SECURITY FRAUD AND THE INTERNAL AUDITOR

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This title is not meant to imply that internal auditors are responsible for security frauds. Perhaps a better title would have been "The Internal Auditor's Role in the Prevention of Security Fraud." However, I like short titles, and this explanation did get me past one of a speaker's major hurdles, the opening paragraph.

What is fraud? One definition, which will suffice for our purposes, is the obtaining of money under false pretenses. Security fraud, the type with which the Securities and Exchange Commission is concerned, includes the fraudulent sale, or offer for sale, of securities.

Perhaps the easiest way to define security fraud is through the use of an illustrative story.

Once there was an oil promoter who acquired a lease on a property at a very reasonable price. The reason he obtained it cheaply was because it had been surveyed by geologists, who reported that chances of finding oil on the property were practically non-existent.

The promoter revised the report to make it read like a report on one of the more favorable locations in the Sultanate of Kuwait, and on the basis of the altered report solicited funds from investors to exploit the property. To lend a semblance of legality to the operation, he actually spent some of the funds to hire a drilling contractor to sink a shallow well. Greatly to the promoter's surprise, the shallow well actually did strike oil. All the investors received back several times the amounts of their investments and were, naturally, pleased. However, they were the victims of fraud.

My example of fraud is not typical, because the investors got back their funds with a profit. Usually, they get back nothing, or at the most, a fraction of their investment. However, success or failure

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of the project has no bearing whatever on whether or not fraud was committed. The fraud occurs at the time solicitation is made.

This is a distinction which is not usually recognized. Crooked promoters often blame, or profess to blame, the Securities and Exchange Commission for investors' losses, claiming that if the Commission had not interfered they would have been able to bring their projects to a successful conclusion, and pay off everyone. A more likely result of inaction on the Commission's part would be additional investors' losses.

Often even the investors blame the Commission for their losses. Many of our fraud cases involve "Ponzi" type operations, in which funds of later investors are used to make the promised payments to earlier investors, or to honor their requests for return of their funds. As long as the earlier investors are receiving returns on their investments and are having their requests for liquidation honored they are, naturally, reluctant to have the payments stopped, even though they are being made at the expense of later investors.

However, even if the Commission were to hold off, such schemes would eventually fall of their own weight. As the number of investors increases, more and more funds are needed to keep up the payments to them. Eventually the sums needed exceed the amounts available, and the promoters begin to renege on their promises. As word of this circulates among other investors they, too, try to get back their funds, and a situation comparable to a run on a bank develops.

Unfortunately, this is often the point at which the Commission first learns of the scheme, as it begins to receive complaints from the defrauded investors. Also, in most cases, by this time the enterprise is hopelessly insolvent. The receiver in the bankruptcy which usually ensues is often hard-pressed to salvage enough to pay the expenses of the bankruptcy. The poor investor, of course, gets nothing.

The Commission's first action on being apprised of a possible violation of the securities laws is to conduct an investigation. If it determines that a violation has occurred, it will seek a temporary injunction through the courts to put an immediate end to the violations. Sometimes the offender consents to the injunction; otherwise the court hears argument from both sides and decides whether or not to issue the injunction. If it is issued a later hearing is held on the basis of which the court decides whether to vacate the injunction or to make it permanent. If the promoter consents to a permanent injunction, the second hearing is unnecessary.

If a registered broker or dealer in securities is involved the Commission may also institute proceedings to revoke his registration with it as a broker-dealer. Since the Securities Exchange Act of 1934 makes it illegal for a person to conduct an interstate securities business unless registered, revocation effectively puts the erring broker-dealer out of business. Needless to say, the revocation power is not exercised arbitrarily, and the broker-dealer is given full opportunity to present his case in a hearing.

If the circumstances warrant, the Commission submits to the Department of Justice a criminal reference report. The report sets forth in detail the violations of the statutes which have been uncovered by the investigation, and recommends criminal prosecution. If the Department concurs in the Commission's conclusion that criminal prosecution is warranted, the case is assigned to an assistant United States Attorney. Members of the Commission's staff then assist the Department of Justice in the preparation of the case, and its presentation before the court.

The Securities Act of 1933 makes it unlawful for any person to sell a security unless a registration statement is in effect as to the security. The Act also makes it unlawful to carry, or cause to be carried, through the mails or in interstate commerce any security for the purpose of sale or for delivery after sale, unless it is accompanied or preceded by a prospectus which meets the requirements of the Act.

There are certain exemptions with which we need not be concerned. Any company contemplating the sale of its securities which has any question as to whether registration is required should consult the Commission's staff.

The prospectus is the heart of the registration statement. It contains detailed information about the company, its history, business, capitalization, property and management, and the uses to which it intends to put the funds derived from the sale of the securities. It also contains financial statements, and it is, of course, in connection with these that the work of the internal auditor is of primary importance.

In addition to the prospectus, the registration statement contains exhibits, comprising such documents as the charter and bylaws, specimen copies of the securities being offered, and certain contracts and agreements.

All of this material is available for public inspection in the Commission's headquarters office in Washington. Photocopies of all or any portion of the registration statement may be purchased through that office.

The registration statements and reports filed with the Commission provide the source of most of the information contained in the various security manuals such as Moody's and Standard & Poors. It is probably through these media that the data filed with the Commission achieves its widest public distribution.

Although material filed with the Commission is examined by its staff, the issuer is still responsible for its accuracy and completeness. Each prospectus must include the following statement in boldface type on its outside front cover: "THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE."

With very few exceptions, the financial statements in every prospectus must be certified by an independent public accountant or certified public accountant. This requirement leads some to believe that primary responsibility for the statements rests with the certifying accountants. This is not so. Although the accountants do assume a grave responsibility when they certify the statements, the primary responsibility still rests with the issuer. It is apparent, therefore, that the work of the internal auditor is of great importance to the company as insurance against the filing of statements which may be incorrect, and therefore false and misleading.

Many of the proceedings which the Commission has brought against companies which filed false financial statements with it would not have been necessary if the erring companies had had a good internal auditing program, and if the financial statements had reflected the results of such a program.

We'll examine a couple of these cases; but first, let's take a look at the persons involved in a stock fraud case, the perpetrator of the fraud and his victim. First, the swindler.

The author of a recent novel about the expatriate financial geniuses who have sought refuge from American justice in Rio de Janeiro concludes that these are a special breed of people.

> "They consider themselves a law unto themselves; they look on the average citizen either as a sucker or a dullard. A sharp deal, usually on the shady side, is a challenge to these people.
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> "Some of them seek power, most of them have wealth, all of them have broken laws and all of them publicly claim they are innocent."

We recognize the breed; we have frequent contact with them in our fraud cases. They have certain other endearing qualities in addition to those just mentioned.

One is pride in their calling, incredible though that may seem to the law-abiding citizen. One of our attorneys saw a man who had been released from prison after serving a term for securities fraud, and asked him what he was doing. The man replied, indignantly, "You know I'm a confidence man."

Those who skirt or violate the securities laws are ingenious, as evidenced by the variety of schemes involved in our cases. For example, when the Commission first started to regulate proxy solicitations it discovered that management of one company was perpetuating itself in control by the clever device of printing the proxy on the back of the dividend checks it mailed to its stockholders. If the stockholder wanted to cash his check he had to endorse it, and when he endorsed it he signed the proxy which, naturally, was in favor of management.

In a more recent case a mining promoter was soliciting loans from numerous investors, securing them by warehouse receipts for "platinum concentrate". He actually had warehoused a large amount of the so-called concentrate, on which he was paying storage on a valuation of $3,000 a bag. Investigation disclosed that the "concentrate" was nothing but common sand, innocent of any trace of platinum or any other mineral or metal of value.

The stock cheats are superlative liars. Some of their best lying is accomplished not by actual misstatements of fact, but by omission of material facts. For example, a company involved in one of our most recent criminal trials was selling interests in what it represented to be second mortgages on owner-occupied houses. A letter to an investor offering interests in two such properties in another state enclosed a picture of the dwelling on one of the properties; but stated that a picture of the other house was not available. It wasn't available because it was non-existent; the other property was a portion of a large empty field.

Finally, the stock swindler is entirely devoid of conscience; I'll give you just one example. One of the victims of one of the ten-percenters which were rampant in California a few years ago was an old man who existed with his bed-ridden wife in a basement apartment. Their only income was their Social Security pension, and the interest on a $1080 savings account.

A salesman for the ten-percenter talked them into investing with his firm. The victim turned his savings account pass book over to the salesman, asking him to withdraw $1000, but to leave the $80 balance in the account for emergencies. The salesman cleaned out the account, taking the entire $1080 for investment in paper which subsequently became worthless.

There is a story about a con man who was asked by the judge how he could swindle people who trusted him. "Your Honor", he replied, "It's virtually impossible to swindle people who don't trust you."

The victims include persons from every walk of life. Doctors and schoolteachers are notoriously susceptible to a fast sales talk. Other investor witnesses I can recall from our cases include businessmen, attorneys, salesmen, a real estate broker, and even, I regret to say, an accountant.

An unfortunate fact is that a large portion of the victims in our cases come from the ranks of the aged, with widows a favorite target. In the first place, they are more likely than younger persons to have available funds, savings accumulated over the years or the proceeds of life insurance policies. Also, they are often existing on inadequate income, and in their desperation to increase that income will take chances that a more prudent person would not consider.

The government is often accused of staging such witnesses with the deliberate intent of evoking the sympathy of the jury. This is not a valid accusation, at least not in the cases with which I am acquainted. The government is aware that it will be challenged if it tries to do this, and is careful to select a fair cross section of investor witnesses.

The charge of witness stacking was made in the case of Greenhill v. United States. Judge Bell, in affirming convictions in this case for securities and mail fraud, answered:

> "The fact that the government used, without objection based on prejudice, as five out of some twenty investor witnesses one who was blind, and others who were peculiarly objects of sympathy did not deprive appellants of due process of a fair trial. Appellants and not the government made them investors and prospective witnesses."

One of the earliest Commission cases illustrating the need for a program of internal audit and control was the McKesson-Robbins case in 1938, which is summarized in the Commission's Accounting Series Release No. 19.

The fraud in this case was engineered by F. Donald Coster, president of the firm. His real name was Philip Musica, under which name he had been convicted of commercial frauds. He was assisted in the scheme by his three brothers, who also went by aliases.

To accomplish the deception, purchases were pretended to have been made by the McKesson companies from five Canadian vendors, who thereafter purportedly retained the merchandise at their warehouses for the account of McKesson. Sales were pretended to have been made for McKesson's account by W. W. Smith & Company, Inc., and the goods shipped directly by the latter from the Canadian vendors to the customers. Payments for goods purchased and collections from customers for goods sold were pretended to have been made by the Montreal banking firm of Manning & Company, also for the account of McKesson. The Smith and Manning companies, and the five Canadian vendors were all either entirely fictitious or merely blinds used by Coster for the purpose of supporting the fictitious transactions.

Invoices, advices, and other documents prepared on printed forms in the names of these firms were used to give an appearance of reality to the fictitious transactions. In addition to this manufacture of documents, a series of contracts and guaranties with Smith and Manning and forged credit reports on Smith were also utilized. The foreign firms to whom the goods were supposed to have been sold were real but had done no business of the type indicated with McKesson.

Coster, or Musica, originated the fictitious transactions in 1923, and continued them until the scheme was uncovered in 1938. There were certain changes made in the operation during its life; but in essence it was as I have described it.

How much was involved in this fraud? The certified financial statements as of December 31, 1937 (the last before discovery of the fraud) reported total consolidated assets of $87,000,000; of these, $19,000,000 were entirely fictitious. Fictitious sales for the year 1937 were over $18,000,000, on which fictitious gross profit of almost $2,000,000 was recorded.

Obviously a scheme of this magnitude could not have been carried on for so long a period without detection had there been an effective system of internal auditing in effect. In its report the Commission said:

"We are convinced by the record that the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. The testimony of the experts leads us to the further conclusion that this vital and basic problem of all audits for the purpose of certifying financial statements has been treated in entirely too casual a manner by many accountants. Since in examinations of financial statements of corporations whose securities are publicly owned the procedures of testing and sampling are employed in most cases, it appears to us that the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized."

The same firm of CPA's served as independent accountants for the Coster enterprises for 14 years, performing annual audits, but failed to discover the gross overstatement of assets and of earnings. As a direct result of the Commission's investigation and recommendations in this case, the accounting profession adopted as standard auditing procedures certain practices, notably the confirmation of receivables and the physical observance of inventories by the certifying accountant, which had theretofore been optional.

Ironically, the controller of McKesson had repeatedly requested a staff of internal auditors. For a short time he had several at his disposal, but they were soon dismissed as too expensive. Later the controller planned an internal auditing program, and after a delay of several years one auditor was hired. However, he was immediately assigned to other work, and never performed the duties of an internal auditor.

Even officials of the company who were not involved in the scheme concurred in the decision not to hire internal auditors. As a result of this false economy, the perpetrators of the fraud were allowed to do their dirty work undetected, with eventual losses to the company which would have financed an internal audit program many times over.

The Commission's requirements relating to the representations to be contained in the accountant's certificate, to the audit standards to be observed, and to the scope of the audit are specified in Rule 2-02 of Article 2 of Regulation S-X. Matters pertaining to internal control are considered under the scope of the audit.

Shortly after the report in the McKesson matter was published, Rule 2-02 was amended. The amendment included the addition of the following paragraph:

> "In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The [independent public] accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed."

This paragraph was deleted from Regulation S-X in 1950, as part of a general revision of the regulation. It was deleted not because the practices which it prescribed were no longer considered necessary, but because by then they had become so generally accepted as standard procedures that specific mention of them in the regulation was deemed unnecessary.

Generally accepted auditing standards require the certifying accountant not only to review the procedures encompassed in the system of internal audit and control, but also to satisfy himself that such procedures are in fact being carried out. Another early Commission case, the Monroe Loan Society case, illustrates the importance of this further step.

This loan company, which had a number of branch offices, had established a system of internal check and control which appeared to be reasonably adequate. However, after the company had registered with the Commission it was discovered that the manager of one of the offices had stolen a large sum of money. He covered his embezzlement by forging loan applications and notes, or by altering legitimate applications and notes, increasing the amounts borrowed and pocketing the difference. An employee had to sign each note as a witness. However, this was done in a perfunctory manner, and the witnessing employee never actually saw the signing of the forged notes.

The internal auditing procedures and internal checks contemplated by the established system should have made the successful operation of this scheme virtually impossible. However, they were not fully carried out, and as a result of this laxity approximately 70% of the loans of this branch office were questionable. The company lost about a half million dollars.

The certifying accountants never made a field examination of the branch offices. They gave as their reason the fact that they were reasonably satisfied as to the adequacy of the company's system of internal check and control.

Again, as in the McKesson case, an adequate system of internal audit, properly carried out, would undoubtedly have detected the defalcations, and originally would have acted as a strong deterrent to anyone contemplating such a scheme.

The cases which I have cited are the only two I can recall in which the internal audit function is specifically mentioned. However, there are numerous cases described in the Commission's opinions which occurred because of the lack of an internal audit program. In all of these cases at least some of the deficiencies in the financial statements filed with the Commission which gave rise to the proceedings would have been detected and prevented had there been an adequate internal auditing program conducted independent of the operating officials of the companies.

The December, 1943 issue of the Journal of Accountancy contains an article entitled, "Viewpoint of the Securities and Exchange Commission on Internal Auditing" by the late William W. Werntz, who was then Chief Accountant of the Commission. I should like to close this paper with a quotation from that article:

> "The Commission is . . . . directly interested in the relationship between the internal auditing system and the regular annual audit by the certifying accountants. Properly developed, the work of the internal and outside auditors is complementary. Together, they can provide well-nigh maximum assurance as to the dependability and fairness of financial statements."