

U.S. house of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515

March 23, 1987

The Honorable John S.R. Shad
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Shad:

For the past two years the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce has been looking into a variety of issues related to financial disclosures of defense contractors, accounting and auditing practices, and the Federal securities laws. During these inquiries, several matters surfaced which relate to the adequacy of the auditing and reporting practices by defense contractors for classified special access programs -- the so-called "black" programs. It appears that defense contractors may be misusing national security classifications to cloak internal problems, to withhold material information and to give misleading impressions to users of financial statements.

During the course of the Subcommittee's legislative oversight inquiry, two potentially serious problems have been observed raising serious questions about the adequate and proper administration of the Federal securities laws:

1. At Lockheed Corporation, and at other defense contractors, certified public accountants appeared to be placing undue reliance on work performed by their clients' own internal auditors. This raises questions whether the generally accepted auditing standard of independence, as fundamental to an audit engagement, is being observed.
2. Defense contractors apparently are not complying with the Securities and Exchange Commission's requirement that all material risks stemming from their contractual and other business relationships with the government be disclosed to stockholders and potential investors when such risks relate to "black" programs.

Lack of Independent Audit

Generally accepted auditing standards, ten of which have been approved and adopted by the American Institute of Certified Public Accountants (AICPA), deal with the quality and acceptability of audits performed by independent auditors. General standard number 2 states that:

In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.

The need for such independence is essential to the auditors' responsibility to users of financial statements. So fundamental to an audit engagement is the concept of independence that the AICPA's Statement on Auditing Standards requires that the auditor disclaim an opinion on the financial statements when the auditor is not independent in fact or in appearance.

Adequate auditor independence may not exist with regard to CPA audits of defense contractors where highly classified "black" program contracts are involved. For example, the Lockheed Corporation performs several billion dollars worth of "black" program business annually for the U.S. government -- a very material portion of Lockheed's total business volume. Yet, the Subcommittee was informed that only one or two individuals, both partners from the accounting firm of Arthur Young & Company which conducts Lockheed's annual audit, are cleared for access to information relating to these "black" programs. Consequently, the bulk of the actual audit work is performed by Lockheed's own internal auditors. Given the ease with which Lockheed has fired internal auditors for bringing to management attention information it would rather not hear about, the audit firm can hardly be considered independent. The Subcommittee has been informed that similar conditions exist at other defense contractors with major "black" programs, such as TRW and Northrop Corporation.

This apparent lack of audit independence seriously limits the usefulness and reliability of the financial statement of corporations involved in major "black" programs. Equally important are the questions this lack of independent audit raises about whether the government's money is being adequately controlled and protected.

In conducting an independent audit, the internal audit function is an important aspect of a client's internal control system. Depending upon the adequacy of the internal audit function, the CPA firm may use internal auditors to perform certain tests of compliance. This, however, does not relieve the independent auditor of the responsibility to perform such tests of the accounting records as may be necessary to express an opinion on the financial statements.

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Noncompliance with Full Disclosure Reporting Requirements

During July 1986, a Subcommittee investigation discovered that Lockheed Corporation had lost control over classified documents related to a multi-billion dollar "black" program -- over 1,500 SECRET and TOP SECRET documents were either missing or were somehow out of accountability. In August, as a result of the Subcommittee's investigation -- and Lockheed's admission -- the Defense Department began withholding progress payments from Lockheed relative to this multi-billion dollar program. Progress payments will continue to be withheld until Lockheed repairs its document accountability system, and the Department gives its stamp of approval to the new system. This had not occurred as of the end of December 1986.

Because the program is "black" -- meaning that the Defense Department does not even acknowledge the program's existence -- everything about it, including the amount being withheld, is classified. As a result, the Subcommittee was told that Lockheed would not file a disclosure statement with the SEC regardless of whether the amount withheld is considered material.

The Federal securities laws are grounded upon the principle of full disclosure. This requires that sufficient information be disclosed to investors to enable them to make an informed investment decision. This requirement does not exclude defense contractors.

Regulation S-X is a central element of the disclosure system. Disclosure requirements include such things as the business of the firm, market price and dividends on outstanding equity securities, financial statements, and management discussion and analysis of financial condition and the results of operations. In addition to the required annual and quarterly reports, a current report must be filed on Form 8-K should certain material events occur.

While the SEC regulations emphasize the need for publicly held companies to disclose material information of both a favorable and unfavorable nature promptly and accurately, the rules do provide for an exemption with regard to disclosure detrimental to the national security. This exemption, contained in 17 CFR Part 230.171, states that where a document or information is omitted for national security reasons:

. . . a statement from an appropriate department or agency of the United States to the effect that such document or information has been classified or that the status thereof is awaiting determination.

The regulation further provides that:

It shall be the duty of the registrant to submit the documents or information . . . to the appropriate department or agency . . . prior to filing them with the Commission and to obtain and submit to the Commission, at

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the time of filing such documents of information, or in lieu thereof, as the case may be, the statements from such department or agency required by . . . this section. All such statements shall be in writing.

The SEC staff has advised the Subcommittee staff that they found nothing in the filings of Lockheed or other defense contractors with the Commission to indicate that a government agency had provided a statement exempting the contractor from filing such documentation.

The Subcommittee has had a long-standing concern about the integrity of financial markets. The maintenance of market integrity requires the ability of investors to rely on adequate independent audit and on full disclosure of information that may materially affect the financial condition of a company. The Subcommittee believes that with respect to defense contractors with major "black" programs, these essential conditions of maintaining market integrity and investor confidence in the securities system may be in jeopardy.

In light of the seriousness of these issues, we would appreciate the Commission's views on how these problems can be resolved both to protect investor confidence in our securities market and to protect the national security.

Should you have any questions regarding this matter, please contact Messrs. Michael Barrett, Peter Stockton, or Bruce Chafin of the Subcommittee staff at 225-4441.

Sincerely,

John D. Dingell
Chairman
Subcommittee on
Oversight and Investigations