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"COOKED BOOKS": NO NEW RECIPES

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Good afternoon. It's a pleasure to appear before the Third Annual Northwest Securities Institute.

When preparing to speak, my first thought was to look for a topic that would be totally new. What I ultimately focused upon was something which I believe to be as timely as it unfortunately is old: financial statement fraud, or more bluntly, "cooking the books." Fifty years after the adoption of the Securities Act of 1933, accurate and reliable financial statements would seem to have been fully embraced as customary for public companies. Yet, recent cases suggest that this premise is not universally held.

Before discussing specific cases and fact patterns, let me venture a conclusion as to a cause of these cases of "cooked books." I cannot avoid attributing some of the increase in these cases to an unthinking or uncritical use of a management tool referred to by some as "management-by-objective," compounded by limited and poor communication between corporate headquarters and divisional managers. Business schools have long taught, and presumably continue to teach, that management-by-objective is a sound approach. I have no quarrel with the approach in theory. But, too often, its inflexible and over-zealous application has caused violations of the federal securities laws.

Some recent cases of falsified corporate records have been egregious and have involved major, respected publicly-held companies. In these cases -- and it initially struck me as puzzling -- there has been no direct, personal gain in the sense of kickbacks, bribes, or theft. Funds or assets have not been improperly diverted for the direct benefit of an officer, employee or other person. Instead, books and records have been altered, and those who participated in the improper activities apparently believed that the manner in which they acted was in the best interests of the company. In some cases, it was an admitted feeling of "team effort" which led loyal mid-level managers, acting in concert with lower-level employees, beyond the bounds of permissible corporate conduct.

Another noteworthy aspect of these cases is the directness and simplicity of the fraudulent practices. Creativity in "cooking the books" appears only occasionally. The fraudulent

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The views expressed in this paper are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff.

activities are relatively simple: recognize revenue prior to a sale; falsify inventory; defer or accelerate customer allowances; ship without invoices or issue invoices without shipping; and play games with a variety of expenses such as advertising, marketing, research and sales promotion. Sometimes the deception has been as easy as following the auditors around the warehouse and adjusting inventory records behind their backs. Sometimes the deception has involved almost childish concoctions of inventory figures out of whole cloth. Sometimes third parties, such as suppliers, have been enlisted to defer or redate invoices. As I said, simplicity seems to be the recurring factor; novelty is almost totally missing.

A third factor which stands out in these cases, which prompted my comments at the outset about management-by-objective, is the organizational structure and operating philosophy of the companies involved. In virtually all cases, there has been an emphasis on decentralized, autonomous management, on the theory that autonomy encourages responsibility, entrepreneurial decision-making, productivity, and therefore profits. I have no quarrel with those objectives. But the corollary to that autonomy has been a lack of accountability. The problems have been particularly heightened when a distant, central corporate management either has unilaterally set fixed productivity goals for a division; or, without expressly stated goals, applied steady pressure for increased productivity. Either way, headquarters may not have considered whether its demands have created an atmosphere in which falsification of books and records at lower-levels becomes possible, if not likely. Moreover, when there is a weakness in central accounting controls, the problem has been compounded, for there has been no way for top management to detect the accounting chicanery at the divisional level, assuming top management was motivated to do so.

At the middle level, management apparently sometimes has adopted the attitude that the responsibility for accurate accounting rested solely with the independent accountants. If a questionable accounting treatment slipped past the auditors, the shenanigans were in some way "blessed." With that attitude, entire divisions apparently came to assume that a little mischief here and there was an entirely appropriate way to achieve profit objectives unrealistically imposed by far-away top management, provided, of course, it got by the auditors.

Frequently accompanying this management philosophy have been various "management incentive" programs, which tie employee remuneration or advancement to productivity standards set by the central office. So, while outright falsification of records is not expressly encouraged, when it comes to holding on to a job for the lowest employee, or to a nice bonus for mid-level management, there has been a motive to cooperate to meet set profit objectives.

As I mentioned at the outset, "cooked books" have surfaced in well-known public companies, not just borderline operations, often with no indication that any manager or employee believed he was acting other than in the best interests of the company, and often with every indication that the deception was achieved with relative ease. And while there has been an inclination to attribute these cases to hard economic times, closer review reveals instances of financial statement fraud during times of financial prosperity as well as financial stress. That prompts one to wonder if the past two years of financial stress will not yield an increase in these cases.

With those general comments, I would like to consider some specific cases. The first involves H.J. Heinz Co. In May, 1980, Heinz filed a Form 8-K Current Report, which detailed Heinz's Audit Committee investigation of questionable accounting practices and restated financial statements previously filed with the Commission. The practices had occurred at three Heinz divisions, and had occurred during relatively profitable years for these divisions.

Heinz's corporate structure provided for decentralized management, with self-sufficient divisions having their own officers and managers. Production and performance criteria, however, were established by Heinz's World Headquarters. During the 1970's, Heinz's World Headquarters established a stated objective of increasing earnings at a compound growth rate of 10-12% per year. The performance standards set for the divisions and subsidiaries were based upon an aggressive plan to turn around a company which World Headquarters had considered -- and I quote from the Form 8-K -- "moribund 20 years ago." There was little or no oversight by World Headquarters of the internal accounting practices of any division.

At the end of the 3rd quarter of each year, World Headquarters reviewed with officers of each division estimates of year-end results. If a possible shortfall appeared, division managers might "be encouraged" to report extra profit by a variety of means, including deferring or reducing discretionary expenses. This management pressure, coupled with the autonomy of the divisions, led to temptation and violations. The Form 8-K perhaps understated the case when it characterized the resulting relationship between World Headquarters and the divisions as a "communications gap." As World Headquarters applied pressure to achieve results, a "fortress mentality" gripped the divisions.

Heinz also had a significant Management Incentive Program, and up to 40% of an employee's annual remuneration was based on a "fair" or "outstanding" effort in achieving profitability goals. The plan emphasized short-term results. Employees interviewed by the Audit Committee believed it a "mortal sin" not to meet their goals.

The Form 8-K indicated that, above all else, this attitude caused the divisions to try to control or limit the demands of World Headquarters. For instance, if a division's income goal for 1975 were $20 million, World Headquarters would increase the goal for 1976 by 15% to $23 million. But if the division exceeded the 1975 goal and earned, for example, $24 million, World Headquarters would set the 1976 goal based on a 15% increase of $24 million, or up to $28 million. The divisions were quick to realize that if they recorded as income only the original lower goal ($20 million) and concealed the additional $4 million income, the division would go into the next year with both a lower goal and a nice $4 million cushion for hard times.

The methods used to falsify results of operations were simple and arbitrary: improperly overstate advertising and market research expenses in one year and understate them in a succeeding year. According to the Form 8-K, the transfer of income from one year to the next frequently had no material effect on consolidated annual statements, but did have a significant effect on quarterly income statements and balance sheets. In certain instances, invoices were solicited from advertising agencies in a current period for services to be rendered during the succeeding period. Shipping invoices were pulled to prevent processing, and a shipping moratorium was declared for the last week of the fiscal year and already issued invoices redated to reflect shipment in the new year.

All of this was accomplished, according to the Form 8-K, through circumvention of existing internal controls by the very division personnel charged with enforcing such controls. The Report concluded that the questionable practices indicated a "lack of understanding throughout the company that responsible and ethical practices are required in connection with all transactions." Yet, the Audit Committee also found no evidence that any Heinz employee sought or gained and direct personal profit, nor any evidence of participation in the actual falsifications by top management in World Headquarters.

The McCormick & Company case (S.E.C. v. Mc Cormick & Company Incorporated, et. al., Civil Action 82-3614, Dist. of Col.; 1982) is a more recent illustration of divisional management's chicanery, with striking similarities. In December, 1982 McCormick and the General Manager of McCormick's Grocery Products Division, a former member of the Board of Directors, consented to the entry of a permanent injunction against further violations of Sections 13(a) and 13(b) of the Exchange Act. The complaint principally alleged that the Grocery Products Division, McCormick's largest division, improperly inflated current earnings. Recognition of allowances due customers were improperly deferred from a one period to a future period, and current expenses for the current period were not accounted for until a future period. The marketing function at the division effectively controlled the accounting function. Thus, expenses easily could be adjusted and moved from quarter to quarter if divisional sales management wished. Another expense improperly deferred was advertising. With the cooperation of the division's advertising agency, billings were delayed from one period to another. In other instances, management personnel either redated invoices or held them up until later periods. To increase revenues, the Grocery Products Division accounted for goods ready for shipment as sales in the current period, even though they were not actually shipped until the succeeding period.

Like Heinz, McCormick had decentralized management. Each division had substantial autonomy and its own administrative, manufacturing, accounting and marketing staff, with corporate headquarters playing essentially a policy and monitoring role. The irregular practices were engaged in at the divisional level and involved a number of personnel at that level, including top divisional management. There was no evidence of diversion of corporate funds for the benefit of any McCormick employee. According to the report filed with the Commission by McCormick's special counsel, those who directed the improper practices believed that the practices were the only means to achieve the unrealistic profit objectives of central corporate management. The practices were regarded by the division as a "team effort."

Special Counsel's Report placed the most severe blame on the manager of the division. Among the factors cited by McCormick's Special Counsel as contributing to the situation was the pressure by distant, top management for increasing profitability. As a corrective measure, the Report suggested joint planning between division and central headquarters on financial and budget matters. The Report also pointed out, perhaps in understatement, that the accounting function was not given the same emphasis in the division as were other functions. But the Report also criticized McCormick's independent auditors for failing "to develop a sufficient understanding" of McCormick's internal procedures, and the Report characterized certain aspects of the audit as "deficient." McCormick has since changed independent auditors.

In November, 1982 the Commission concluded an administrative proceeding pursuant to Section 15(c)(4) of the Exchange Act against Ronson Corporation (Admistrative Proceeding File No. 3-6191; Rel. No. 19212, November 4, 1982), determining that Ronson's annual and periodic reports filed with the Commission for 1976 through 1980 did not comply in material respects with Section 13 of the Exchange Act and the rules thereunder. Again, we see a similar pattern. Ronson's executive offices are located in New Jersey. During the late 1970's, Ronson's aerospace group, "RHUCOR California," engaged in a pattern of improper recognition of revenue prior to product shipment. In many cases, this income was recognized prior to completion of the product. This effort was undertaken by

RHUCOR personnel to meet profits expectations set by central headquarters in New Jersey.

When these practices were brought to the attention of senior management, public disclosures were made and a special audit review conducted, which resulted in a restatement of financial statements for 1976 and 1977. The Special Review, however, did not uncover other practices which caused distortions in Ronson's financial statements. These included the practice, at interim reporting periods, of arbitrarily adjusting month-end inventory figures by amounts necessary to achieve a pre-determined pretax year-to-date and monthly profit margin of 9% to 12% of sales. After month-ending inventory was determined, RHUCOR's accounting personnel would prepare a preliminary income statement. After the monthly financial statements were finalized, except for the ending inventory figure, the controller adjusted the inventory to achieve a predetermined pre-tax profit margin of 9% to 12%. After consultation with RHUCOR California's plant manager, this "adjusted" figure was then used to prepare RHUCOR California's and thus Ronson's consolidated financial statements. Obviously, RHUCOR's activity not only increased earnings but also resulted in purely fictitious inventories.

A physical inventory was taken as of the end of February, 1980 as part of the Special Review procedures undertaken by Ronson. This physical inventory for February, 1980 was "rolled back" to December 31, 1979, and the inventory book balance adjusted accordingly. However, it was impossible to make an actual count of the previously uncounted inventories for 1977 and 1978. For those years, Ronson used estimated gross profit margins to "cost out" the inventory, but failed to disclose in its restated financial statements that such financial statements were based upon such estimates.

The final case I would like to discuss involves a 1982 action by the Commission against a mid-level manager of a wholly-owned subsidiary of the Dorsey Corporation (S.E.C. v. Tate, Civil Action No. H-82-0175 (R) S.D. Miss. 1982), who was charged with aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act. The manager was in charge of a glass container manufacturing plant, with responsiblity for personnel, purchasing, manufacturing and record-keeping. For two years, he intentionally falsified daily production reports and corporate records concerning the plant's operations, resulting in an inventory overstatement of $1 million.

The manager's methods were quite simple. Each day, he received production reports from subordinates. New, inflated figures, which were the product of his imagination, were called in to corporate headquarters. He also falsified physical inventory summaries of raw materials which were sent to the head office and used to evaluate the efficiency of his plant. As a result, periodic reports filed by Dorsey with the Commission were materially incorrect. The falsifications were made without the knowledge of any executive officer of Dorsey. The Commission's investigation revealed no evidence of negligence or theft. The inventory overstatement was the result of the manager's desire to make his plant appear more productive and to promote his own career.

The manager also manipulated the results of the plant's annual physical inventory to approximate his cumulative daily falsifications. His method again was simple. After physical counts had been made and recorded on tickets at the head of each row of containers, and before the tickets were removed and sent to the head office, he simply followed the auditors around and changed the numbers. He explained: "If there was, say, an '11' on the tickets, I could change it to a '41'." The activities of this single individual resulted in a 25% overstatement of the subsidiary's operating profit for 1978.

It should come as no surprise to anyone here that such conduct may violate any of several provisions of the federal securities laws. Immediately coming to mind are inaccurate filings and books and records in violation of Section 13(a) and (b) of the Exchange Act. In addition, liability may arise under Section 10(b) of the Exchange Act and Rule 10b-5. If the issuer makes an offering of securities during the period in which inaccurate financial statements are on file, liability also may arise under Sections 11 or 12 and 17 of the Securities Act, as well as under Section 10(b) of the Exchange Act and Rule 10b-5. During a tender offer, false financial statements may give rise to liability under Sections 10(b) and 14(e) of the Exchange Act. Finally, violations of Section 14(a) of the Exchange Act may occur if the deficient financial statements are contained in a proxy statement. Without attempting to identify all of them, numerous provisions of state law may be violated.

If there are "cooked books," one or more of a number of parties may be implicated: lower-level employees, mid-level management, officers, directors, and sometimes third parties, such as customers or suppliers. Obviously, all of these parties are not implicated in all cases. Laying the correct measure and type of liability at the feet of the properly deserving party is often a difficult exercise, and distinctions can become rather fine. For example, if a lower-level employee or mid-level manager is on an individual frolic, acting without the knowledge, acquiescence or approval of senior management, it is difficult to prove that the issuer acted with the "scienter" required for a Rule 10b-5 violation. If senior management actually participates in "cooking the books," the entire analysis obviously changes. In that case I personally have no doubt that their activities and "scienter" can be imputed fairly to and result in violations by the issuer. Obviously, the extent and duration of the involvement of senior management may vary from case to case, and a minimal or passing involvement may not be sufficient to impute scienter to the issuer.

In the case of the outside auditor, assuming he has no actual knowledge of the "cooked books," liability generally will depend upon whether he recklessly disregarded warnings or "red flags." Red flags might, for example, involve altered invoices or a high proportion of goods shipped immediately before the end of a quarter or year. Recklessness by the auditor, I believe, might also be inferred from a significant degree of inadequacies in the issuer's internal accounting controls. I make that statement recognizing that an auditor does not opine on the adequacy of internal accounting controls. Nevertheless, if there is an absence of effective accounting controls in substantial areas of a company's operations, the degree of caution required of the auditor and the need for "tough questioning" increases.

Customers, suppliers, and other outside parties also can play a role. Customers, for example, might agree to take delivery of merchandise with the understanding that it can be returned after the close of the accounting period. An advertising firm might agree to delay billing to permit an issuer to defer expenses until a later accounting period. If such action is taken with the knowledge that it assists a company in improperly accounting for its operations, the customer or supplier may have aided and abetted a federal securities law violation. One case dealing with third party liability is SEC v. Liberty Equities Corp., (D.D.C. 1970). In that case, the issuer each year, immediately before fiscal year-end, borrowed funds from its bank. The funds were immediately invested in the bank's CD's, and the CD's were pledged as collateral for the loan. After year-end financial statements were prepared and distributed, the loans were paid by cashing the CD's. The issuer's financial statements did not show that the CD's were pledged. The Commission alleged that the bank knew that the loans served no legitimate business purpose and only dressed up the issuer's year-end balance sheet. The bank eventually consented to an injunction against aiding and abetting the company's fraudulent reporting.

Thus far I've focused on how books can be cooked and who may be liable for what violation. Perhaps we should consider who is harmed by this violative activity. The harm may be the consequence of being named as a defendent in a Commission enforcement proceeding, monetary losses in private damage actions, the expense of litigation, damage to reputation and professional standing, or diminution in value of investments when the price of the company's stock predictably falls. I submit that those who may be harmed in some fashion include:

1. Large and small investors who own both debt and equity securities of the issuer.

2. Management and directors of the issuer, who may be damaged monetarily, as well as from the standpoint of reputation and standing.

3. Insiders who own large blocks of stock of an issuer, such as an estate or family trust. As exposure of the wrong-doing occurs, the value of their holdings may drop dramatically and become more illiquid than is normal.

4. Merger partners, who may have overpaid to acquire stock or assets of the issuer.

5. Underwriters who distribute securities for the issuer. Not only may they find themselves named defendants, they may be the principal defendant and be looked at by plaintiffs as the "deep-pocket."

6. Employee-stockholders, who purchase securities directly or through employee benefit plans.

7. Financial analysts who give investment advice about the issuer and its securities relying upon the reported financial statements.

8. Honest employees and managers who are denied career opportunities and salary increases.

9. The wrongdoing mid- and lower-level employees who, perhaps mistakenly, thought they were following the company line and become a scapegoat when exposure occurs.

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

11. Attorneys for the issuer, and perhaps for the underwriters.

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

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

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

Given the number of people who are or may be damaged, one must wonder how and why such fraudulent conduct continues. The only answer I can give is that issuers and aggressive managers too often allow such chicanery to become viewed as an acceptable feature of management-by-objective, or as an accepted practice of properly managing earnings, or as an organizational necessity, or merely as a matter of "team spirit." By and large in the cases I have discussed there was no "intent to cheat" in the sense of intentionally inflating the issuer's stock because of an immediately forthcoming new stock issue or acquisition. Instead, It was day-to-day business as usual.

And let us remember that these cases have has not involved innovative or creative fraud. Case after case it's the same basic story: padded inventory, pre-recognized sales, improperly deferred expenses, and simply phony transactions. Many apparently have forgotten the teaching, from forty years ago, of McKesson & Robbins, Inc. (ASR 19, 1940): "The time has long passed, if it ever existed, when the basis of an audit was restricted to the material appearing in the books and records .... [T]he partner in charge ... was not sufficiently familiar with the business practices of the industry in question and was not sufficiently concerned with the basic problems of internal check and control to make the searching review which an engagement requires." Although that statement was directed at outside auditors, its logic applies with equal force to senior corporate management when divisions are allowed and encouraged to operate autonomously to achieve profit goals set arbitrarily by distant corporate management. Such a situation gives rise to the same need for internal checks and controls and searching review.

The simple lesson is that preventing "cooked books" requires careful attention to sound accounting controls and procedures, but that lesson seems not easily learned. To illustrate the recurring nature of these problems, let me quote from several Accounting Series Releases issued over the last four decades.

1. "We are not satisfied therefore that even under Price, Waterhouse & Co.'s views other accountants would condone the failure to make inquiries of the employees who actually took the inventory and to determine by inspection whether there was an inventory as represented by the client."

   ASR 19, 1940. McKesson & Robbins.

2. "We have also found that in certifying such financial statements the respondents failed to comply with generally accepted auditing standards ... by their reliance upon the unsupported and questionable representations of the Seaboard Management...."

   ASR-78, 1957. Seaboard Commercial Corporation.

3. "A major deficiency of the Stirling Homex audit was Peat, Marwick, Mitchell & Co.'s reliance on the unsupported, undocumented representations of management."

   ASR 173, 1975. Stirling Homex.

4. "Throughout the years, it appears that no auditor ever asked for supporting documentation for this asset account, nor did the auditors ever confirm with outside sources the existence of the balances."

   ASR-196, 1976. Equity Funding.

5. "In its audits of both Mattel and Geon, Arthur Andersen & Co. uncritically accepted various management representations with little or no verification or documentation."

   ASR-292, 1981. Mattel, Inc.

Again, these quotes focus on an outside auditor's reliance on management's representations, but the message is much broader. Senior or central corporate management which places itself in a distant castle, issues profit and productivity goals by fiat, creates an atmosphere where a division or a division head has "failed" if the goals are not achieved, and fails to install and follow tough internal accounting controls seems to me to be every bit as subject to criticism as the auditor who relies upon undocumented representations of management. If management wishes to set highly ambitious performance objectives and follow some form of management-by-objective philosophy, and allow divisions to be autonomous, they must realize that "cooked books" at lower-levels is one foreseeable result. Self-interest alone should lead senior management to install procedures to assure that accurate data is available to them as the basis of informed business judgments.

For those companies who continue to demand that mid-level managers achieve highly-ambitious performance objectives but who are insensitive to the pressures they create and who do not improve internal controls, given the growing number of such cases, the question must be raised as to whether such conduct is sufficiently reckless to support charges -- including fraud -- against those managers and the corporation when the predictable "cooking of books" occurs.

Some of you may be surprised by the strength and bluntness of my statements. But you should not be. This is not a gray area; there are no difficult legal issues; no sophisticated analysis is required. This is everyday, commonplace, fraud -- plain and simple.

All of you are undoubtedly aware of the Commission's attack on insider trading, on the premise that it destroys investors' confidence in the integrity of the securities markets. I fully concur in that effort. Yet, I can think of no activity -- insider trading included -- which can do greater damage to investor confidence than financial statement fraud. Those who would profit from "cooked books" are few compared to the number of people who are harmed. I enlist the efforts of all present, whether from the private or public sector, in affording the highest priority to detecting and eradicating this pernicious and seemingly expanding form of fraudulent activity.

Thank you.

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