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ACCOUNTING SHENANIGANS AND THE COMMISSION'S 1984 RESPONSE

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Commissioner

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

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Accurate Financial Statements As the Key to Sound Disclosure

Before I came to the Commission, I spent almost sixteen years in private practice as a securities lawyer, representing both underwriters and issuers. I spent much time on "due diligence" for securities offerings and participated in the preparation of many periodic reports for clients. In my area of practice, it was frequently impossible to separate legal from accounting issues, and I worked on virtually a day-to-day basis with the accounting profession -- both independent auditors and internal financial officers and accountants.

Time and time again the absolutely critical importance of accurate financial statements was brought home to me. My experience in private practice left me no doubt that the last thing an attorney who works on a securities offering, whether as counsel to the issuer or underwriter, wants to experience is learning six months after the offering that the company is taking a $50 million write-off. Such events have a rather dramatic impact on restful sleep.

As a Commissioner, my vantage point has changed, but recent experience has only reinforced my views about financial statements. The reliability and integrity of financial statements and financial data is fundamental to capital formation, for it ensures not only fair disclosure but also fair competition among those issuers who compete for capital. The inescapable fact is that the narrrative portion of a disclosure document, even if prepared by the most experienced and cautious securities attorney, is worthless if based on false or misleading financial statements. That is so because the narrative portion describes a company that does not exist, and the entire disclosure process is corrupted as a result. If anything, the Commission's integrated disclosure system has heightened the need for constant attention to the integrity of financial statements. Everyday decisions made when preparing periodic reports under the Securities Exchange Act of 1934 -- narrative disclosure and financial data alike -- now have enhanced significance, for they may be incorporated by reference into registration statements under the Securities Act of 1933 for public offerings done with great rapidity.

All this means one thing -- the integrity of financial statements must not be compromised. The market cannot tolerate it; the corporate community should not tolerate it; and the Commission will not tolerate it.

This distinguished group, the Chicago Chapter of the Financial Executives Institute, comprised of financial officers of companies headquartered in or near one of America's great cities, provides an excellent opportunity for reflection upon the Commission's attitude in 1984 about the integrity of financial statements. Depending on how one views it, I suppose I bring both good news and bad. For those who are genuinely concerned about the accuracy and integrity of financial statements, the good news is that the Commission shares that concern. For those who are not deeply concerned about the accuracy and integrity of financial statements -- whether they be overly aggressive corporate managers or overly compliant auditors -- that's bad news, for take notice that 1984 will be a year of reckoning.

Before turning to specifics, let me point out one distinction. Two types of activity can undermine the integrity of financial statements, although they overlap and blur in some instances. Those are "cooked books" on one hand and "cute accounting" on the other.

"Cooked books" is perhaps the more publicized of the two and is illustrated by our late 1982 injunctive action against McCormick & Company.* The Commission alleged that McCormick's current earnings were improperly manipulated by various activities. These included improperly deferring to future periods current expenses such as customers' promotional allowances and advertising, redating invoices, and accounting for goods ready for shipment as current sales even though not shipped until future periods. To achieve this, employees made false statements to the auditors, kept two sets of expense records, permitted auditors to review only the fictitious records, and altered shipping invoices and advertising bills. McCormick and a division manager consented to the entry of permanent injunctions against violations of Sections 13(a)(inaccurate filings) and 13(b)(2)(A) (inadequate books and records) of the Exchange Act.

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* S.E.C. v. McCormick & Company Incorporated, et. al., Civil Action No. 82-3614 (D.D.C. 1982).

This type of activity, involving essentially the falsification of books and records either to manufacture or accelerate revenues or to defer or conceal expenses, is the common "cooked books" case.*

In addition to "cooked books," the Commission also has focused on what some have characterized as "cute accounting" or "cute fraud." These cases involve the misapplication of accounting principles and interpretations, or at least pushing standards to the extreme, to achieve desired, albeit distorted, results. Two related cases addressing this this type of activity are the Commission's injunctive action against Litton Industries** and administrative proceeding against Touche Ross.*** In Litton and Touche Ross, the common accounting question was whether, and under what conditions, cost overruns associated with a new shipyard and Navy shipbuilding contracts could be deferred based on Litton's claimed expectation of recovery of cost overruns from future contracts and from claim negotiations with the federal government. Litton ultimately consented to a court order, under which it agreed to submit its cost deferral and cost-to-complete accounting decisions to special review by its audit committee and an independent auditing firm consultant. In late 1983, the Commission censured Touche Ross for accepting, without adequate basis, Litton's judgment that the entire cost overruns would be recovered and for accepting, without adequate basis, Litton's judgment to defer $328 million in costs based on the

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* A number of other recent Commission cases have involved "cooked books." See, e.g., Form 8-K dated May 8, 1980 filed by H. J. Heinz Co. (operating divisions improperly deferred recognition of revenue to control profit objectives imposed by corporate headquarters); SEC v. Tate, CCH Fed.Sec.L.Rep. ¶98,835 (S.D. Miss. 1982) (plant manager inflated production reports and physically altered auditors' inventory tickets; SEC v. McLouth Corporation, CCH Fed.Sec. L.Rep. ¶98,032 (D.D.C. 1981) (arbitrary adjustments to inventory, improper recognition of profits through movement of inventory from one plant to another, and failure to recognize unusual year end sales); SEC v. Saxon Industries Inc., 82 Civ. 5992 (S.D.N.Y. 1982) (creation of non-existent inventory of $64 million in one division and improper recognition of earnings when fictitious inventory was transferred through intercompany accounts).

** SEC v. Litton Industries, Inc., CCH Fed.Sec.L.Rep. ¶97,891 (D.D.C. 1981).

*** In the Matter of Touche Ross & Co., Securities Exchange Act Rel. No. 20364, November 14, 1983 (CCH Fed.Sec.L.Rep. ¶73,416).

expectation that they would be recovered through future new shipyard revenues. These two related cases demonstrate that the Commission is prepared to challenge financial statements deemed misleading not necessarily because of "cooked books," but because of the misapplication or stretching of proper accounting principles.

Having identified these two types of misconduct, let's turn to recent Commission initiatives and actions, including three forthcoming accounting cases.

Stretching Accounting Principles

First, let's talk about other instances of failure to apply accounting principles properly. In July, 1983 Aetna Life and Casualty Company consented to the issuance of a Report of Investigation under Section 21(a) of the Exchange Act and agreed to restate and substantially reduce earnings reported for the first three quarters of 1982.* The Section 21(a) Report focused on Aetna's recognition, beginning in 1981, of current income based on anticipated future tax benefits of net operating loss ("NOL") carryforwards. This practice continued through the first three quarters of 1982. The tax benefits so recognized as current income amounted to $203 million of $333 million net income reported for the nine months months ended December 31, 1982.

Under generally accepted accounting principles, tax benefits from NOL carryforwards cannot be recognized until they are actually realized, except in those unusual circumstances when the realization is assured "beyond any reasonable doubt" at the time the loss carryforwards arise. This standard is one of the most stringent tests in accounting, comparable in the eyes of many to the burden of proof in a criminal trial. According to a survey conducted at the behest of Fortune in preparing an article about Aetna and this income recognition practice, Aetna was the only company out of a data base of 4,000 companies sampled that, in 1981, was recognizing current income from NOL's.** In sum and substance, given the stringent nature of the test for income recognition, the Commission was unconvinced by Aetna's assertion that future realization of tax benefits was assured "beyond any reasonable doubt," even if it may have been "more likely than not" that they would be realized.

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* In the Matter of Aetna Life and Casualty Company, Securities Exchange Act Rel. No. 19949, July 7, 1983 (CCH Fed.Sec.L.Rep. ¶73,410).

** Loomis, "Behind The Aetna," Fortune, November 15, 1982, page 56.

In an early 1983 administrative proceeding under Section 15(c)(4) of the Exchange Act, the Commission challenged Clabir Corporation's valuation of the market value of certain portfolio securities listed on the New York Stock Exchange, even though that valuation was determined after consultation with Clabir's outside auditors.* Companies generally must value portfolio securities at the lower of cost or market. Financial Accounting Standards Board Statement No. 12 provides that, in the case of listed securities, market is determined by the quoted price on the securities exchange. Clabir instead used as "market" value a higher price, based upon certain oral offers from the issuer to repurchase the portfolio securities. The "oral quote" exceeded both Clabir's cost and current NYSE prices, which were less than cost. Clabir determined to carry the securities at cost and reported income for the third quarter of 1981 which was 58% higher than if Clabir had used the NYSE quoted price. The transaction was not concealed as such and outside auditors were consulted, but the Commission nonetheless was willing to disagree about questions of accounting principles.

In another recent Section 15(c)(4) administrative proceeding, the Commission charged that Southeastern Savings and Loan Company and Scottish Savings and Loan Association improperly deferred the recognition of certain losses arising from transactions in Ginnie Mae certificates and Treasury bond futures contracts, claimed to be hedging transactions.** If Southeastern had recognized the losses on the transactions, its Form 10-K for the year ending December 31, 1982, would have reported a net loss of more than $1.9 million, instead of net income of $248,000. Similarly, the Form 10-Q's for Scottish for the three-month and six-month periods would have reported net losses exceeding $1 million each quarter, instead of net income of $171,000 and $198,000.

Each association had extensive discussions with its auditors over several months, seeking concurrence in this accounting treatment. The independent auditors for Southeastern and Scottish ultimately advised that the losses on the transactions could not be deferred and amortized over a number of years as the associations wished and that the full losses had to be recognized currently. The two thrift associations reacted by discharging their auditors and retaining another accounting firm, which concurred in the treatment sought by the associations. That was

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* In the Matter of Clabir Corporation, Securities Exchange Act Rel. No. 19504, February 16, 1983.

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

followed by our administrative proceeding, which the associations settled by consenting to an order under Section 15(c)(4) and a restatement.

In addition to the impermissible stretching of an accounting principle, a significant, troubling factor in Scottish and Southeastern was "shopping" to find auditors who would countenance this "cute" accounting. Rest assured that if the choice or application of accounting principles comes to the Commission's attention as a problem, any "shopping" that has occurred will be a big, bright red flag upon which the Commission will not hesitate to focus critically.

In any case, judgments about accounting principles must be well-reasoned and supported. Particularly with respect to novel or aggressive interpretations, I would also suggest that they be well-documented, so as to withstand the scrutiny of hindsight.

Some Emerging Focus -- Problems and Remedies

Management's Discussion and Analysis of Financial Condition and Results of Operations

The Director of our Division of Enforcement and our Chief Accountant have publicly disclosed that they will be paying closer attention to "Management's Discussion and Analysis," colloquially known as "MD&A," in periodic reports filed under the Exchange Act. MD&A requires discussion of known events and trends that can reasonably be expected to have an impact on future results. That discussion is mandatory, not voluntary. A company is required to disclose unfavorable developments as soon as they are apparent, even if they have not yet had a discernible impact on the historical financial statements.

The importance of an accurate MD&A was highlighted, and the willingness of the Commission to move in this area demonstrated, in our recent injunctive action against Ronson Corporation.* The Commission alleged that Ronson violated an earlier Commission order entered pursuant to Section 15(c)(4) of the Exchange Act by filing annual and periodic reports which contained materially misleading MD&A's.** Ronson consented to a federal court order directing compliance with the prior Commission order.

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* SEC v. Ronson Corp., Civil Action No. 83-3030 (D.N.J. August 5, 1983).

** In the Matter of Ronson Corporation, Securities Exchange Act Rel. No. 34-19212, November 4, 1982.

In particular, Ronson's 1982 Form 10-K and Form 10-Q's for the first two quarters of 1983 failed to disclose that Ronson's largest customer, which in 1981 accounted for approximately 15% of Ronson's consolidated revenues and approximately 33% of earnings from continuing operations before income taxes, had shut down the operations which required purchases from Ronson, had suspended all such purchases from Ronson, and was unlikely to resume such purchases in the foreseeable future. These filings also failed to disclose the impact of technological changes upon the customer which, when the customer resumed purchases, were likely to lead to a substantial reduction in the levels of purchases from Ronson for an indefinite period. Ronson was required to amend its 1982 Form 10-K and the defective Form 10-Q's.

Ronson carries a two-fold message. First, when material facts that will have a negative impact on a company's business are known, they must be reported promptly and completely, regardless of their immediate impact on historical financial statements. Otherwise, the MD&A, even in a Form 10-Q, may be materially misleading. Second, the preparation of the MD&A must be a thoughtful exercise, looking to the future and discussing trends, not a mechanical one focusing solely upon historical financial data.

Non-Subsidiary Subsidiaries

Other "cute" accounting devices have made recent appearances. We have seen several instances (not yet made public in an enforcement proceeding but expected to be so shortly) where a public company causes the creation of a separate corporation and then advances funds to cover the new company's start-up costs and initial operations. I call these "non-subsidiary subsidiaries," borrowing from current argot in the banking world. The sponsor usually does not own any of the new company's stock, but it may (1) hold notes convertible at will into a substantial majority of the new company's shares; (2) provide the sole means of financing the new company's substantial operating losses; (3) effectively control the new company; and (4) have planned from the inception to acquire the new company, in part or whole, as soon as it achieved profitable operations. The sponsor carries the advances as an asset in its financial statements, thus avoiding recognition of expenses or losses in its financial statements during the early years of the affiliate's efforts.

Such an arrangement may be nothing more than a sham to avoid consolidating the financial statements of the new corporation with those of the sponsor, which may be a de facto parent. Even if consolidation were not required, in view of the exposure of the sponsor's assets to loss, the fact that the new company is operating at a loss and has negative net assets, and the new company's inability to survive without continuing support from the sponsor, carrying the advances as an asset is highly questionable. At the very least,

the periodic filings of the sponsor must disclose the nature of the relationship, the commitments to the new company, and the market value of the advances or investment. All in all, this type of activity appears to be a total sham, yet companies are engaging in this type of conduct.

Major Breakdowns and Ancillary Relief

In this advanced and enlightened year of 1984, one would hope that major accounting breakdowns would not occur. Unfortunately, they occur too frequently. These cases typically involve the use by a company and several individuals of numerous schemes to overstate a company's earnings and financial condition over a number of years. Practices may include willfully and extensively falsifying corporate records, lying to auditors, and coercing vendors into covering up the practices and participating in the wrongdoing. They also may involve improperly applying accounting principles, making numerous false disclosures concerning the accounting principles which were applied, and repeatedly violating generally accepted accounting principles. To be a bit more specific, we see such activities as a company (1) representing that it capitalizes only legal costs relating to the defense of its patents, when in fact the company capitalizes virtually all legal costs, most of which should have been treated as expenses when incurred; (2) capitalizing large amounts of other costs which clearly are normal operating costs and not capital expenditures; and (3) representing that sales are not recognized until products are shipped to a "ultimate consumer," when in fact revenue is recognized upon shipments or consignment to dealers and salesmen.

The impact of such misdeeds can be most significant, causing overstatements of earnings and assets by many millions of dollars and by enormous percentage amounts. Such cases demand that the Commission seek permanent injunctions against the company and a widening circle of individuals, which may include not only officers at the top and financial officers, but also officers in charge of such functions as marketing, finance, operations, and manufacturing, and even officers of subsidiaries.

The significance of such cases goes beyond the specific violations. In these major breakdown cases, the Commission may conclude that it is appropriate to seek extensive ancillary relief, such as a restatement of prior years' financial statements, the appointment of new directors acceptable to the Commission, thus diluting incumbent management's control, heightened responsibility of the audit committee, further diluting incumbent management's control, a review of certain accounting practices, and perhaps even the retention by the audit committee of its own accounting firm, acceptable to the Commission, as an adviser. That's a far cry from merely a prohibitory injunction, even one coupled with a restatement.

If you wish to reflect upon the Commission's seriousness about fraudulent financial statements, you should think long and hard about the scope of the ancillary relief I have just outlined. In fact, you can look forward in the near future to the filing of an action reflecting substantially the facts and seeking the ancillary relief I have just outlined. I also would suggest that you consider the broad ancillary relief obtained against A. M. International, Inc., in May, 1983 for violations of the anti-fraud, reporting, and accounting provisions of the securities laws.*

Bank Accounting Matters

Concerns about accurate financial statements and accounting practices of bank holding companies also has become a focus, concentrating in large part on the adequacy of loan loss reserves and the accuracy of disclosures with respect to banks' policies for establishing loan loss reserves. We see instances where bank holding company periodic reports misrepresent that loan loss reserves are based on periodic reviews of loan portfolios on a loan-by-loan basis, with particular attention paid to problem loans, when the actual practice is merely to multiply total outstanding loans and leases by an arbitrary percentage, perhaps based on the average reserves of a peer group of banks. Notwithstanding a dramatic decrease in the quality of the loan portfolio, the reserve percentage is not being increased. That obviously results in material overstatements of income, sometimes by more than 100%, and materially false Form 10-Q's and Form 10-K's. We also are seeing periodic reports which contain materially misleading statements and omissions with respect to formal agreements with a regulatory body imposing substantial restrictions on operations and activities. You can expect to see a forthcoming Commission enforcement case based on such a fact pattern.

Similarly, the Commission is concerned about the failure of bank holding companies to adjust provisions for loan losses on a quarterly basis to appropriately reflect changing risks in the loan portfolio. During the year some holding companies have become aware of a deterioration of the quality of many loans, arising from factors such as concentration of loans in one industry adversely affected by economic conditions. Year-end adjustments to loan loss reserves to reflect the decline in the quality of the loan portfolio do not remove the violations arising from quarterly reports which failed to adjust the reserves promptly. You likewise can expect to see a forthcoming Commission action based solely upon the alleged inadequacy of loan loss reserves in a single quarterly report.

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* SEC v. A. M. International, Inc., Civil Action No. 83-1256 (D.D.C. May 2, 1983).

The Use of Stop Orders to Deal
With Defective Financial Statements

Another emerging problem with financial statements seems to be an apparent attitude on the part of some that aggressive, or even inappropriate, accounting in a registration statement for a public offering carries with it little risk other than a stern comment and correction. Misleading financial statements in a 1933 Act registration statement are and should be of particular concern to the Commission. Yet, our staff is in no position to "audit" information in registration statements. When those with that responsibility fail to do so, a stop order proceeding under Section 8 of the Securities Act may well be warranted, and the Commission is moving toward more use of stop order proceedings to deal with defective financial statements, even if the issuer proclaims itself willing to amend to correct the deficiency.

A recent example of a stop order proceeding based upon false financial statements involved Chipwich, Inc.* Chipwich ultimately consented to the entry of an order finding that its financial statements improperly treated as sales and recorded as revenue transactions involving the street carts from which its ice cream products were sold, and that the financials therefore were materially inaccurate. As a result, Chipwich improperly recognized $2.5 million as revenue, which represented 54% of reported revenue, and caused its reported loss of $782,000 to be materially understated. Chipwich had treated the "sale" of vendor carts as bona fide sales, resulting in revenue. Yet, these were not "sales" under the controlling FASB Statement (No. 49), but were financing arrangements for several reasons. To make matters worse, the "sale" of the carts was so structured as to give rise to an "investment contract" and therefore an unregistered sale of security in a violation of Section 5 of the Securities Act of 1933. As part of the settlement, Chipwich agreed to retain new independent accountants who would treat the transactions correctly under Statement No. 49, to withdraw its pending registration statement, and to send its shareholders restated financial statements and a copy of the stop order.

You may expect to see stop orders used to deal with other instances of defective financial statements. While the cases I have in mind may be confined to initial public offerings, I would simply note that stop order proceedings are not limited to first-time filings.

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* In the Matter of the Registration Statement of Chipwich, Inc., Securities Act Release No. 6491, September 30, 1983.

Some Concluding Observations

In the interest of full disclosure, I should tell you that our backlog of financial statement fraud cases is substantial and expanding. I hope I have given you an idea of the dimension and complexity of the problems we face, and I hope I have communicated the seriousness of our concerns.

Let me conclude by sharing some views on the apparent causes of financial statement fraud. No matter how new the angle, nor how creative the device, inevitably at least one of three characteristics seem to exist:

(1) Aggressive corporate executives who manage by objective, and who see the manipulation of financial statements as an acceptable, if not entirely proper, means to achieve that end.

(2) A Board of Directors which is either isolated, indifferent, unquestioning, insensitive, or simply unwilling to ask tough questions.

(3) Insufficient regard or respect for the auditing and accounting functions -- in short, an attitude that views accounting as the place to put dullards and deadwood.

Regardless of the characteristic, and whether the result is "cooked books," "cute" fraud, or both, we are seeing a failure of corporate stewardship, a breakdown in management's accountability to shareholders. After all, is it not a basic tenet of corporate stewardship that management has a paramount duty to report financial results correctly to the true owners of the corporation -- its shareholders?

Apparently there are some tough questions which need to be asked with frequency, but are not being asked, at least in the cases I have discussed. Let me try to identify what I believe those questions to be:

1. What sort of atmosphere pervades the company? If the company espouses management by objective, an otherwise legitimate tool, has that become a glib synonym for finding ways to manufacture results when objectives are not met? Is the overwhelming focus on short-term results? In other words, is there an attitude that says, "Don't tell me about problems and next year -- get me the profits now"?

2. Are senior corporate executives accessible and sensitive to problems? Or is their attitude "onward and upward"? In other words, as long as the company makes money and the financial statements get by the auditors, don't tell me about problems.

3. Does the Audit Committee function effectively, or is it window-dressing? When did the Directors last review accounting policies, procedures and controls with a critical eye, with the independent auditors, and corporate counsel if need be, encouraged to express concerns directly to the Board of Directors on difficult and sensitive financial or disclosure issues?

4. Are internal financial executives intimidated by the other executives? Are they simply not supported by other executives and the Directors? Do they have an effective mechanism to deal with tough issues head-on, without fear of discharge, personal loss, or ostracism?

The proper answers to these questions are, of course, self-evident. If you cannot answer them correctly, and do so quickly, I suggest that you and your fellow executives have some serious thinking to do. If my remarks do nothing but give you, the internal financial officers, the leverage to cause those questions to be addressed properly, this evening has been time well-spent. For let me close by assuring you of the Commission's seriousness about this area.

It has been a pleasure to visit with you this evening. May all your experiences with the Commission be confined to social occasions such as this.

Thank you.

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