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(202) 272-2650

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ARE "COOKED BOOKS" A FAILURE OF CORPORATE GOVERNANCE?

James C. Treadway, Jr.
Commissioner

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ARE "COOKED BOOKS" A FAILURE OF CORPORATE GOVERNANCE?

Good afternoon. It's a pleasure to appear before the American Society of Corporate Secretaries.

Today, I would like to try to bring together two topics some, at least initially, might believe to be unrelated. The first is phony financial statements, colorfully known as "cooked books"; the second is corporate governance, a topic much discussed during the 1970's but a less fashionable topic for recent discussion.

Let me start with a brief review of recent developments in the "cooked books" area. Financial statement frauds and outright falsifications of books and records are not new. But the problem is persistent; the new cases are egregious; and they have involved major, blue chip companies -- such as Heinz, McCormick, and Ronson.

While "cooked books" may not be a new problem, the recent cases have some aspects worth noting. First, these new cases seem to arise in a corporate atmosphere which tolerates or encourages reporting profits, even if they do not exist. Three factors seem to create that atmosphere: (1) aggressive and arbitrary demands by top management that divisions and subsidiaries achieve unrealistic profit goals; (2) poor communications between headquarters and the divisions; and (3) the failure or absence of adequate internal controls or checks and balances in the corporate structure.

The next aspect I would focus on is the fact that the employees who have participated in "cooking the books" apparently believed they were acting in the best interest of the company. In some cases, it was an admitted feeling of "team effort" rather than an effort to realize immediate personal gain, such as from theft, kickbacks or bribes.

The third general factor emerging from these cases is the lack of creativity in "cooking the books." The methods have been startlingly simple -- pre-recognize revenue; falsify or totally concoct inventory; ship without invoices or issue invoices without shipping; and play games with a variety of expenses. Sometimes third parties, such as suppliers, have been enlisted to defer or redate invoices. But creativity has been almost totally missing. Indeed, the methods have been so crude that I wonder why the participants thought their activities would remain undetected for any length of time.

But I believe the single most significant factor to emerge from these cases is the organizational structure of the companies involved. I refer to a decentralized corporate structure, with autonomous divisional management. Such a structure is intended to encourage responsibility, productivity, and therefore profits -- all entirely laudable objectives. But the unfortunate corollary has been a lack of accountability. The situation has been exacerbated when headquarters has unilaterally set profit goals for a division or, without expressly stating goals, applied steady pressure for increased profits. Either way, the pressure has created an atmosphere in which falsification of books and records at middle and lower-levels became possible, even predictable. This pressure-filled atmosphere has caused middle and lower level managers and entire divisions to adopt the attitude that the outright falsification of book and records on a regular, on-going, pervasive basis is an entirely appropriate way to achieve profit objectives, as long as the falsifications get by the independent auditors, who are viewed as fair game to be deceived.

With that general background, let me briefly discuss the three cases I mentioned -- Heinz, McCormick and Ronson. In May, 1980, Heinz filed a Form 8-K Current Report, which detailed Heinz's Audit Committee's investigation of questionable accounting practices and restated financial statements previously filed with the Commission. The falsifications at Heinz occurred over a seven year period (which was generally profitable) and shifted millions of dollars of income from year-to-year, sometimes increasing and sometimes decreasing reported income. For example, the falsifications increasesd 1979 reported income alone by $16 million. In late 1982 the Commission sought and by consent obtained an injunction against McCormick and a division manager, barring them from further violations of Sections 13(a) (inaccurate filings) and 13(b)(2)(A) (inadequate books and records) of the Securities Exchange Act of 1934 (S.E.C. v. McCormick & Company Incorporated, et. al., Civil Action No. 82-3614, D.D.C. 1982). The falsifications at McCormick occurred over a four year period and involved an overstatement of revenues by $48 million and income by $4.1 million. Finally, in late 1982 the Commission concluded an administrative proceeding against Ronson Corporation, finding that falsifications occurring at Ronson over a four year period resulted in an overstatement of revenues by $6.3 million (Admin. Proc. File No. 3-6191, Rel. No. 34-19212, November 4, 1982).

All three cases have some striking common characteristics:

1. The divisions and subsidiaries which "cooked the books" were autonomous, with little or no oversight by headquarters, particularly in the areas of auditing, accounting, and internal controls.

2. Constant, strong pressure was exerted by distant top management on subsidiaries and divisions to achieve profit goals set unilaterally and arbitrarily by corporate headquarters.

3. Communications between divisions and headquarters about the practicability of reaching established profit goals ranged from limited to non-existent.

4. Headquarters and top management created an atmosphere in which sales and marketing functions in the divisions were viewed as more important than accounting and auditing.

5. That atmosphere caused division managers and employees to believe that "cooking the books" was one way to achieve the profit goals and that this was acceptable to headquarters, perhaps even anticipated.

6. The division employees engaged in the improper activities as part of an admitted "team effort." In some instances, the employees stated that they believed it a "mortal sin" not to meet the profit goals.

7. No employee involved received any direct personal benefit.

8. The falsifications were large, simple, and direct. Expenses were improperly shifted from one accounting period to another. Goods ready for shipment, sometimes not even manufactured, were accounted for as sales in the current period, even though not actually shipped or manufactured until a succeeding period. False statements were made to auditors. Multiple sets of expense records were kept. Shipping invoices and bills were altered, with third parties sometimes enlisted to assist.

9. The falsifications were undetected by top management and the Board of Directors, not for brief periods of time, but for years and years. In short, the break-down was systemic.

Considering the number of parties actually or potentially involved or responsible -- lower-level employees, mid-level managers, officers, directors, and sometimes third parties -- I could dwell at length upon the respective liabilities of various parties. But that exercise would serve little purpose unless it were to identify a more important problem -- a dysfunction or break-down in corporate structure. That is my focus today -- structure. If corporate managers, operating under constant pressures from above to report profits, are allowed to believe that the corporate structure will tolerate reporting questionable or non-existent profits at the expense of the integrity of the company's financial statements, "cooked books," a devastating kind of fraud seems bound to occur in massive proportions.

Before discussing the structural problem further, let me elaborate upon my characterization of "cooked books" as "devastating." First, look at the number of parties who ultimately are damaged by "cooked books."

1. Large and small market-place investors in both debt and equity securities of the issuer.

2. Management and directors of the issuer, regardless of the ultimate determination of their individual culpability.

3. Owners of large blocks of stock of an issuer, such as estates or family trusts. As exposure of the wrong-doing occurs, the value of such holdings may drop dramatically and they become more illiquid than is normal.

4. Merger partners, who may have overpaid to acquire subsidiaries, divisions, or the issuer itself.

5. Underwriters who distributed securities for the issuer and find themselves named defendants, if not the "Deep-Pocket."

6. Market-makers and retail brokers effecting transactions in the issuer's securities.

7. Auditors for the company, who may find themselves a named defendant, or be the subject of an investigation, or lose a client.

8. Attorneys for the issuer, and perhaps for the under-writers.

9. Financial analysts who gave investment advice about the issuer and its securities relying upon the issuer's financial statements.

10. Employee-stockholders who purchased securities of the issuer directly or through employee benefit plans.

11. The wrongdoing mid- and lower-level employees who "cooked the books" to help the company but became scapegoats when exposure occurred.

12. Banks and other institutions which made loans to the issuer on the strength of its financial statements.

13. Suppliers who extended credit to the issuer on the basis of its reported financial viability.

14. The issuer itself, in any number of ways.

15. General investor confidence.

Second, what is the impact of "cooked books" on our system of disclosure, which is largely based on voluntary compliance and minimal governmental interference? "Cooked books" cause false financial statements; if the financial statements are false, it is impossible for the narrative portion of any disclosure document to be accurate; and the entire disclosure process is therefore totally undermined.

So back to my original question. What do "cooked books" have to do with corporate governance? I would characterize corporate governance as an approach to the management of a public company which has as its essential premise the idea that the corporation should institute and enforce adequate controls and procedures to assure that the corporation is operated solely for the benefit of stockholders. Sound corporate governance requires a structure and procedures which will preclude undesirable activity prior to its occurrence or, if it does not preclude it, will detect and remedy it with promptness. More specifically, corporate governance means oversight of management by an active and questioning Board of Directors and the use of whatever other mechanisms of oversight, reporting and review -- such as independent Audit and other Committees at the Board of Directors' level and appropriate counterparts at other levels within the corporation -- as are necessary to assure that corporate managers at all levels are properly sensitive to and discharge their paramount duty to stockholders. And the duty of managers to stockholders surely must include accurately accounting for the management of the corporate assets by not "cooking the books."

To describe the opposite, sound corporate governance does not mean directors who, by active participation or by a wink of the eye, tolerate "cooked books" or an atmosphere where "cooked books" may occur, nor does it mean an "ignorance is bliss" attitude, nor an attitude that says " don't bother me as long as we're making money." In short, sound corporate governance does not mean directors and managers who fail to institute and enforce internal controls and procedures to assure that the corporation is managed solely for the benefit

of the stockholders. And as I said earlier, an essential element of soundly managing a corporation surely must include accounting accurately to the stockholders for the management of their assets. Is not the failure or inability to do so the classic example of directors who do not or cannot direct and managers who do not or cannot manage?

In the three cases I discussed, all involving companies with a decentralized structure, two elements demonstrate a failure of structure and governance. First, information about improper or illegal behavior failed to reach top management, or the Board of Directors, or the Audit Committee for years before the crisis broke. Second, the Directors and senior management apparently failed to convey to others the need for accurate accounting, compliance with the securities laws, and the elimination of improper or questionable activities. Yet, common sense alone tells us that a decentralized corporate structure, where operational decision-making is shifted from senior to middle-level management and lower, is precisely the kind of structure where good internal controls and good communications assume the utmost importance. And I believe that is true not only from a legal standpoint, but also simply as a matter of sound management and good business sense.

If we look at the 1970's sensitive payments cases, indeed, if we go back to the 1950's price fixing scandal in the electrical equipment business, we see many of the same circumstances which have caused "cooked books." These include competitive pressures, the inevitability of operating "close to the line" in some areas of the law, the difficulty of resisting long established operating practices, an emphasis on short-term profits, which some believe is heightened by mandatory quarterly reporting, top management's isolation from operations, an inability or unwillingness of top management to monitor or scrutinize activities at these levels, and perhaps some insensitivity to signs of illegality. In both types of cases perhaps a general observation can be made that the Board of Directors -- and particularly the Audit Committee -- was not sufficiently active and questioning.

To elaborate further upon my answer to the question of what corporate governance has to do with cooked books, I would make three observations. First, the concept of corporate governance need not always be associated with the exotic or with socially visible objectives, as it perhaps was in the 1970's. Second, corporate governance in fact is another term for sound corporate management, or an approach emphasizing sound, realistic planning, open lines of communication, and adequate internal controls. Third, how can a corporation be said to be soundly managed, and therefore properly governed, if "cooked books" occur year-after-year, since that means that the corporate managers

are not even capable of telling stockholders to whom they owe a fiduciary duty how well or poorly they managed their assets?

So what needs to be done? Can corporate governance be improved to prevent "cooked books"? If so, can it be done within the existing statutory and regulatory framework? Or is it time for a new approach?

Let's discuss some ideas about improving corporate governance in an effort to reduce "cooked books."

1. As a general proposition, would corporate procedures and controls, and therefore corporate governance, be improved and enhanced if the accountability of individuals for violations of the securities laws were increased? Presently, alleging violations by individuals may require the construction of an aiding and abetting or other secondary liability theory. Would an increase in individual accountability cause individuals at all levels in the corporation to insist that the corporation institute and enforce controls and procedures which would cause the corporation to be governed in such a way as to preclude or minimize violations such as "cooked books"?

2. More specifically, Section 13 of the Exchange Act, the section requiring accurate and adequate annual and periodic reports, expressly imposes an obligation only upon the issuer. Should Section 13 be amended to confer upon the Commission express authority to proceed directly against individuals who cause, aid and abet, or contribute significantly to an issuer's violation? If so, should this expanded prosecutorial power be available in lieu of naming the company as a defendant, on the theory that injunctions against issuers sometimes are cumbersome and may damage the corporate entity and therefore innocent stockholders? Or should it be merely an additional tool?

3. Should Sections 10(b) and 14 of the Exchange Act be similarly revised?

4. Should the Exchange Act be amended to add a provision similar to Section 9 of the Investment Company Act of 1940, which automatically bars a person who has been enjoined from violations of the federal securities laws from serving as an officer, director, or employee of a registered investment company. Do today's publicly-owned corporations have characteristics which make it appropriate to continue to distinguish them from investment companies? Are stockholders of industrial companies entitled to less protection than stockholders of investment companies?

5. Rule 2(e) of the Commission's Rules of Practice authorizes the Commission to bar professionals from practicing before the Commission. One of the predicate acts is an

injunction against violations of the federal securities laws. If an individual is enjoined from violating the securities laws, such as by participating in "cooking the books," should the Commission have additional authority to institute a Rule 2(e) - type administrative proceeding with a view toward barring such person, totally or in part, permanently or temporarily, from acting as an officer, director, or senior employee of a public corporation?

6. Section 15 of the Exchange Act establishes an elaborate scheme of supervisory responsibilities for registered broker-dealers with a view toward preventing violations of the federal securities laws. Should all publicly-owned companies be subject to a similar requirement, so that the Commission, after an administrative proceeding, could bar, suspend, or impose limits on the activities of individuals within a corporation who failed to discharge their supervisory duties?

The above ideas focus on increasing the accountability of individuals within a corporation in an effort to improve corporate governance and structure to deal with the insidious and destructive problem of "cooked books." Granted, their adoption also would represent expansions of the Commission's enforcement arsenal. But the by-product could be a clear and resounding demand by such individuals that corporations be structured, operated and governed in a way which would avoid violations and therefore individual liabilities. A criticism frequently leveled against the present remedy of an injunction, particularly against a corporation, is that it can be a "meat-axe" approach, perhaps injuring innocent stockholders and not addressing the underlying problem. If that criticism is valid, perhaps more refined, precise tools should be available to the Commission.

To be sure, some may feel either that "cooked books" are not that serious, or that the present method of dealing with the problem is adequate. Such persons presumably would reason that the Commission should continue with the injunction as the primary tool, focusing first and foremost on the issuer. By no means do I mean to argue for that theory today. But, in the interest of fairness, let me identify a few of the arguments which might be made:

1. Whatever the drawbacks, an injunction is a judicial process and therefore is inherently fairer than an administrative proceeding. That argument undercuts broader powers to institute any type of administrative proceeding, whether against individuals or corporations.

2. In the case of injunctions, focusing upon the corporation as the primary offender represents a realistic recognition that individual responsibility within a corporation is often

diffuse and that it is difficult, if not impossible, to identify with certainty and fairness all the wrongdoing individuals.

3. The imposition of primary responsibility at the corporate level is a form of self-regulation. It encourages the corporation to police itself and those under the corporate umbrella in order to avoid greater governmental intrusion into internal corporate affairs in the long run.

4. If the Commission were to pursue individuals to a greater extent, would the company endure far longer and greater disruption while the Commission prolonged its investigations and continued to pour over corporate records and transactions for long periods of time in an effort to ferret out all the wrongdoers and determine their relative culpability?

5. If some concept of greater individual accountability were adopted, would that result in defendants who are less sophisticiated, less wealthy, or are represented by less sophisticated counsel being sacrificed as scapegoats as the respective degrees of liability of the various individuals are determined?

6. Is it simply unfair to bring down all the might and resources of the federal government upon individuals rather than upon the corporate entity which has the ability and means to fend for itself?

As I said, all of my ideas are enforcement-oriented, in that they would impose individual liability as a means of improving corporate procedures and governance. I will stop with that for today, other than to observe that other approaches to improved corporate governance are likewise available.

I have attempted to deliver these remarks in a generally netural tone, without becoming a committed advocate of any of the suggestions. But I obviously do not believe the suggestions to be beyond the pale. Indeed, most of the approaches already are embodied to some extent in the securities laws. "Cooked book" cases are proliferating; their effect is devastating; and we can expect to see more. I firmly believe these cases represent a failure of structure and corporate governance, and that the time is ripe to consider the inter-related issues of "cooked books," corporate governance, and individual accountability.

With those thoughts, I will close. I hope my comments will serve to prompt debate and discussion and that those in this room will participate in that dialogue.

Thank you.

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