

NEWS

**SECURITIES AND
EXCHANGE COMMISSION**
Washington, D. C. 20549

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Address to

The Metropolitan Washington, D.C. Chapter of
the National Association of Black Accountants

Washington, D.C.

March 8, 1985

Investor Protection, The SEC,
And The Independent Auditor

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Commissioner

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

INVESTOR PROTECTION, THE SEC,
AND THE INDEPENDENT AUDITOR

I am pleased to have been invited to address the Metropolitan Washington, D.C. Chapter of the National Association of Black Accountants on the happy occasion of your annual awards dinner. My remarks tonight concern the accountant's role, as financial reporter and independent auditor, in the capital formation process. I know that this is one audience that is fully aware of the critical importance of preparing and auditing financial statements relied on by the investing public.

As you know, this topic is quite timely. The SEC for the last several years has made deceptive accounting practices and fraudulent financial reporting, colorfully nicknamed "cute accounting" and "cooked books", respectively, a high priority item on its enforcement agenda. During fiscal year 1984, for example, the Commission brought four times as many "cooked books" cases as insider trading cases, and between 1983 and 1984, the number of financial fraud cases brought by the Commission increased by one-third. I think it is fair to say that all of the Commissioners consider fairly presented financial statements to be the core of our disclosure system and essential to its effectiveness. Overly aggressive accounting and audit failures that result in the filing of materially inaccurate financial statements threaten the integrity of our capital markets, and the Commission regards such failures, therefore, as very serious matters.

Recently, a Congressional committee, chaired by Representative John Dingell, has begun far-reaching hearings on the

accounting profession. According to a recent Wall Street Journal article, Representative Dingell intends to examine "the SEC's oversight of the accounting profession" and to see "how the accounting profession is functioning as part of the federal regulatory system." 1/ The level of failed audits, Representative Dingell asserts, has been "too high and too spectacular." 2/ Opening the hearings, Abraham Briloff, an outspoken critic of the accounting profession, alluded to a "crisis of confidence" in the accounting profession. 3/ In light of these comments and others made in the press recently, I think you would agree that perhaps now, more than ever before, the adequacy of the accounting profession's role in the capital formation process is being examined and challenged.

Recent failures of prominent publicly held companies (e.g. Penn Square, Baldwin United, Continental Illinois) and, of course, the pending Congressional hearings have drawn considerable attention to the accounting profession's system of self-regulation. Self-regulation is a viable way, I believe, to maintain the highest standards possible for accounting and auditing. Others, however, see things differently. Representative Dingell has stated that his hearings will focus on the "mixed results of

1/ Wall Street Journal, February 19, 1985, at 4 (Berton & Ingersoll, "Rep. Dingell to Take Aim at Accountants, SEC In Hearings on Profession's Role as Watchdog")(hereinafter referred to as "Hearings").

2/ Id.

3/ Wall Street Journal, February 21, 1985, at 16 ("Dingell Rebukes SEC On Its Disciplining of Accounting Firms").

letting accountants regulate themselves," 4/ and he criticizes the SEC for "delegating rulemaking to selected private organizations and relying upon the large accounting firms to police themselves." 5/ A prominent witness at the Congressional hearings has stated that the process of peer review is not effective because accountants do not apply severe sanctions to one of their own group. 6/ I do not want to get too far into the topic of self-regulation and its advantages and disadvantages, because self-regulation is a topic worthy of an entire speech, if not an entire article. I raise the issue only because it sets the tone for the theme of my speech, which is that if your industry, the accounting industry, wishes to regulate itself, each one of you must do your part to see that the present system works.

Tonight, I would like to focus upon the need for each accountant to perform his or her tasks with the highest professional standards. Nothing less will ultimately convince Congress and the investing public that the present system of self-regulation and SEC oversight is a viable and effective one.

Scrutiny of the accounting profession is not going to subside -- the accountant's role is far too fundamental to the disclosure process underlying the federal securities laws. Less than a year ago, the Supreme Court focused on one aspect of

4/ Hearings, supra note 1.

5/ Washington Post, February 21, 1985, at E.2. (Ross, "Accounting Industry Practices Said in Need of Major Reform").

6/ Washington Post, February 21, 1985, at E.2., supra note 5 (quoting Robert Chator, Associate Professor of Managerial Economics and Policy at the State University of New York at Buffalo).

that role, the accountant as auditor, and described it in the loftiest and most serious terms. I quote!:

"By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to [the] investing public. This "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." 7/

Don Kirk, President of the FASB, has called upon accountants to uphold "professionalism," which he defines as a voluntary commitment to achieve excellence, objectivity and integrity in the practice of accounting. 8/

I recognize that nothing could be easier than for the Supreme Court, Representative Dingell, Don Kirk, and me to urge and insist that accountants strive toward high standards of professionalism. I also realize that there are complex pressures making the accountant's task more difficult today than it has been. Let's take a look for a minute at some of those pressures.

Many commentators have observed that management is under intense pressure to achieve short-term financial results.

7/ United States v. Arthur Young & Co., _____ U.S. _____, 104 S. Ct. 1495, 1503 (1984)(emphasis added).

8/ Address by Donald J. Kirk, "Standards and Other Requisites of Professionalism" (April 26, 1984).

Frank Wheat, a former SEC Commissioner and former partner of mine, observes that:

"never in my years of practice [have I] seen such management concentration on maximizing short-term results in contrast to investing for the long term. 9/

Some speculate that this short-term focus is the result of today's greater participation of institutional investors in the stock market who, it is presumed, have a shorter-term focus than individual investors. 10/ Others, such as Frank Wheat, assert that short-term earnings must be high to keep the stock price up, and thereby keep takeover raiders away. 11/ Whatever the reason, this pressure sometimes results in accounting practices specifically designed to accelerate revenue or delay expense recognition. These practices may be part of a conscious plan to "cook the books", or simply the by-product of aggressive management putting pressure on subordinates and themselves to meet ambitious goals. But whether the direct result of fraudulent intent or the

9/ Address by Francis M. Wheat, "The SEC--An Opinionated and Affectionate Comment on the First 50 Years and What Might Lie Ahead" (November 1, 1984).

10/ See Sloan, "Why Is No One Safe?", Forbes, March 11, 1985 at 137; Testimony of Andrew C. Sigler, Chairman of the Board, Champion International Corp., before the Securities and Exchange Commission, October 31, 1984.

11/ Address by Francis M. Wheat, supra note 9. See also Behr, "Defensive Maneuvers," Washington Post, February 28, 1985, at B.1. (attributing to former Chairman of the SEC, Harold M. Williams, the following statement: "A company that lets its earnings--and stock price--slip by pushing capital into research and other long-range building blocks is asking for a takeover.").

indirect result of institutional pressure, too many accounting practices being used today are anything but in accordance with GAAP.

What checks are there on management determined to cook the books or on an issuer with institutional flaws? One hopes that the independent director and the audit committee are diligently looking for and responding to warning signs. Ultimately, the threat of an SEC enforcement action or private litigation may provide some deterrent. As a practical matter, however, I submit to you that the independent auditor is the first and most important line of defense against the filing of materially misleading financial statements. Performing the duties of a "public watchdog" in a pressure-charged environment is no easy task. The difficulty is greater now than ever before, and, unfortunately, only likely to grow worse. But, for each one of you, there can be no short-cuts.

Another recent phenomenon complicating the role of the independent auditor is price competition. Many professionals have seen their clients grow more and more concerned with the costs of their services, and the accounting profession is no exception. Loyalties between the accounting firm and the issuer are not as strong as they once were. Many clients today are quite willing to part company with an accounting firm if another firm will give them a slightly better price, even at the cost of a less effective audit. There is no magic in their eyes to an opinion rendered by a particular firm. 12/ As a result, one

12/ Address by James C. Treadway, Jr., "The Accounting Function... Under the Spotlight and Under Pressure" (October 19, 1984).

prominent accounting professor asserts that "the audit today is as much a commodity as a gallon of gasoline." 13/

Notwithstanding the complex pressures affecting the accountants, however, it seems to me that a call to professionalism is still appropriate, and indeed, in order. It probably cannot be said too often that accountants must strive for objectivity, integrity and excellence. But, instead of simply repeating what has been said quite well by others, I would like to add a slight twist to their definition of professionalism. I am doing so in light of the great pressures and the complex environment in which the accountant now functions. I urge each of you to strive for what I call "effective professionalism." My definition of that term, of course, includes objectivity and integrity, and a voluntary commitment to excellence. However, it also includes a certain savvy on the part of the accountant, a heightened sensitivity to warning signs of institutional flaws or conscious fraudulent practices. Before I go too far with this, I will candidly admit that I am not an accountant; therefore, I would not begin to try to tell you how to prepare or audit financial statements. Nevertheless, it seems to me that you can be as independent and righteous as one could be, but if you walk through an audit blind to warning signals, you will not be very effective. As a Commissioner, I have seen certain patterns of accounting breakdowns that I would like to share with you to aid you in your quest for "effective professionalism". I would like to

13/ New York Times, October 3, 1984, at D.1.

focus on three situations that should raise red flags for any independent auditor, but which all too frequently are ignored. In discussing these situations, I may seem to be directing my remarks more to those of you in the field of public accounting than those who are a part of management. Quite to the contrary, the message is for management as well because you are the ones that should not be engaged in the practices that raise the red flags.

First is the practice of opinion shopping, that is, an issuer soliciting a number of accounting firms in search of one who will bless a questionable accounting practice. Let's look briefly at one recent case of opinion shopping that led to Commission action. 14/ In October of 1983, two North Carolina savings and loan associations sold futures contracts for U.S. Treasury bonds. A sharp decline in interest rates caused a sharp decline in the value of the Treasury-bond futures. In closing out their positions so as to be able to reinvest in GNMA certificates, both associations stood to suffer material losses. Seeking to avoid immediately recognizing the losses, the associations sought to add the losses to the basis of the GNMA certificates and amortize the losses over time. Each association was told by its independent accountant that the loss could not be deferred and amortized. After extensive "shopping", each found

14/ See 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): In the Matter of Stephen O. Wade, Ralph H. Newton, Jr., and Clark C. Burritt, Jr., Securities Exchange Act Release No. 21095 (June 25, 1984).

the same accounting firm who concurred in the desired treatment, and who rendered an unqualified opinion on the associations' financial statements.

The Commission sued the company, of course, as well as its auditors. In bringing a Rule 2(e) proceeding against the accounting firm that concurred in the desired treatment, and its partners, the Commission noted that the qualities of integrity, objectivity and independence are particularly important in the opinion-shopping context. Auditors must be extremely sensitive, the Commission concluded, to violations of GAAP when an issuer shops around for another opinion after having had a disagreement with its auditor. The reasons for the Commission's concern are obvious. To the extent that unqualified opinions are for sale no matter how shabby the accounting, all accounting firms are under pressure to bend the rules. An accounting firm that gives in to opinion shopping weakens the entire fabric of the disclosure system. Unfortunately, the SEC has seen entirely too many cases of accounting firms giving in to opinion shopping lately. My advice, therefore, is to think twice or even three times when an issuer comes to you after having a disagreement with its prior auditor!

The second situation that should send up "red flags" to any independent auditor is the year-end or period-end transaction that dramatically improves the income statement for the year or period. In October, 1984 the Commission brought an injunctive action against Chronar Corp., 15/ alleging in part

15/ SEC v. Chronar Corp., Litigation Release No. 10552 (October 3, 1984).

that it improperly recognized revenue from a purported "sale" of a technology manual to a Swiss corporation five days before the end of its 1983 fiscal year. Chronar recognized \$1.8 million in revenue from the "sale", about 81% of total reported revenue for the year. Had the \$1.8 million in revenue not been recognized, Chronar would have reported a net loss for fiscal 1983 of over \$1.7 million. Instead, it reported a nominal profit of \$8,000. The transaction, in fact, was a sham, and recognizing revenue from it violated GAAP because (1) the contract in substance actually related to a prospective sale of machinery and equipment, thus the transaction was a disguised present sale of technology, (2) there were substantial uncertainties with respect to collection, and (3) there were doubts about Chronar's ability to satisfy certain performance guarantees relating to the equipment. These uncertainties prevented the earnings process from being complete.

There are, of course, many variations on revenue recognition techniques that companies use to boost their reported income at year end. For example, last fall, the Commission filed an enforcement action against Tandem Computers, Inc. 16/ and three of its officers, one of whom was its controller, for improperly recognizing revenue so that its net income was materially overstated. Tandem recognized sales revenue (1) on equipment shipments without having signed purchase orders or contracts on file, (2) on contin-

16/ See, e.g., Securities and Exchange Commission v. Tandem Computers Incorporated, Robert C. Marshall, Henry V. Morgan and James G. Treybig, C 84-6413-JPV (N.D. Calif.), Litigation Release No. 10050 (October 2, 1984).

gent orders subject to material unsatisfied conditions, and (3) on shipments which occurred after the end of its fiscal year.

The Chronar and Tandem situations are more than aggressive accounting -- they are gross violations of GAAP. These type of year-end sham transactions have been entirely too prevalent in financial statements filed with the Commission and disseminated to the public. So, beware of the sale or group of transactions at year-end or period-end that have dramatic effects on the income statement!

Let's look at one final situation in which the independent auditor should be extremely sensitive to violations of GAAP: reserves, particularly for loan losses in the financial statements of lending institutions. As all of you know, the independent auditor must be aware of the business environment in which his client operates. Such awareness is especially important when evaluating the adequacy of reserves. In the last two years, the Commission has brought a number of cases involving financial institutions specializing in loans to volatile industries, such as oil. All too often, these types of financial institutions have been too slow in reserving for loan losses. 17/ When auditing the financial statements of such firms, the independent auditor must pay close attention to the adequacy of reserves for loan losses!

17/ See, e.g., In the Matter of Utica Bankshares Corporation, Exchange Act Release No. 20702 (February 29, 1984); In the Matter of Intrawest Financial Corporation, Litigation Release No. 10,294 (February 28, 1984).

To sum up, please do not assume that opinion shopping, period-end transactions, and reserves constitute a comprehensive list of red flags. They are merely examples of situations that have repeatedly resulted in audit failures, followed often by Commission action against the issuer and occasionally the independent auditor. It is my hope that by being especially aware of the dangers posed by these and other suspicious situations, the independent auditor can both compete effectively in these complex and challenging times and fulfill his mandate as the "public watchdog", thereby achieving the goal of "effective professionalism."

I thank you once again for a most enjoyable evening, and I wish all of you well.