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THE COMMISSION, ACCOUNTING AND (?) ACTIVISM

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

THE COMMISSION, ACCOUNTING, AND (?) ACTIVISM

Introduction

Recently a reporter asked why I, and others at the Commission, have demonstrated such an interest in accounting. I cannot speak for others, but let me share my perspective. Financial statements are the foundation of our disclosure system. If their integrity is undermined because they are inaccurate or distorted, the entire disclosure process is corrupted. Why? It's simple -- the accompanying narrative portion of the disclosure document is worthless, because it describes a company that does not exist.

Yet, I understand that the Commission's interest in accounting matters over the past two years, which has become quite visible, is viewed with concern in some quarters. I hear some suggest that the Commission may be overly zealous. I understand that some suggest that we are trying to substitute our hindsight judgment for that of corporate executives and auditors who acted in good faith. I personally reject both suggestions.

Enforcement actions focusing on accounting seem to generate the most publicity, and perhaps that's to be expected. The enforcement record speaks for itself. The Commission has brought an increased number of actions against corporations, senior and middle level managers, and, in some instances, independent auditors. Our level of concern about depository institution accounting and reporting practices has risen. For example, we have brought cases against bank holding companies when their financial statements have disguised poor performance -- even if the problems were confined to a single quarterly report. We have invoked stop-order proceedings -- a technique some thought obsolete -- to curtail improper accounting used in some public offerings, apparently in the hope that the filing might "slip by" or at worst receive a stern letter of comment and opportunity to correct.

That is the briefest possible summary of our recent enforcement record. I thought it straightforward and easily understood, at least until I began to hear others express surprise about the Commission's interest in accounting frauds and accounting matters. Perhaps that surprise arose because of a misperception that the Commission was less likely than in the past to bring traditional fraud cases. If that misperception existed, I trust it has been erased. And it is only fair to note that enforcement actions focusing on accounting will continue.

The Commission's interest in accounting from a non-enforcement perspective has also generated publicity. The Commission's public debate on the FASB's proposal on in-substance defeasance in December, 1983 comes quickly to mind. The junior stock controversy likewise comes to mind. There are many other examples.

Given the recent focus on accounting matters, some overall reflection seems timely. Is the Commission on the right track? Is this, as some have suggested, a time of Commission activism on accounting? Is our focus too narrow or too broad? To address those questions, I propose to discuss a broad spectrum of accounting issues. With that overview, I'll let you answer those questions.

The "Perry Unit"

Let's begin with an enforcement focus and an organizational matter. During the 1981-82 recession, more specifically in October, 1982, the Commission reorganized the accounting function in the Enforcement Division. John Fedders, the Director of the Enforcement Division, sought someone with top level, extensive private practice experience to fill an enhanced and more prominent position of Chief Enforcement Accountant. Fedders located and recruited Glenn Perry, formerly a partner at Peat, Marwick, and Mitchell. Glenn functions solely in an enforcement role. He has assembled and oversees a team of thirteen highly qualified accountants in the Enforcement Division. Under his guidance, each financial statement fraud investigation is normally staffed with one attorney and one accountant. In the past, accountants have not played as significant a role in enforcement matters. In addition, Perry assists the financial fraud investigations and cases in the Commission's regional offices.

The results are evident. In 1983, the Commission brought twice as many financial statement fraud cases as in 1982. 1984 may see even more. Although Glenn may leave soon, I expect the enhanced position of Chief Enforcement Accountant will continue to be filled by a similarly qualified person. That position -- filled by an experienced accountant with an increased accounting staff -- has given the Commission substantial additional enforcement capacity. That has resulted in more cases and the ability to address more complex issues.

Why Some Companies Go Astray

Moving from that organizational point, let's turn to recent cases. For a moment, let's forget legal and accounting theory and focus on the corporate environment and the circumstances which apparently cause some companies to go astray.

I recently saw an article in the New York Times called "Irrational Executives: Analysts Offer a New View." But the writer wasn't talking about securities analysts. He was the Science Editor, and he reported that psychologists have gained new insights into corporate behavior marked by destructive psychological patterns. He wrote about an often admired corporate style -- the "jungle fighter." To quote -- his "lust for power leads him to experience 'life and work as a jungle where it is eat or be eaten'." The Editor conceded that some of the "jungle fighter" may be useful in the corporate world, but that at the extreme it distorts reality. He concluded that many who have that attribute principally aim to subjugate or to impress, not necessarily to accomplish substantively. After all, if everyone accepts the impression of accomplishment, reality is irrelevant. Even worse, this type's insistence on submission can force the stronger and more honest subordinates to move on, leaving a group of "Yes Men."

This may sound theoretical and a bit divorced from accounting issues, but bells went off when I read the article. So many financial statement fraud cases seem to occur in a corporate environment marked by "jungle fighter" mentality. Those at the top arbitrarily set unrealistic goals and affirmatively decree that goals must be met at all costs -- up or out, eat or be eaten -- or they tolerate an atmosphere which says the same. The mid- and lower-level employees who engage in accounting shenanigans are not seeking to fool the boss -- rather to please him by demonstrating they're also tough enough to survive in the jungle.

Let's consider two cases -- A. M. International 1/ and U. S. Surgical. 2/ In mid-1982 the Commission sued A. M. International for numerous violations of the federal securities laws. 3/ The Commission alleged that AM grossly overstated its results of operations, assets, and shareholders' equity, understated liabilities, and misstated statements of changes in financial position. The Commission also alleged that various notes to AM's financial statements were false and misleading, including those describing accounting policies, interim results of operations, unusual income, bank loans and long-term debt, and the financial condition of AM's finance subsidiary. The fraud was astonishingly pervasive, infecting at least eleven of AM's operating divisions.

1/ SEC v. A. M. International, Inc., Civil Action No. 83-1256 (D.D.C. 1983), Litigation Release No. 9980 (February 27, 1984).

2/ SEC v. United States Surgical Corporation, Civil Action No. 84-0589 (D.D.C. 1984), Litigation Release No. 10293 (February 27, 1984).

3/ Sections 17(a) of the Securities Act and Sections 10(b), 13(a) and 13(b)(2) of the Exchange Act.

How was it accomplished? Losses related to inventory were improperly deferred and inventory was otherwise overstated; books were kept open after cut-off dates to increase sales and earnings; sales were recorded although products were not shipped; sales were inflated by deliberate double-billing; operating leases were recorded as sales; allowances for losses were arbitrarily reduced without any basis whatsoever; sales were recorded although the products were only shipped to branch offices and a public warehouse, not to customers; accounting policies were changed that increased earnings without any disclosure; known errors that resulted in increased earnings were ignored; intercompany accounts were out of balance and the differences were arbitrarily reclassified as inventories; known inaccuracies in books and records were not investigated -- let alone resolved; costs of sales were manipulated; fixed assets were not depreciated; expense accounts were understated; and accounts payable were simply not recorded. It was as if someone were following a master manual on how to falsify financial statements.

For a bit of the "jungle man" flavor, listen to a couple of paragraphs from the Commission's complaint:

> During the course of the 1980 fiscal year, A.M.I.'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 character 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 AMI to have a public offering of its securities in the Fall of 1980, and the belief that a pre-tax profit of $10 to $12 million for the 1980 fiscal year was necessary in order to proceed with the offering.
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> ...In response to the pressure...various divisions... engaged in widespread and pervasive accounting irregularities...in order to present results of operations which conformed to budget performance objectives. Throughout the 1980 fiscal year, AMI's corporate headquarters learned of many instances of accounting irregularities employed by its divisions. Despite this knowledge, AMI continued to pressure its divisions to meet projected operating results.

AM consented to a permanent injunction, including broad ancillary relief designed to place greater control over accounting and financial reporting matters with a significantly strengthened and more independent Audit Committee and with the independent auditors. 4/ By the way, I would note that the Commission is continuing its private investigation of the AM matter, notwithstanding the settlement at the corporate level.

Egregious accounting and financial reporting irregularities are likewise alleged in the Commission's recent case against United States Surgical Corporation and seven members of its management. 5/ The Commission alleged that, beginning at least in 1979 and continuing through 1983, the defendants materially overstated Surgical's earnings and financial condition in a concerted effort, as follows:

- In 1979, Surgical reported pre-tax earnings of $7.9 million, when Surgical earned less than $6.3 million.
- In 1980, Surgical reported pre-tax earnings of $12.1 million, when Surgical earned less than $8 million.
- In 1981, Surgical reported pre-tax earnings of $12.9 million, when Surgical earned approximately $200,000.

4/ For example, AM is required to maintain an Audit Committee of non-management Directors for a period of three years; to appoint, after confirmation of its plan of reorganization, two qualified, independent persons to serve as additional Directors and on the Audit Committee; and to retain its independent auditors for a three-year period to report on AM's accounting systems and procedures and to assess the adequacy of its system of internal accounting controls. This is in addition to any review which is part of the annual audit and should be sufficient in scope, when coupled with the annual audit to provide reasonable assurances that all material weaknesses have been discovered. Among other areas, the independent accountants are directed to review AM's accounting system and procedures with respect to revenue recognition; intercompany transactions; accounting for and pricing of inventories; and establishment of and periodic adjustment to asset valuation allowances. The independent accountants must provide a written report of the review, and AM is required to take "any and all necessary and appropriate steps to correct or eliminate all material weaknesses noted."

5/ Its president and chief executive officer, executive vice-president of marketing (the wife of the president), executive vice-president of finance, comptroller, vice-president of manufacturing, executive vice-president of operations, and former national sales manager.

The Commission alleged in its complaint that Surgical:

- Issued falsified purchase orders to vendors, who in turn submitted untrue invoices so that Surgical's reported cost of parts was decreased and its reported costs of materials was improperly capitalized by over $4 million.

- Shipped significant quantities of unordered products to customers and recorded them as sales.

- Improperly treated shipments on consignment to its dealers, salesmen, and certain foreign entities as sales, resulting in a cumulative overstatement of income by over $2 million.

- Improperly failed to write-off assets which could not be located or had been scrapped and capitalized certain operating costs as overhead, increasing earnings by millions of dollars.

- Improperly capitalized approximately $4 million dollars of legal costs, purportedly for the defense of certain patents, when those costs did not relate to the defense of patents and should have been charged to operations as incurred.

- Beginning in 1981, improperly capitalized the costs of 10,000 parts each time it purchased a new or modified mold or die. Such improperly capitalized costs alone amounted to approximately $5.7 million in 1981.

Without admitting or denying the allegations, Surgical consented to an injunction against numerous violations of the securities laws 6/ and to broad ancillary relief designed to strengthen the accounting and auditing functions, the Audit Committee, and the independent auditors. 7/ The individual defendants also consented to broad

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6/ Sections 10(b), 13(a), 13(b)(1) and 13(b)(2), and 14(a) of the Exchange Act.

7/ Surgical was ordered, among other things, to appoint two new unaffiliated directors, acceptable to the Commission, for a period of at least 5 years, to serve on the Audit Committee; to maintain and strengthen the position of chief internal auditor; to review certain past and present accounting practices, retaining independent auditors to aid in the review;

[Footnote continued on next page]

injunctions and undertakings. They were ordered to make only complete and accurate statements and filings for Surgical or other issuers and acknowledged a contractual obligation to repay bonuses tied to reported results of operations.

When I think about the patterns of conduct alleged in cases such as AM and Surgical, and there are others, the "jungle man" theory intrudes into my thought processes. In other cases, where the corporate environment was tainted, we have heard about something described more genteely as "team spirit." In those cases, senior and middle level corporate officers -- when asked about their role in the scandal -- frequently explained that everyone thought it was necessary for the good of the company -- good, old team spirit. In one case, a mid-level manager responded that he did it because he had a family and a mortgage, and he thought such activity was commonplace in the business world. Perhaps "jungle man mentality" and "team spirit" are interrelated -- the first either leads to or is simply a more advanced stage of the second.

Cute Accounting

From such reflections on the corporate environment and "cooked books," let's move to "cute accounting." My definition is stretching accounting principles and interpretations to or beyond the breaking point to achieve desired -- albeit distorted -- results. The effect can be just as dramatic as "cooked books." Our March, 1984 stop-order proceedings against Pro-Mation, Inc. 8/ illustrates the point. The key issue involved the carrying value of amounts owing by, and an investment in, Energy Collectors, Inc., a privately held company organized by and controlled by the same investors who organized and controlled Pro-Mation. Energy Collectors was created to conduct research and development activities previously conducted

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[Footnote 7/ continued from previous page.]

to take whatever action was necessary, including restatement, amendment or adjustment of its financial statements; to retain independent auditors to review and report to the Audit Committee on Surgical's current accounting policies, practices, procedures, and controls, their propriety and effectiveness, and the conduct (scope, timing, and effectiveness) of the audit function; to have its Audit Committee review Surgical's financial statements, filings with the Commission, written reports of earnings or financial condition, and accounting practices, procedures, and controls; and to have Surgical's Audit Committee engage a separate accounting firm for at least three years to assist it in fulfilling its independent responsibilities.

8/ In the Matter of the Registration Statement of Pro-Mation, Inc., Securities Act Release No. 6522 (March 30, 1984).

by Pro-Mation itself. Energy Collectors had accumulated losses of five times its gross revenues and a substantial shareholders' deficit. Pro-Mation had advanced substantial sums to Energy Collectors (cash and accrued interest) and carried these as assets in its financial statements, despite Energy Collectors' poor financial condition, which realistically rendered these amounts uncollectible. After the end of 1982, Pro-Mation swapped these receivables for Energy financials at an amount equal to the advances. But the preferred stock was substantially worthless, since the cash advances and accrued interest was uncollectible.

By creating and advancing funds to a separate corporation, Pro-Mation avoided recognizing any loss in its financial statements, even though the losing operations previously had been conducted directly by Pro-Mation. Yet, Pro-Mation (1) provided the sole means of financing Energy Collectors' operating losses; (2) effectively controlled Energy Collectors; (3) had the _de facto_ power to compel an exchange of the notes at any time for a substantial equity ownership of Energy Collectors; and (4) in fact did so.

Under these and similar circumstances, the first question that needs to be addressed is whether the second corporation actually is a disguised or sham subsidiary -- a "non-subsidiary subsidiary." Even if one might construct a contorted, technical argument that consolidation is not required, substance must control over form. In view of the exposure of Pro-Mation's assets to loss, the fact that Energy Collectors was operating at a loss and had negative net assets and was unable to survive without continuing support from Pro-Mation, at the absolute minimum carrying the advances as an asset is improper. Pro-Mation's periodic filings certainly should have fully disclosed the relationship, the commitments to the new company, and the market value of the advances or investment.

This example of cute accounting -- a "non-subsidiary subsidiary" -- demonstrates a too-often recurring abuse -- stretching accounting principles and interpretations to achieve desired but distorted results.

Shopping for Auditors

Cute accounting efforts frequently result in disputes with auditors, which in turn can lead to shopping. Granted, there are bonafide reasons for changing auditors. But if the Commission focuses upon possible accounting violations and finds that shopping has been involved, that activity will be a bright red flag.

I have one personal observation. In my years in private practice, I never saw shopping accomplish what the shopper wanted. Our recent administrative proceedings involving Southeastern Savings and Loan Company and Scottish Savings and Loan Association 9/ are illustrative. Each association had extensive discussions with its auditors over several months, seeking concurrence of the auditors in deferring and amortizing over several years certain losses arising from claimed hedging transactions in Ginnie Mae certificates and Treasury bond futures contracts. The independent auditors ultimately advised that the losses had to be fully recognized currently. The two associations discharged their auditors and retained the same accounting firm, which concurred in the desired treatment. That was followed by our administrative proceeding, which the associations settled by consenting to an administrative order and restatement -- hardly what the shopping was intended to accomplish.

The Auditors

No discussion about accounting matters is complete without some reference to auditors' responsibilities, particularly when major accounting breakdowns occur. In such cases, it is simply inevitable that the Commission will ask whether the auditor fulfilled its professional responsibilities.

For example, last year the Commission concluded to the contrary and brought both a civil injunctive action and Rule 2(e) public administrative proceeding against Fox & Company. Those actions arose from three unrelated Commission investigations into the audits of Saxon Industries, Inc., Flight Transportation Corporation, and Alpex Computer Corporation. In Saxon, the major problem was totally fictitious inventory. By the end of 1981, Saxon's books and records carried approximately $75 million of nonexistent inventory. Saxon's computer was even programmed to automatically add false figures to inventory levels. In Flight Transportation, two subsidiaries recorded fictitious revenues of approximately $5 million and $13.5 million in 1981 and 1982, respectively, from nonexistent operations. In addition, Flight's assets were overstated in 1981 by at least $2.7 million through falsified records reflecting cash in a non-existent Cayman Islands bank account. In Alpex, at least $900,000 of company funds were diverted and misapplied for the Chief Executive Officer's personal use, while Alpex filed false and misleading periodic reports disguising the true nature of these transactions.

Our three investigations revealed severe audit deficiencies. Fox allowed the scope of the audits to be limited; ignored numerous "red flags" which should have caused expanded audit procedures; failed to plan and adequately supervise the audits; failed to obtain sufficient competent evidential matter to support their opinion; and

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9/ In the Matter of Accounting for Gains and Losses In Connection With Certain Securities Transactions, Securities Exchange Act Rel. No. 10166, October 6, 1983.

failed to exercise due professional care in conducting the audits. In Saxon, for example, Fox auditors allowed themselves to be denied access to the company's premises, working from a motel.

As in the case of AM and Surgical, the Commission sought and obtained extensive ancillary relief focusing on Fox' SEC audit practices and restricting Fox for a period from accepting new SEC audit clients. 10/

The Arthur Young Case

Let's move to a different focus, but no less important -- the recent Supreme Court ruling in United States v. Arthur Young & Co. That case arose from an IRS summons directing AY to produce tax accrual workpapers prepared in connection with its audit of a client. AY resisted, partly for concern that the ability of the IRS to obtain such information from auditors would inhibit clients' candid discussion of tax matters with auditors. In turn, that could adversely affect the quality of financial disclosure under the federal securities laws.

The District Court disagreed. The Court of Appeals reversed, holding that the public interest in promoting full disclosure between public accountants and their clients, and in turn ensuring the integrity of the securities markets, required protection under a court-fashioned limited work-product privilege. The Supreme Court found that no confidential accountant-client privilege exists, emphasizing the entirely different roles of attorneys and accountants. An

> independent accountant owes ultimate alliance to the corporation's creditors and stockholders, as well as the investing public...[t]his 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations. (Emphasis added.)

10/ The court ordered a Special Review Committee to examine Fox' audit practices for SEC clients and ordered Fox to submit this report to the Commission and to implement any and all recommendations of the Committee -- whether Fox agrees with them or not. The court also ordered Fox not to accept new SEC audit clients until adopting the Review Committee recommendations. This review was completed in January 1984. Finally, one year after the submission of the report, a supplemental review must occur to determine whether Fox has adopted and effectively implemented the Committee's recommendations. In connection with the Alpex audit, the Commission also recently concluded Rule 2(e) administrative proceedings against two Fox & Company partners and an audit manager.

The Supreme Court held that a privilege was not necessary to ensure the quality of disclosure, believing that companies had adequate incentive to cooperate fully with the auditor. After all, the auditor must disclaim an opinion or qualify its opinion if it believes that the scope of the audit examination is so limited that the auditor cannot ascertain whether tax liabilities have been accurately stated.

The Commission received persistent entreaties to participate in the case. The Commission wants to do everything possible to further full disclosure. Yet, to encourage the candid communications between client and auditor which would arguably enhance disclosure meant arguing in favor of a privilege which would restrict the government's access to evidence. We opted to stay out of the case.

The long-range consequences of this case may be substantial. With all of the emphasis on "public watchdog," "total independence from the client at all times," "complete fidelity," and "public trust," the Supreme Court has set up at least a judicial stage for a reexamination of the auditor's role, function and obligation in many contexts. That potential merits an entire speech.

But I will make one observation. Whatever discomfort this decision may cause, public companies nonetheless are required to maintain candid communications which will permit auditors to satisfy themselves about the tax accrual and express an unqualified opinion. That may be uncomfortable, but a public company cannot avoid its obligation of full and complete disclosure. That must take precedent over tax strategy.

Accounting Standards and Specific Financial Reporting Issues

Thus far, I seem to have focused on enforcement and litigation matters. But the Commission's accounting interest is much broader, extending, among other areas, to the standard-setting process and to specific financial reporting issues.

Part of the Commission's role in accounting matters includes oversight of the Financial Accounting Standards Board. Some have criticized the Commission for not playing a more formal role in the standard-setting process. A full disclosure of the relationship between the Commission and the FASB -- what it is, what it should be, whether the Commission's present level of oversight is effective -- is also a topic for another day.

I would note, however, that the Commission has taken recent steps to enhance the oversight process. We have increased the number of formal, public meetings between the Board and the Commission to provide an opportunity for greater exchanges of views and ideas.

The goal is not to debate each issue before the FASB, but to share views and to involve the Commission more directly in the standard-setting process at an earlier stage. This process was agreed upon by the Commission following a spirited debate among the Commissioners when we considered in-substance defeasance. That meeting revealed differing perceptions among various Commissioners about the workings of the oversight process -- if not some sense of unease. We hope that a more regular exchange between the members of the Commission and FASB members will further the standard-setting process. I will not suggest that this amounts to the heavy-handed, preemptive oversight some advocate, nor do I suggest at all that we view the FASB negatively. I only suggest that this development is worth noting.

Turning to specific financial reporting issues, in February, 1984 the Commission proposed significant changes in interim financial reporting, including quarterly segmented information. More specifically, the Commission proposed presentation of certain industry segment information in Form 10-Q's and a more specifically mandated discussion of reportable segments in the management's discussion and analysis for both interim and annual financial statements. The Commission also gave advance notice of possible additional rulemaking concerning additional segment reporting disclosures and uniform disclosure of off-balance sheet financing arrangements.

In 1977, the Commission deferred to the FASB on interim segments. In 1979 the FASB, however, dropped its project on interim reporting, including segments, and recently determined not to reopen the segment aspects at this time. The Commission nonetheless has proposed these substantial additional financial statement reporting requirements. I cannot predict the Commission's ultimate action on the proposals. But the point is that the Commission was interested enough to "step up to the issue" unilaterally -- in fact to step out in front of the FASB -- principally influenced by the user community which has claimed that this information has much value. That merits your reflection.

Conclusion

My comments today have focused on accounting from several perspectives -- cooked books and the corporate environment, cute accounting, the Perry unit, professionalism and the obligations of auditors, the relationship between the integrity of financial statements and the disclosure process, issuers' obligations of candor with auditors, the standard-setting process, and specific financial reporting requirements. Obviously, I have not begun to discuss any one area exhaustively, but have tried to outline the breadth of accounting issues of keen interest to the Commission. In turn, I hope that will emphasize how critically the Commission views

accounting matters. In a very real sense, accounting is what the Commission is all about. There is no other topic the Commission focuses upon from as many different, but ultimately interrelated, perspectives. Whether all of this amounts to some new spirit of activism in the accounting area or merely is the Commission doing what it always has done, I leave for others to debate. But I come back to my starting observation -- the integrity and accuracy of financial statements is paramount to the disclosure process. All involved should be guided accordingly.

I hope I have shared with you some perspective about the Commission's interest in accounting matters. I close with a note of encouragement and challenge. The challenge is for the Commission, the FASB, the accounting profession, and reporting companies to co-operate to make the process work and to see that accounting occupies its deserving position of prominence. The encouragement is that I believe we all want to see that occur, as evidenced by functions and gatherings like this.

I thank you for inviting me to speak and for your attention.

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