

PAYMENTS OUTSIDE THE CORPORATE ACCOUNTABILITY SYSTEM:
A PROBLEM FOR MANAGEMENT, AUDITORS AND SOCIETY

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I would like to talk this morning about something that has in the last two or three months been of very deep concern to me, and that is the increasing evidence that seems to be emerging of immorality at the highest corporate levels. As an academic full of faith in our political and business system, Watergate came as a great shock to me as it did to most people. I didn't believe that political activities of the sort that emerged were in fact going on and yet of course they were. However, the system did work and the price was paid by those who behaved in a fashion that was unacceptable to society.

In many ways, however, recent disclosures of corporate activities have been even more shocking to me in terms of my expectations. A year ago if someone had told me that top executives of companies like Minnesota Mining, Gulf, Phillips and Northrop were running back and forth to Switzerland and to the Bahamas with suitcases full of cash I would have dismissed that person as one who viewed everything conspiratorially. But the fact is that just such activities were taking place. It is humbling and frightening to be so wrong in such a matter.

It does raise in my mind serious questions as to how well our business system is in fact working. Our society places tremendous wealth and resources at the discretionary use of corporate executives. It will not continue to do so if these executives do not act in a fashion consistent with the laws, mores and expectations of the society. There have been past scandals and frauds and there of course will be others in the future, but when the leaders of the business community countenance and participate in the removal of millions of dollars of cash from the corporate accountability system for illegal and unaccounted-for purposes it leads me to be suspicious of the system in a way that Equity Funding type frauds do not.

You know an Equity Funding type fraud is shocking but it is sort of old-fashioned criminality; one recognizes there will be some of this type of activity going on in the world even

though we hope to prevent it to the extent possible. This type of fraud doesn't raise the serious questions as to the fundamental levels of moral performance on the part of major sectors of the business community that are raised by recent disclosures. In addition, the fact that in a number of cases the independent public accountants were aware of what was going on is even more distressing. The effect of these actions on the credibility of the business community among the public, among educators, among regulators, and legislators is tremendous. The costs are high indeed because the business community does not have a large excess of goodwill in these communities which it can allow to be written off.

Certain justifications are given for these actions which I believe are unacceptable but nevertheless deserve some attention. First, in almost every case it appears that the executives involved believed that everybody did this. "That's how business is done." I do not believe this is a reflection of the American business ethic, either in practice or in theory. I do not believe it is acceptable to the society and I don't believe it will be countenanced. Obviously, this everybody-does-it justification is a least common denominator approach and it is not acceptable. It has been raised over the years to justify a broad spectrum of activities. It is raised in our personal lives. I have been told by my sixteen-year-old daughter that everybody permits their sixteen-year-old daughter to drive their car whenever and wherever she wants except us. This is something that has not been persuasive to me, but she views it as an extremely persuasive argument.

Other people extend the argument and suggest that they did this sort of thing because they could not survive without doing it, and because it was in the interests of the stockholder that they participate in bribes, political contributions and the like. Again, I think that is an argument that doesn't hold water. Stockholders above all have a primary interest in the moral strength of the business society, because they are dependent upon the acceptability of that society for their

ultimate returns. Stockholders in public companies must be aware that even where such actions may contribute to their short-run economic interest, they cannot be countenanced or justified on that basis. Economic failure is a risk that owners take. They know they take it. To say that it perhaps can be avoided by dishonest means is not an appropriate way for a corporate manager to view his responsibility. Obviously he is not in the position where he wants to see his corporation fail or his stockholders be disadvantaged, but nevertheless I think he must recognize the mores of the society within which he operates. Where there are risks of failures, there must be disclosure of these risks. The financial statements must tell the story, but I don't believe this is a justification of this type of action.

Now I may sound rather simplistic in my approach and I don't believe that the decisions in these areas are easy ones. The pressures for actions of this sort are substantial and there are obviously gray areas. It is not hard for me to make a judgment in a case where a million dollar or multi-million dollar payment is made to a chief of state in exchange for favors of one sort or another. That's a pretty clear-cut case. It is much tougher when a firm is advised that there are certain entities which will expect a commission in connection with certain sales it hopes to make within a particular part of the world. Is that commission in fact a bribe, or is it in fact a legitimate business expenditure? These are not easy questions. On the other hand, I think we all should recognize that we cannot operate a business society based on the payoff, or on cash under the table. I think that the best tests may be whether a payment could be publicly disclosed and whether it is made within the corporate accountability system. If it meets those tests, it is probably a legitimate corporate expenditure not requiring special disclosure. If it doesn't there are significant problems.

What are the responsibilities of various parties in working to avoid a repetition of what we have been seeing in recent months? First, of course, there is a responsibility on corporate management at all levels not to participate in or approve of such actions. Management must design the best possible systems to prevent such things from happening. They must be aware of the vulnerable areas in corporate activity. Auditors of course must also keep these possibilities in mind in testing systems. When a management discovers that such activities are taking place it is their responsibility to stop them immediately. It is certainly necessary that the board of directors be fully and promptly informed of all details and where the items are material, there should be public disclosure, both of the fact that it happened and the fact that it has been stopped.

In determining what is material, I think it is apparent in this type of item that we cannot simply look to the dollar amount involved and compare it with the sales, capital, total assets or any other quantitative measure relating to financial statement numbers. The nature of the item as well as the amount must be considered; so must the potential impact on the business if this item is discovered and stopped.

If senior management is involved in such activities, that fact alone may be sufficient to make disclosure necessary regardless of the amount, since it reflects on the way in which the company has been run. We have seen a few attempts at disclosure on a voluntary basis and I would have to say I don't feel they have been entirely candid in many cases. Disclosure cannot be dealt with on a half-way basis with an artfully obtuse statement.

It is not sufficient, for example, to simply say that you have in a particular circumstance made certain payments for legal services when you have been bribing local legislators to change a particular law. Disclosure must be explicit.

In addition, if there is an effect on future operations from the decision of the corporation to stop making such payments or from their public disclosure, the financial statements clearly must reflect this fact, normally through some form of footnote disclosure.

While management bears the principal responsibility for making these disclosures, the independent public accountant has a responsibility as well. I would like to touch upon two elements of that. First, there is the question of what is the accountant's responsibility for finding such items and second, there is the question of what is his responsibility for taking action when such items are discovered.

First, I think initially it should be said that finding such items should not be deemed to be a primary objective of an audit examination. I think auditors operate in an environment based on an assumption of good faith and that they cannot avoid operating on this assumption without incurring unacceptable costs. Nevertheless, even without focusing upon this as a primary objective, it seems to me that audit programs must be devised to indicate awareness of vulnerable areas and to make extended tests in particularly vulnerable areas. Auditors must be very sensitive to anything outside the regular accountability system of the corporation. As they examine corporate activities, they should raise questions where there are grounds for suspicion that illegal payments are being made. They should obtain specific representations from management in regard to the existence or absence of illegal payments and funds outside the corporate accountability system. Despite such procedures, I don't think there is any question that a management determined to hide substantial payments of an illegal nature from their auditors will be successful in doing so. Fundamentally, that is why I believe this is first a management problem.

An alert auditor with his eyes open and with appropriate relationships with management at various levels will find such items in many cases. Then the question must be faced as to what action he should take. In several situations, as I've indicated, we have seen in our investigations that the auditors have known what was happening. Where they know, where they discover such actions, in the course of an examination, what are their responsibilities? Clearly the first step that they would have to take is to be certain that each member of the board of directors is informed by them and that action is taken to stop the practice. This means a direct communication from the auditor to each member of the board of directors. Next, if the board does not take action to stop the practice, it seems to me that the auditor has a responsibility to resign and to report fully the reason for his resignation on the letter accompanying a Form 8-K if he is the auditor of a public company and his client does not set forth the facts clearly in its filing. The Form 8-K statement that requires disclosure of disagreements between auditors and clients covers this type of item.

Third, the auditor has to consider the need for disclosure in financial statements. It is obvious that statements must reflect the operations fairly, and not just in numerical terms. Responsibility does not stop with the proper income statement classification. You do not solve your problem by determining whether a bribe is a general and administrative expense or a cost of sales. In addition, as I indicated in looking at management's responsibility, the impact of halting such payments must be considered in evaluating materiality. We have had a couple of situations where it appears as though the halting of such payments will have a very significant effect upon the company's ability to operate as it has been and therefore there becomes a question as to whether the past financial statements are a fair representation. I believe that any time the auditor or the preparer of financial statements has knowledge that facts exist which make it highly

unlikely that results of the past are a reasonable representation of what may be expected in the future, there is a need for disclosure of these facts, if the historical statements are to meet the test of fairness.

In addition, the auditor obviously must consider the possible need for disclosure elsewhere than in the financial statements and in this connection and perhaps in some others it is not unlikely he will be talking with his attorney.

The SEC's responsibility in such items I think also should be considered. First, it is clear that we must investigate and pursue cases which come to our attention to be certain that there is adequate disclosure and adequate action. In some cases we may have the responsibility of referring matters to the Department of Justice for criminal prosecution. In addition, I think it is the Commission's responsibility to consult with registrants as to appropriate disclosures in difficult cases. I do not believe, however, that the Commission is likely to take the position in many cases or perhaps in any case that disclosure is not necessary.

It is generally much better to deal with the problems of disclosure before the fact rather than after. We recently, for example, had an inquiry about a company that was considering a deal which would have resulted in a substantial cash payment outside the corporate accountability system, and in this case the company came in with their accountants and said that this was a deal which they thought might be good for the stockholders, but they were troubled by it. They asked whether they would have to make disclosure of this substantial amount of cash that is being paid to a not-directly related party outside the corporate accountability system. I think they were almost relieved when we advised them that disclosure would have to be made. At that point they said there could be no deal under such circumstances, and I think they were relieved at that also. We were able to help them see the long run interest of their stockholders as

opposed to their short term economic interest. I believe that this problem is a serious one for the business community. I would not suggest that it is so widespread that it is a cancer that will destroy our business system but we have seen in the past few months that it is certainly sufficiently widespread to be categorized as a disease that needs treatment, needs to be faced, and needs to be dealt with. If it is not, the fundamental ability of the American business system to operate both here and around the world will be severely affected and I believe then we will all suffer.