NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Remarks to

INSTITUTE FOR CORPORATE COUNSEL

LOS ANGELES, CALIFORNIA

MARCH 11, 1983

"COOKED BOOKS": JUST OLD, UNAPPETIZING RECIPES

James C. Treadway, Jr.
Commissioner

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

"COOKED BOOKS": JUST OLD, UNAPPETIZING RECIPES

Good afternoon. It's a pleasure to appear before the Institute For Corporate Counsel.

When preparing to speak, my first thought was to look for a topic that would be totally new and give me the opportunity to share with you some particularly current insights. What I ultimately focused upon, however, was something which is both old and unfortunately timely: financial statement fraud, or more bluntly, "cooked books."

Before discussing specific cases and fact patterns, let me venture a conclusion as to one possible cause of the recent increase in cases of "cooked books." I believe some, perhaps most, of the increase can be attributed to an aggressive demand by top corporate management that subsidiaries and divisions achieve unrealistic profit goals, compounded by poor communications between corporate headquarters and the divisions. I have no criticism of corporations and corporate managers who seek to maximize earnings for stockholders through sound planning. But when headquarters arbitrarily sets profit goals and unceasingly applies pressure for profits, there comes a point where an atmosphere is created which tolerates, or even encourages, reporting profits at all costs, even if they do not exist.

Recent cases of "cooked books" have been egregious and have involved major companies. By and large 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." Granted, these activities may have led to bonuses, promotions, or good standing in the eyes of the company and the "team." But they have not involved direct, immediate personal gain from theft, kickbacks, bribes, or diversion of assets.

Another noteworthy aspect of these cases is the lack of creativity in "cooking the books." The methods are simple: pre-recognize revenue; falsify inventory; ship without invoices or issue invoices without shipping; and play games with a variety of expenses. Sometimes the deception has been as easy as following auditors around and adjusting inventory records behind their backs. Sometimes the deception has involved total concoctions of inventory figures. Sometimes third parties, such as suppliers, have been enlisted to defer or redate invoices. But true creativity is almost totally missing. Indeed, the methods frequently are so crude that it prompts me to wonder why the participants thought their activities would remain undetected for any length of time.

The third feature which stands out in these cases, which prompted my comments at the outset and, I believe, may be the single most significant factor, is the organizational structure and operating philosophy of the companies involved. I refer to a decentralized corporate structure, with autonomous divisional management, a structure intended to encourage responsibility, productivity, and therefore profits -- all entirely laudable objectives. But the corollary has been a lack of accountability. The situation has been exacerbated when central headquarters has unilaterally set profit goals for a division or, without expressly stating goals, applied steady pressure for increased profits. Either way, headquarters' demands may have created an atmosphere in which falsification of books and records at middle and lower-levels became possible, perhaps predictable. And frequently present in these cases have been various incentive programs, which tie employee remuneration or advancement to productivity standards set by the central office.

Middle level management sometimes appears to have adopted the attitude -- operating under headquarters' pressure for profits -- that the responsibility for accurate accounting rests solely with outside auditors. If a questionable accounting treatment managed to slip by auditors, it was 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 unrealistic profit objectives imposed by far-away top management, provided, of course, it got by the auditors.

There has been an inclination to attribute these cases to difficult economic times. Undoubtedly, hard times may play a role. But closer review reveals that "cooked books" have occurred during good years as well as lean. That suggests that we may have seen only the proverbial tip of the iceberg and that recent hard times may yield an increase in these cases. That is a distressing thought.

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

Heinz's corporate structure emphasized decentralization, with self-sufficient divisions having their own officers and managers. Performance criteria for divisions, however, were established unilaterally by World Headquarters. During the 1970's, World Headquarters established a stated objective of increasing earnings at a compound growth rate of 10-12% per year. This objective was part of 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 accounting practices of any division.

At the end of each third quarter, World Headquarters reviewed with officers of each division estimates of year-end results. If a shortfall appeared possible, division managers might "be encouraged" to report extra profit by a variety of means, including deferring or reducing discretionary expenses. Employees interviewed by the Audit Committee stated that they believed it a "mortal sin" not to meet the goals set by headquarters. This pressure, coupled with the autonomy of the divisions, resulted in "cooked books." The Form 8-K perhaps understated the case when it characterized the relationship between World Headquarters and the divisions as a "communications gap."

The Form 8-K indicated that, above all else, the pressures caused the divisions to try to control or limit the demands of World Headquarters. For instance, if a division's income goal for one year were $20 million, World Headquarters might plan to increase the goal for the next year by 15% to $23 million. But if the division exceeded the original goal and earned, for example, $24 million, World Headquarters would set the goal for the second year 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 of $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 cushion for hard times.

The methods used 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.

All of this was accomplished through circumvention of controls by the division personnel charged with enforcing controls. The Audit Committee found no evidence that any Heinz employee sought or gained any direct personal profit, nor any evidence of participation in the falsifications by top management at World Headquarters. But the Audit Committee did conclude that the questionable practices indicated a "lack of understanding throughout the company that responsible and ethical practices are required in connection with all transactions."

The McCormick case (S.E.C. v. McCormick & Company Incorporated, et. al., Civil Action No. 82-3614, D.D.C. 1982) is a more recent illustration of "cooked books," 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 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.

Like Heinz, McCormick had a decentralized corporate structure. Each division had substantial autonomy and its own administrative, manufacturing, accounting and marketing staff. According to a Form 8-K filed in May, 1982, which summarized an investigation by Special Counsel, the irregular practices were engaged in at the divisional level and involved a substantial number of personnel, including top divisional management. There was no diversion of assets for the benefit of any McCormick employee, nor any 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 GPD team effort."

Among the factors cited by Special Counsel as contributing to the situation was the pressure by distant, top management for greater profits. Special Counsel concluded 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. As a corrective measure, Special Counsel suggested joint planning between division and central headquarters on financial and budget matters.

The Form 8-K also pointed out, perhaps in understatement, that the accounting function was not given the same emphasis in the Division as were other functions. Special Counsel also criticized McCormick's independent auditors for failing "to develop a sufficient understanding" of McCormick's internal procedures, and characterized certain aspects of the audit as "deficient." McCormick has since changed independent auditors.

In November, 1982 the Commission concluded an administrative proceeding against Ronson Corporation, finding that Ronson's annual and periodic reports filed with the Commission for 1976 through 1980 did not comply with Section 13(a) of the Exchange Act. (Adm. Proc. File No. 3-6191; Rel. No. 34-19212, November 4, 1982). 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 some instances even prior to completion of the product. This effort was undertaken by RHUCOR personnel to meet profit expectations of 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 Review, however, did not uncover other practices which caused distortions in Ronson's financial statements. These included the practice of arbitrarily adjusting month-end inventory by amounts necessary to achieve a pre-determined pre-tax year-to-date and monthly profit margin. After month-end inventory was determined, RHUCOR's accounting personnel prepared a preliminary income statement. After the monthly financial statements were finalized, except for the inventory figure, the controller adjusted the inventory by an amount sufficient to achieve a predetermined pre-tax profit margin of 9% to 12%. This "adjusted" figure was then used in RHUCOR'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 Review. 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 is <u>S.E.C. v. Tate</u> (Civil Action No. H-82-0175 (R) S.D. Miss. 1982.) In that case, the Commission charged a mid-level manager of a wholly-owned subsidiary of the Dorsey Corporation 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 manufacturing plant, with responsiblity for personnel, purchasing, manufacturing and recordkeeping. For two years, he intentionally falsified daily production reports and other corporate records, resulting in an inventory overstatement of $1 million, a

25% overstatement of profits of the subsidiary for 1978, and therefore inaccurate periodic reports by Dorsey. The overstatement was the result of the manager's desire to make his plant appear more productive and to promote his own career.

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. The manager then falsified annual physical inventories to approximate his cumulative daily falsifications. To prevent the auditors from discovering this, he devised a plan. After inventory counts were made and recorded on tickets at the head of each row of containers, but before the tickets were removed, he followed the auditors around and changed the numbers. He explained: "If there was, say, an '11' on the ticket, I could change it to a '41'." These falsifications were made without the knowledge of any executive officer of Dorsey. The Commission's investigation revealed no evidence of negligence or theft.

Obviously, conduct of the type I have discussed may result in violations of any one of several provisions of the federal securities laws. Immediately coming to mind are inaccurate filings in violation of Section 13(a) and inadequate books and records or controls in violation of Section 13(b)(2) of the Exchange Act. Section 10(b) of the Exchange Act and Rule 10b-5 and Section 17 of the Securities Act of 1933 also quickly come to mind. If the issuer makes an offering of securities using financial statements based on "cooked books," Sections 11 and 12 of the Securities Act of 1933 may give rise to additional liabilities. Finally, violations of Section 14(a) of the Exchange Act may occur if deficient financial statements are contained in a proxy statement.

If there are "cooked books," a number of parties may be implicated: lower-level employees, mid-level management, officers, directors, and sometimes third parties, such as customers or suppliers. 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, a key element of a Rule 10b-5 violation by senior management or the issuer -- scienter -- would appear missing. If senior management participates in "cooking the books," that conclusion may quickly change. While some minimal involvement of senior management may not be sufficient to support a charge of a violation of Rule 10b-5 by senior management or the issuer, the degree of senior management's involvement must be carefully scrutinized. And regardless of whether senior management or the issuer has violated Rule 10b-5, the issuer nonetheless has an obligation under Section 13(a) to file correct periodic reports and an obligation under Section

13(b) to have books and records accurately and fairly reflecting transactions and to have adequate internal accounting controls.

In the case of the outside auditor, liability generally will depend upon whether he failed to conduct the audit in accordance with generally accepted auditing standards or disregarded "red flags" to the point of recklessness. I will not, however, dwell today upon the responsibilities of outside auditors. That topic merits a separate discussion. But if an issuer is found to have "cooked the books," I think it would be safe to assume that the Commission's Division of Enforcement will closely examine the auditor's actions.

In the case of third parties, if they cooperate -- such as by delaying billings -- with the knowledge that they assist a company in improperly accounting for its operations, the third party may have aided and abetted a violation of the federal securities laws. That is not a new concept, at least not from the Commission's perspective. Going back to 1970, we find SEC v. Liberty Equities Corp. (D.D.C. 1970) as a case on point. Each year immediately before year-end Liberty Equities borrowed funds from its bank, immediately purchased the bank's CD's, and pledged the CD's as collateral for the loan. As soon as Liberty Equities' year-end financial statments were distributed, the loans were paid by cashing the CD's. The 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 company's year-end balance sheet. The bank eventually consented to an injunction against aiding and abetting the company's violations.

Thus far I've focused on how books can be "cooked" and who may have committed particular violations. Perhaps we should consider who is harmed by this 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 diminished value of investments. I submit that those who may be harmed include:

1. Large and small market-place investors in both debt and equity securities of the issuer.

2. Management and Directors of the issuer, regardless of the ultimate determination of their individual culpability.

3. Owners of large blocks of stock of an issuer, such as estates or family trusts. As exposure of the wrongdoing occurs, the value of such 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 have distributed securities for the issuer. Not only may they find themselves named defendants, they may be looked at as the "deep-pocket."

6. Market-makers and retail brokers effecting transactions in the issuer's securities.

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

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

9. Financial analyst who gave investment advice about the issuer and its securities relying upon the issuer's financial statments.

10. Employee-stockholders who purchased securities of the issuer directly or through employee benefit plans.

11. The wrongdoing mid- and lower-level employees who, perhaps mistakenly, thought they were following the company line but became scapegoats when exposure occurs.

12. Honest employees and managers who have been denied career opportunities and salary increases.

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

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

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

16. General investor confidence.

If my assessment correctly identifies the scope and magnitude of the damage, we must ask how "cooked books" continue to occur. A principal reason seems to be that issuers and overly-aggressive managers have allowed their demands for profits to create a corporate atmosphere where accounting shenanigans became an accepted feature of operations, or a customary practice in managing earnings, or merely 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 stock issue or acquisition. Instead, it was day-to-day business as usual. And let us remember that these cases have not involved innovation or creativity. Case after case it's the same, old story: pad inventory, pre-recognize sales, improperly defer expenses, and simply engage in phony transactions.

Preventing "cooked books" requires careful attention to sound accounting controls and procedures, and a corporate atmosphere and structure which emphasizes the significance of such controls and procedures -- at all levels. But that lesson of attention to detail and the need for verification and sometimes tough-minded questioning seems difficult to learn.

To draw a parallel, let me quote from a few Accounting Series Releases over the last four decades.

1. "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 concerned with the basic problems of internal check and control to make the searching review which an engagement requires."

   ASR-19, 1940. In the Matter of McKesson & Robbins, Inc.

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. In the Matter of Touche, Niven, Bailey & Smart, et al. (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. In the Matter of Peat, Marwick, Mitchell & Co. (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. In the Matter of Seidman & Seidman. (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. In the Matter of Arthur Andersen & Co. (Mattel, Inc.)

These quotes focus on an outside auditor's unquestioning reliance on management's representations, but the message is much broader. Senior corporate management which places itself in a distant castle, issues profit goals by fiat, creates an atmosphere where a division or a division head has "failed" if the goals are not achieved, but fails to install and follow tough internal accounting controls is equally subject to criticism as the auditor who relies upon undocumented representations of management.

If companies wish to continue to demand the mid-level managers and autonomous divisions achieve highly-ambitious performance goals, they must be sensitive to the pressures they create and the need for sound internal controls and sometimes some skepticism and tough questioning about results reported by the divisions. If not, given the growing number of cases of "cooked books," the question must be asked whether such conduct is sufficiently reckless to support charges of violations of the securities laws -- including fraud -- against those managers and the issuer when the predictable "cooking of books" occurs. And in some cases I believe we also must consider the role of the Board of Directors and the Audit Committee. Where were they when the "books were cooked;" were there red flags which they ignored or failed to appreciate; how much attention have they paid to internal controls; did they condone or contribute to a corporate atmosphere where "cooked books" became likely if not inevitable?

Some of you may believe my remarks to be blunt and perhaps they are. But this is not a gray area; the legal issues are not particularly difficult; no especially sophisticated analysis is required. The simple fact is that issuers, senior management, directors and Audit Committees by now should be sensitive to the possibility of "cooked books" in autonomous, profit-pressured divisions, but that sensitivity apparently is lacking.

While I have focused on the problem of "cooked books" at divisional or lower levels, perhaps I should digress and note that "cooked books" can occur at higher levels. For example, the Commission recently obtained a permanent injunction against Saxon Industries and members of its top management, prohibiting violations of Sections 10(b), 13(a), 13(b)(2) and 14(a) of the Exchange Act. (S.E.C. v. Saxon Industries, Inc. et al., S.D.N.Y. 82 Civ. 5992 (1982).) The Commission also brought a separate injunctive action against certain mid-level officers of Saxon. From 1968 until 1982, when Saxon filed for reorganization under Chapter 11 of the Bankruptcy Code, top officials of Saxon directed a scheme to falsify Saxon's books and records by creating non-existent inventory, which amounted to $64 million in one division. Most of the fictitious inventory was created through false computer runs, and in some divisions the auditors failed to take a physical inventory. Not only was wholly fictitious inventory created, but as Saxon transferred the fictitious inventory through intercompany accounts, fictitious earnings were recorded on the transfers of non-existent inventory. I note that Saxon's internal accounting was centralized in its corporate headquarters and the division's financial officers did not operate autonomously but were answerable to top management.

In S.E.C. v. McLouth Steel Corporation (D.D.C. 81-1373 1981), the Commission principally focused on the improper use of the equity method of accounting, but also charged McLouth with arbitrary adjustments to its iron ore reserves, improper recognition of profits resulting from the arbitrary movement of inventory from one plant to another, falsification of inventory records, improper assignments of LIFO inventory costs, and failure to disclose unusual year-end sales. Although only the issuer was named as a defendant, these activities were directed by a member of senior management. McLouth consented to an injunction against further violations of 17(a)(2) and (3) of the Securities Act and Section 13(a) of the Exchange Act.

So while I have concentrated on the problems of "cooked books" at lower levels and the role a corporate structure and atmosphere may play in this problem, senior management has not been totally innocent of wrong-doing in all cases.

All of you undoubtedly are 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 "cooked books." "Cooked books" cause false financial statements; 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 undermined. The eradication of "cooked books" deserves the highest priority in both the private and public sectors. I hope it will receive that priority.

Thank you.

* * * * *