client desires. Otherwise, the opinions of auditors are of little value to those who rely on them--whether they be the auditors' clients or others such as investors, creditors and governmental agencies.

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] 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] 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. Such conduct is especially egregious when it occurs in the context of a change in independent auditors. (emphasis added)

Conclusion

In conclusion let me state my belief that the work of the accounting profession is important to the well-functioning of the Commission and to the integrity of our financial markets. I appreciate that accounting is an art involving the application of sound judgment, not a mathematical exercise. Nevertheless, where a significant departure from the established norms is apparent, the Commission's track record indicates that it will be there to ensure compliance with generally acceptable auditing and accounting standards.