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THE COMMISSION'S ENFORCEMENT PROGRAM AND THE INTEGRITY OF FINANCIAL STATEMENTS

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Today I want to share some thoughts about the Commission's enforcement program and a matter of long-standing and continuing concern to the Commission -- the integrity of financial statements. I hope you will note that I did not say concern only about financial statements which are fraudulent in a strict sense, but concern about the integrity of financial statements, which is perhaps a broader concept. Two propositions provide the starting point for my comments. First, if the integrity of financial statements is undermined, i.e., if they are materially false or inaccurate, it is impossible for the narrative portion of any disclosure document to be accurate, and the entire disclosure process is corrupted. Second, the parties who are injured if that occurs are almost too numerous to list. They include not only the investors in the issuer and its officers and directors, but many innocent third parties who in some way rely on the financial statements of the issuer. These may include lenders, merger partners, underwriters, market-makers in the issuer's stock, auditors, attorneys, trade creditors, and virtually any other party dealing with the offending issuer. In addition, the offending issuer as an entity suffers over the long term, and with it its innocent employees.

Let me start with a brief review of some recent instances where the integrity of financial statements have been undermined. These instances are most distressing, for they do not involve high-flying conglomerates or wheeler-dealers, but instead involve regulated entities, presumably staid, conservative, and supervised. More than with cases involving other types of companies, these cases create a particular sense of uneasiness. Perhaps it is because I tend to accord regulated entities a presumption of regularity in the conduct of their affairs. Unfortunately, recent experience suggests that presumption may be ill-supported.

The Commission's recent case involving Security America Corporation is a good example. (*Securities and Exchange Commission v. Charles M. Stange and Herbert E. Burdett*, D.D.C., Civ. Action No. 83-0762.) Security America was the holding company for Security Casualty Company, an insurance company regulated by the State of Illinois. Security Casualty reinsured workmen's compensation policies and directly wrote health and accident insurance. For several years Security America overstated its net worth and net income in financial statements, including those used in connection with a public offering of common stock, by understating the loss reserves of Security Casualty.

The understatement was accomplished in several ways. In estimating medical costs on workmen's compensation claims, Security Casualty used a 1945 mortality table, which failed to reflect the longer life expectancies supported by medical advances. Security also failed to use an inflation factor in calculating estimated costs, and frequently used lower estimated annual medical costs than were reported or recommended by the primary insurer for these claims. This was contrary to accepted industry practice and to the advice of Security Casualty's own consulting actuary. Second, estimated reserves were calculated on the basis of claims actually paid, but Security Casualty had suspended payment on billings from two major primary insurers for claims made under policies that were reinsured with Security Casualty. Security Casualty concealed the fact that it was not paying these claims from its consulting actuary. When the actuary estimated reserves, the loss reserves inevitably were significantly understated. Third, as a result of its losses in its direct insurance business, mostly automobile insurance, Security Casualty was imposing rate increases. Lacking adequate data to determine which groups of policyholders were causing the losses, Security Casualty imposed across-the-board rate increases rather than distributing the rate increases among the policyholders causing the losses. Policyholders with good risk profiles, who could obtain lower cost insurance elsewhere, went elsewhere. Security Casualty was left with the poor risks who could not obtain insurance elsewhere. Despite being left with a pool of policyholders with adverse characteristics, Security Casualty did not adjust its loss reserves, but instead informed its actuary and auditors that no adverse factors were associated with its pool of policyholders.

The Commission brought an injunctive action against two senior officers of Security Casualty for violations of the antifraud provisions of the federal securities laws and an administrative proceeding against the company's auditors.

A second recent case (In the Matter of Accounting for Gains and Losses Incurred In Connection With Certain Securities Transactions, Securities Exchange Act Release No. 20266, October 6, 1983) illustrates the problems another type of regulated entity -- depository institutions -- can encounter in a climate of volatile interest rates. Two state-chartered, state-insured savings and loan associations, Southeastern Savings & Loan Company and Scottish Savings and Loan Association, entered into a merger agreement and filed related proxy materials with the Commission. During 1981, both institutions had received deposits from the sale of all savers certificates, insured market rate certificates, and various certificates of deposit which they in turn sought to invest in long-term liquid instruments to lock-up favorable yields. Upon the advice of the same financial adviser, an investment banking firm, each invested in 15% and GNMA certificates. The institutions were concerned, however, that

any increase in interest rates would cause a decline in the market value of the GNMA certificates and expose the institutions to losses if they had to sell the GNMA certificates to generate cash to satisfy customers' withdrawals of deposits. As a protective measure, the associations sought to hedge their positions in GNMA certificates by selling futures contracts for U.S. Treasury bonds.

In the Summer and Fall of 1982, interest rates dropped rather than increased. The market value of both GNMA's and Treasury bonds increased, but Treasury bonds increased in value more than the GNMA's because the market anticipated that the high interest rate mortgages underlying the GNMA's would be prepaid at an earlier date due to the availability of cheaper mortgage money. That perception caused the market to value the GNMA certificates as a relatively short-term instrument. Fearing prepayment of the GNMAs, both institutions sold their 15% and 16% GNMA certificates and purchased 8% through 12.5% certificates. Almost simultaneously, they closed out their Treasury bond future contracts at large losses and hedged the new GNMA positions with GNMA futures contracts.

Both institutions deferred recognition of the net losses realized from closing out the Treasury bond future contracts. Instead, they added the loss to the cost of the new GNMA positions, planning to amortize the amount of losses over a twelve-year period. Thus, the losses were not recognized currently in the financial statements filed with the Commission. Each association had extensive discussions with their auditors over several months, seeking concurrence in this accounting treatment. Failing to obtain such concurrence, each discharged their auditors and engaged a new firm that agreed with them on the deferral of the losses.

In the administrative proceeding, we only sought a corrective restatement of the financial statements. Despite the absence of fraud allegations, this case nonetheless highlights the inaccuracies which can result when corporate managers take the attitude that an accounting treatment that "dresses up" a company's financial statements is acceptable if they can only browbeat their auditors into acquiescence or, failing that, find another auditor who will acquiesce. That attitude is the direct opposite of the concern corporate managers should have about the integrity of financial statements. The end result is inaccurate financial statements because of management's attitude. Must we not ask whether that attitude significantly differs from the attitude of managers who turn their backs, knowing or suspecting that inventory is being falsified by middle or lower level employees, merely because the end result is more reported profits? I will return to that thought later.

The Southeast-Scottish case also highlights again the insidious and potentially destructive practice of "shopping" to find an accounting firm willing to support an extreme position. When a company has taken an accounting issue, as both institutions did, all the way to the national level of a major accounting firm and has been rebuffed, despite threats to discharge the accounting firm if it did not accede, questions about the good faith of the issuer and its management are inevitable if the case comes to the Commission. And if the succeeding auditor blesses a practice rejected by its predecessor, questions about that auditor are likely to arise. Granted, room exists for disagreement on close questions, but where a practice is clearly contrary to established accounting literature, blessing such a practice in the face of a considered opinion to the contrary inevitably will cause inquiry into both the issuer and the successor accounting firm.

Two other recent cases involving regulated entities further demonstrate the danger of overly aggressive interpretations of accounting standards. The first is our administrative proceeding against Aetna Life and Casualty. (In the Matter of Aetna Life and Casualty Company, Securities Exchange Act Release No. 13949, July 7, 1983.) In 1981 and 1982, Aetna took into current income approximately $230 million of anticipated future tax benefits from net operating loss carryforwards. Aetna asserted that it expected to incur substantial additional losses during the next two to five years. As these further losses occurred, Aetna proposed to recognize in current earnings $300 million to $500 million in related, anticipated tax benefits.

Authoritative accounting literature, however, permits current recognition only if future realization of the tax benefits is "assured beyond any reasonable doubt." This is a most stringent standard, intended to allow current recognition only in rare and exceptional circumstances. In all other cases, the benefit is to be recognized only if and when it is realized. In Aetna's case, the question was the degree of certainty of future profits to offset the losses. In other words, could Aetna demonstrate that it would realize profits "beyond any reasonable doubt"? The Commission sought restatement of Aetna's financial statements and a reversal of the recognition of income. Aetna eventually agreed to the restatement, but its decision may have been complicated considerably by the fact that Aetna had sold hundreds of millions of dollars of stock during the period in which the disputed tax benefits were being recognized as income.

Another recent instance of aggressive accounting interpretation by a regulated entity involved Financial Corporation of America, a savings and loan holding company. FCA's wholly owned subsidiary, State Savings and Loan, improved its balance sheet and income statement by two questionable practices. First, SS&L purportedly

"sold" foreclosed properties and delinquent loans. To finance these purported sales, SS&L made loans on other property owned by the buyer, and those loans provided the down payment for the "purchase" of the delinquent mortgages and foreclosed real estate. The remainder of the financing was divided into first and second mortgages, usually at 1-1/2% below the non-competitive Federal Home Loan Mortgage Corporation bid. The size of the first mortgage was determined by the monthly payment which would be supported by 40% of the expected rentals from the properties. The second mortgage, commonly called a "sleeping second", required no payments during the life of the mortgage and only simple interest accrued.

The Commission asserted that these transactions could not be recognized as sales under generally accepted accounting principles because the risk of ownership had not passed to the buyers and, contrary to Financial Accounting Standards Board Statement No. 66, the buyers had not adequately demonstrated a commitment to pay for the property. After lengthy negotiations with our staff, FCA acceded to the Commission's demand for restatement. That restatement reduced 1982 net income from $36.2 million to $27.2 million and added about $430 million in foreclosed real estate, delinquent loans and accrued interest to the balance sheet.

In addition to these four cases, we recently have seen the Commission focus again upon the question of an auditor's conduct, and in a dramatic fashion. Our recent action against Fox & Company, one of the largest accounting firms in the country, resulted in Fox being enjoined from violations of the antifraud provisions and the periodic reporting provisions of the federal securities laws. (Securities and Exchange Commission v. Fox & Company, S.D.N.Y., Civ. Action No. 83-4311.) In addition, the Commission obtained an order requiring Fox to establish a Special Review Committee to review and report on the manner in which Fox conducts its SEC audit practice. That report will be filed with the Commission and the Court, and Fox is required to implement all recommendations made by the Committee.

It is unusual for the Commission to bring an enforcement action against an entire major accounting firm, rather than against the individuals directly involved. The auditing failures in this case, however, were so widespread and represented such a systemic deficiency that an action against the firm was warranted and the Commission felt that the action should be in the form of an injunction. The Commission's complaint, in no soft terms, charged that Fox had issued unqualified opinions on the financial statements despite the fact that Fox recklessly failed to comply with generally accepted auditing standards, recklessly failed to verify inventories, and recklessly allowed a client to limit the scope of the audit, to restrict physical access to records, and to prohibit conversations with any employees not designated by the client. In one instance Fox was not even provided adequate on-site work space, but was relegated to a nearby motel.

In light of my previous comments about "shopping" for an auditor, I note that the Commission also charged Fox with failing to make adequate inquiries of its predecessor auditor concerning the integrity of management, disagreements with management, and management's reason for changing auditors. The failure to inquire of the predecessor contributed to the charge that Fox aided and abetted violations of the antifraud provisions of the federal securities laws.

A lack of integrity in financial statements is not a new problem. But these recent cases are particularly distressing, given the fact that they involve regulated entities and, in some instances, "shopping" for accountants. As I said earlier, my instinct is to accord a presumption of regularity to the affairs of regulated entities, but that presumption may be unwarranted. On the surface, we might conclude that these cases are different from more egregious financial statement fraud cases, sometimes called "cooked books" cases, involving non-regulated entities. But let's compare them to some "cooked books" cases not involving regulated entities to see if any real differences exist.

Within the past two years we have seen outright "cooked books" involving well-known commercial companies. Heinz and McCormick are two examples. A common aspect of these cases is that they arose in a corporate atmosphere which tolerated or encouraged reporting profits, even if they did not exist. That atmosphere was caused by four factors: (1) aggressive and arbitrary demands by top management for the achievement of unrealistic profit goals; (2) a highly decentralized corporate structure, with virtually autonomous divisions; (3) poor communications between top managers who unilaterally and arbitrarily set the profits and the divisions which were supposed to produce the profits; and (4) the failure or absence of adequate internal controls and a failure by certain headquarters to oversee adequately the accounting practices of the divisions. In the resulting atmosphere, middle and lower level managers came to have the attitude that outright falsification of books and records on a regular, ongoing, pervasive basis was an entirely appropriate way, sanctioned by senior management, to achieve profit objectives. The employees who participated in undermining the financial statements frequently believed they were acting in the best interest of the company, sometimes admitting that it was all a "team effort." In these cases, the wrongdoing was startlingly direct and 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.

In May 1980, Heinz filed a Form 8-K Current Report, which detailed an internal investigation of questionable accounting practices and restated financial statements previously filed with the Commission. The methods used by the divisions to achieve the

demands of World Headquarters, and undermine the integrity of the financial statements in the process, were simple. 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. 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.

The December, 1982 McCormick case (S.E.C. v. McCormick & Company Incorporated, et. al., Civil Action No. 82-3614, D.D.C. 1982) has many 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 permanent injunctions against further violations of Sections 13(a) (inaccurate filings) and 13(b)(2)(A) (inadequate books and records) of the Securities Exchange Act of 1934. The complaint principally alleged that the Grocery Products Division, McCormick's largest division, improperly inflated current earnings. Recognition of promotional allowances due customers was improperly deferred from one period to a future period, and the Division did not account for other expenses (primarily advertising) for a current period until a future period. In addition, the Division accounted for goods ready for shipment as sales in the current period, even though they were not actually shipped until the succeeding period. To conceal these activities, false statements were made to auditors, two sets of expense records were kept and auditors were permitted to review only the fictitious records, and shipping invoices and advertising bills were altered.

McCormick had the same type of decentralized corporate structure as Heinz. Special Counsel concluded that the pressure by distant, top management for greater profits contributed to the situation and that those who directed the improper practices believed that the practices were the only means to achieve the unrealistic profit objectives of central corporate management. There was no indication that anyone who participated believed they were acting other than in the company's best interests. The Form 8-K stated: "No one was happy about engaging in the practices but they were regarded as part of a ... team effort." As a corrective measure, Special Counsel suggested joint planning between division and central headquarters on financial and budget matters. Special Counsel also pointed out, perhaps in understatement, that the accounting function was not given the same emphasis in the Division as were other functions.

Let's think for a moment whether Heinz and McCormick are significantly different from the cases involving regulated entities, Southeast and Scottish, Security, Aetna and FCA? In Security America, managers lied to the auditors and actuaries, improperly deferred expenses by not paying reinsurance claims while concealing

facts, and using outdated actuarial tables to conceal losses in a manner just as blatant as falsifying inventory or maintaining two sets of expense records. Southeast and Scottish may have been a bit more sophisticated, or at least thought they were. They structured a highly questionable accounting treatment which deferred the recognition of losses -- expenses, if you will -- and shopped until they found an auditor to bless the treatment. Aetna took an aggressive position in the face of one of the most stringent accounting standards currently in effect and sold hundreds of millions of dollars of stock on the basis of inaccurate financial statements. FCA engaged in highly questionable accounting practices to defer the recognition of losses -- again, expenses, if you will -- by attempting to convert defaulted loans into current loans through transactions in which the buyers took no risk but stood to profit if property values increased substantially. The real question in these cases, I suggest, as well as in Heinz and McCormick, is the attitude of management toward the company's financial statements and management's concern about the integrity of those statements. I cannot conclude that the attitude is significantly different, and that is a distressing conclusion.

So what do we learn from these cases? Can we draw any helpful conclusions? I'll try.

1. As disturbing as these cases may be, particularly those involving regulated entities, we must concede that they are not new. Every few years, it seems as if a new generation of corporate managers, and perhaps accountants and attorneys, arrive on the scene who are convinced they have discovered the new way to create profits from thin air and who regard the integrity of financial statements as an inconvenient interference.

2. One answer, valid in the past and today, is that the integrity of financial statements can be ensured only if corporate managers and auditors pay careful attention to sound accounting controls and practices and conservative interpretations and insist upon a corporate atmosphere which emphasizes the significance of controls, procedures and thoughtful interpretations from top to bottom.

3. Top corporate managers must be especially sensitive to the pressures they put on others when they intentionally foster, or passively allow to exist, an atmosphere that says, "Don't tell me about your problems. Get me the profits. And if you're not a good enough manager to do so, there are others." That approach is bound to undermine the integrity of financial statements.

4. An attitude on the part of management that says, "Get me the profits today. I need them this year. I'll worry about next year next year" is just as destructive, whether the profits are generated by the outright falsification of books and records or by the distortion of generally accepted accounting principles. Either way, the integrity of the financial statements is undermined.

5. Corporate managers should not regard their auditors as adversaries, particularly when it comes to interpretations of accounting principles. And "shopping" is as insidious a practice as ever.

6. An industry that is having particularly hard times -- the thrift industry comes to mind -- is flirting with disaster if it adopts the attitude that only today counts, that only this year's profits are important, even if they have to stretch or violate GAAP and engage in bizarre transactions. Doing so on the assumption that such treatment or transaction will pass muster with a primary regulator is short-sighted. The Commission is still there, and the Southeast-Scottish case demonstrates our interest and involvement in these areas.

7. Outside professionals -- auditors, lawyers, financial advisers, and investment bankers -- do their client a noteworthy good when they exert their influence to dissuade their clients from stretching GAAP to the ultimate degree to achieve short-term goals.

8. The Commission's enforcement efforts in this area can be expected to continue and intensify. The Commission may not have the resources to bring all cases that should be brought. But to ensure that the corporate world is aware of the degree of our concern about the integrity of financial statements, I assure you that we will bring as many cases as we can, we will seek sanctions with the severity necessary to communicate our concern, and we will name as defendants as wide a group of participants as need be.

My comments, particularly the last few are blunt. So be it. This is not a gray area; the legal issues are not particularly difficult; no especially sophisticated analysis is required. As I said at the outset, 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 corrupted. Neither the Commission, the investing public, nor those who do business with public companies can tolerate such a result.

Thank you.

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