

PEAT, MARWICK, MITCHELL & CO.
CERTIFIED PUBLIC ACCOUNTANTS
345 PARK AVENUE
NEW YORK, NEW YORK 10022

WALTER E. HANSON
SENIOR PARTNER

April 9, 1976
CHAIRMAN'S OFFICE
RECEIVED

Chairman Roderick M. Hills
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

APR 12 1976

SEC. & EXCH. COMM.

Photocopy from Gerald R. Ford Library

Dear Chairman Hills:

Re: Improper Payments

At a recent meeting of the AICPA Advisory Group C members with the SEC, you requested that the firms represented furnish you with information regarding how they were dealing with improper payments. While I was not personally at the meeting, I am pleased to attach a memorandum which summarizes the development of PMM&Co.'s guidelines and the approach we have used to resolve improper payments, together with copies of our internal published guidelines and a client newsletter on the subject. I have previously gone on record with members of the SEC and staff concerning my strong feelings that the absence of specific guidelines from the SEC as to what they require in the form of disclosure has caused enormous problems for the accounting profession. The Commission must be well aware of the fact that the role of the auditor is difficult enough when there are guidelines and legal requirements which he can insist the client comply with. Currently, however, the SEC appears to be taking the position that the accountants are acting as watchdogs for the SEC and should be enforcing non-existing rules. While I certainly agree that accountants have been very concerned over this matter and have been encouraging their clients to make disclosure of improper payments, I think the implications beyond this as to the accountants' role are both misleading and unfortunate. Specifically:

1. I do not believe that any of the accounting firms have extended their auditing procedures to uncover improper payments. Clearly the accounting firms have increased the awareness of their personnel to this problem, but their auditing procedures have remained unchanged. In a speech some time ago Mr. Burton was quoted as stating that he did not believe there was a need to change auditing procedures.

Chairman Roderick M. Hills
April 9, 1976
Page Two

2. Once a determination has been made that any improper payments are not sufficiently material to require disclosure in the financial statements, the accountant may render advice but he is not in a sound position to go beyond this point. It is difficult to convince clients of the need to disclose when the accountant can only point to speeches given by SEC officials or published reports of the actions of others. This becomes even more difficult when legal counsel advises their clients that the Federal Securities Laws and Regulations apparently do not require the types of disclosures that are being advocated informally by the Commission and its staff.

I recognize full well that this entire area is evolving and involves considerations that are extremely far reaching. Thus I recognize why the Commission may have difficulty in concluding on what disclosure or other requirements should be embodied in rules and regulations. Nevertheless, I believe that under the circumstances the SEC's position has not been responsible. It will have serious longer range detrimental effects on the accounting profession and its ability to deal effectively in its public role if the SEC continues to attempt to put the burden of acting as a watchdog on the profession without more definitive guidelines. For the Commission to indicate publicly that the accountants have developed new procedures to uncover illegal payments when such is not the case is most unwise and unfortunate.

I hope that the enclosed material will assist you in establishing guidelines on improper payments. If we can be of further assistance, we would be pleased to hear from you.

Sincerely yours,

WEH: ebs
Enclosures

Photocopy from Gerald R. Ford Library

Memorandum Regarding Development of PMM&Co. Guidelines and Approach Used by PMM&Co. to Resolve Improper Payment Problems

The revelations of illegal corporate political contributions in connection with the so-called Watergate investigation provided the initial impetus of concern about improper payments. In addition, as the energy crisis brought about higher prices for petroleum products, countries in the Middle East began to purchase large amounts of military equipment. During 1974 significant commission arrangements with agents in the Middle East surfaced and in July of that year the Department of Defense issued an article entitled "Agents' Fees in the Middle East." However, it was not until the United Brands case broke in April 1975 that the seriousness of the potential problems began to be appreciated. (For a history of this subject, see "The Corporate Watergate," a special report published in October 1975 by the Investor Responsibility Research Center, Inc.)

PMM&Co. took steps throughout 1975 and is continuing in 1976 to alert its professional personnel and clients about concerns over improper payments:

- Five SEC Partner Reports were issued to U.S. partners from April through September 1975.
- In June 1975 an Ad Hoc committee was formed in the Department of Professional Practice - Accounting and Auditing (the "Department") to resolve client questions and problems in the area of improper payments.
- During the Summer and Fall of 1975 discussions on this topic were held at the Firm's senior technical committee meetings.
- At meetings around the world of PMM&Co. partners, the concern about improper payments was explained so as to build up an awareness of the potential problems throughout PMM&Co. Such meetings involved partners in several parts of the world including Continental Europe, Latin America, Canada, South America, and the Caribbean. In addition to these international partnership meetings, several regional meetings of U.S. partners were held which included discussions about improper payments.
- In December 1975 PMM&Co. issued Auditing Standards Bulletins No. 1975-11 and No. 1975-13 to provide guidance to the auditor on improper payments. (Auditing Standards Bulletins are not meant for distribution outside PMM&Co.)
- To promote a better understanding among PMM&Co. clients and to provide some guidance in dealing with improper payments, a special edition of Executive Newsletter was issued on this topic in February 1976.

The Department closely monitors developments and disclosures in the area of improper payments:

- Speeches delivered by SEC officials are studied in order to appreciate the most current SEC attitude.

- Congressional hearings and testimony are also followed.
- Selected Form 8-K and other SEC filings are reviewed.
- Disclosures and articles reported in The New York Times and Wall Street Journal, as well as certain other periodicals, are reviewed. Such reports are maintained in a newspaper clipping file for reference.

Attached to this memorandum is an exhibit of the documents issued by PMM&Co. on the subject of improper payments. The documents are also attached.

Auditing Standards Bulletins (ASB) No. 1975-11 and No. 1975-13 represent PMM&Co. official policies on improper payments. ASB 1975-11 states: "The ordinary examination of financial statements performed in accordance with generally accepted auditing standards is not specifically designed to discover improper payments." Furthermore, PMM&Co. "...does not believe there is a professional obligation to extend audit tests for the purpose of attempting to discover improper payments. Nevertheless, in view of the extensive attention currently focused on improper payments, the Firm believes the auditor should advise and counsel top management about such payments." Consultation about improper payments is normally carried out at the parent company level and may be extended to subsidiaries and divisions (including foreign operations) at the discretion of the engagement partner.

On page 3 of ASB 1975-11 it is noted that a revised client representation letter has been prepared which deletes reference to "illegal payments and political contributions." For a very short period of time PMM&Co.'s standard representation letter required management to make a written representation about its knowledge of "illegal payments and political contributions." Several problems were encountered in requesting such a representation. Management was frequently not in a position to represent that certain payments were legal because the legality of payments may sometimes only be determined by litigation. Thus, management may have no basis for making such a representation. Moreover, it was determined that at times the word "illegal" was too restrictive because certain payments, although technically legal, could nevertheless be construed to be improper. In addition, client representations contained in the standard letter relate to the financial statements taken as a whole with due regard to the related measures of materiality. Thus, an illegal political contribution of, say, \$10,000 may be immaterial to the financial statements, but may indeed be material in another context. In light of these problems, PMM&Co. decided to remove the written representation of "illegal payments and political contributions" and substitute the approach set forth in ASB 1975-11, which PMM&Co. believes results in a candid and satisfactory consideration by clients and auditors of the current public concern over improper payments.

Page 4 of ASB 1975-11 states: "Definitive guidelines for disclosing improper payments have not been established. Pending the issuance of such guidelines, the Department of Professional Practice - Accounting and Auditing should be consulted when an improper payment comes to the auditor's attention." A general overview of the Department's approach is described below.

The partner in charge of the Department's Office Advisory Group coordinates the consultation regarding clients' improper payment problems. This coordination helps to ensure that PMN&Co. employs a consistent approach in resolving such problems. PMN&Co.'s in-house legal counsel is frequently involved in the resolution of inquiries, and the senior partner is advised of client problems and is personally involved in major or complex issues.

When an improper payment problem is brought to the Department's attention, information is sought about the nature, purpose, recipient, and amount of payment. Some common questions include:

- Is the payment legal?
- Who knew, approved, or condoned it?
- How was the payment made (i.e., cash, check, secret bank account, etc.)?
- Was the payment recorded and described properly in the books (i.e., was the internal control system circumvented)?
- Are the payments continuing or have they been stopped?
- What is the potential liability to the company due to fines, damages, taxes, penalties, etc.?
- What amounts of assets and income are at risk?
- Where the tax returns prepared properly?

If, based on responses to the above questions and any other relevant information, it is concluded that the payment(s) in question is indeed improper or that the propriety of the payment is substantially in doubt, PMN&Co. would consider proceeding as follows, depending on the nature and materiality of the amount:

- Request management to seek advice of legal counsel.
- Request management to advise audit committee so it, together with legal counsel, can give the problem appropriate consideration in order to formulate judgments about corrective action, disclosure, etc.
- Recommend that consideration be given to making a special investigation of possible improper payments.
- Recommend that the board of directors be advised of the problem and obtain the board's concurrence with the course of action suggested by management, legal counsel, and the audit committee.

After obtaining a reasonable understanding of the facts and potential consequences, an audit judgment is made as to whether the payment in question is material in the

context of the financial statements upon which PMM&Co. is reporting. PMM&Co.'s position on material improper payments is set forth on page 4 of ASB 1975-11. Experience so far indicates that the improper payments disclosed to date do not normally require disclosure in the financial statements to prevent those statements from being misleading.

Thus, the remaining question arises when an improper payment that is judged not material to the financial statements but appears to be of a type characterized by the SEC and others as material information in another context. PMM&Co. believes the auditor's legal responsibility in this area relates to the fairness of the financial statements. PMM&Co. does not believe the auditor has a professional obligation to require disclosure (or "Blow the Whistle") of matters that are not of sufficient import to have a significant impact on the financial statements. Nevertheless, PMM&Co. recognizes the current sensitivity associated with improper payments and believes that clients should give full consideration to such payments even though they do not affect the financial statements.

PMM&Co. believes that substantial reliance should be placed on legal counsel's advice concerning the appropriate course of action regarding "immaterial" improper payments. Accordingly, PMM&Co. usually suggests that management obtain legal counsel's opinion on the necessity of disclosure of such payments in a Form 8-K, proxy statement, or in any other manner. In some instances where it is clear that a payment is improper and it appears to possess the characteristics that the SEC has indicated as requiring disclosure (or where apparently similar payments were previously disclosed by other companies), PMM&Co. would recommend that the client make a disclosure or arrange to discuss the matter with the SEC. Clients are cautioned about the likelihood that the payment will eventually be disclosed due to a question at a stockholders meeting, a question from underwriters when selling securities, or a leak from a disgruntled employee or a competitor. Clients are also cautioned about subsequent SEC investigations and sanctions and IRS investigations, relating to potential tax fraud.

If legal counsel concludes that no disclosure to the SEC or to shareholders is necessary and the audit committee and board of directors concur with that decision, PMM&Co. would not insist on disclosure with the understanding that subsequent questions from stockholders or others would have to be addressed fairly in light of all the surrounding facts and circumstances.