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The Time Has Come : A Call to the Accounting Profession to Join the Fight Against Financial Fraud

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by
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[Introductory note: Stanley Sporkin, United States District Judge, was appointed to the United States District Court for the District of Columbia by President Ronald Reagan on December 17, 1985.

Judge Sporkin received his B.A. degree in 1953 from Pennsylvania State University and earned his LL.B. degree in 1957 from Yale Law School. He is admitted to the United States Supreme Court, as well as the Pennsylvania, Delaware, and D.C. Bars.

Judge Sporkin served as a law clerk to The Honorable Caleb M. Wright, chief justice of the U.S. District Court for the District of Delaware, from 1957 to 1960; served as a law clerk to Judge Paul Leahy, senior judge of the U.S. District Court for the District of Delaware, in 1960; and practiced law as an associate in the firm of Haley, Wollenberg & Bader.

Judge Sporkin was the director of the Division of Enforcement of the Securities and Exchange Commission from 1974 to 1981; he had joined the SEC in 1961 as an attorney working on the Special Study of the Securities Market. He was CIA General Counsel from 1981 to 1986. He is also a Certified Public Accountant, a member of the American Bar Association, Delaware Bar Association, Federal Bar Association, Phi Beta Kappa, Phi Kappa Phi, Phi Delta Phi, and the American Institute of CPAs.]

INTRODUCTION

It is a great honor for me to be here this evening. I hope that we will get in some dialogue a little later on because I think that is really the big benefit of programs of this kind -- an interaction and exchange of ideas. Programs like these contribute greatly to the development and betterment of professional standards.

The United States has had some difficult times during the past three decades. Over this period, we've seen the demise of our number one ranking in industry after industry. We are no longer the premier supplier of capital goods and our supremacy in other fields continues to slip. The one place where we continue to excel is in our financial markets and our financial services areas. This is so despite the fact that our performance in these areas has not always been exemplary. In this dynamic and changing world, our premier status in these areas cannot be taken for granted. Our foreign competitors are prepared to move in if we continue to falter.

This is not the only challenge that our financial markets face. One of the great hallmarks of our financial markets is their basic honesty and integrity. And our accounting profession has been key in insuring this state of affairs.

During the recent past, however, the profession has not always lived up to its duties and responsibilities. In a paper I delivered in October 1988 at the State University of New York at Binghamton, I warned the profession that if it continued to underperform, it would face a challenge from a different direction, namely the computer. At that time I had this to say:

> I truly believe the accounting profession is at a crossroads. With more computer refinements and discoveries, there is a real possibility of the emergence of a new profession that may have as profound an impact on the accounting profession as the word processor has had on the old line typewriter.
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> But why do I say the computer does present a real challenge to the profession? I say it because the profession has not entirely distinguished itself during the past several decades and is slowly seeing the erosion of the case it has made repeatedly -- that it is an indispensable component of our thriving economic system. Because of the growing list of substandard audits, the profession is slowly losing its credibility.
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> The profession can exist only so long as it is performing a valuable service. Our economic system has long relied on the integrity of the financial statements of our major corporations that form a key part of our free enterprise system. We have seen too many recent instances of flawed accounting reports that simply have been chalked up to the overworked explanation that a certain amount of poor financial reporting is inevitable. The inevitability excuse is largely unacceptable in today's technological age. With the recent revelations of poor audits involving major industrial and financial concerns, we are finding our accounting system becoming slowly sapped of its credibility.
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> As a CPA, I am a great believer in the profession and want more than can I articulate for it to survive. I want it to use the technological revolution to its advantage and not have to view the computer as a threat. It is, however, clear that in today's age, if a system cannot produce, it will not survive. Now, for the first time, those in the profession who have become smug and self-satisfied with its current state must realize that the profession without a rededication to its underlying principles may no longer be indispensable. For the profession to continue to thrive, it must not misperceive its role and position in the free enterprise landscape.
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> I urge the profession to become alert to this threat. The prescription for its survival in today's technological world is obvious: the profession must recommit itself to its independence in every sense of the word.

That's what I said several years ago. Where are we today? Well, I don't believe that the profession needs any additional challenges or incentives to get its act together. It is clear it recognizes the precarious position it is in. It has seen the ranks of its major performers reduced by 25 percent, going from the big eight to the surviving six.

Accounting firms have paid out more money to resolve lawsuits brought against them during the past five years than during any comparable period in this nation's history. But this litigation explosion is not over. Many cases are still pending and more are being brought each day. What is more, many of these lawsuits cannot be written off as nuisance suits. In much of the recent litigation against the profession, the actions have been brought by government agencies. The lawsuits are usually well-founded and the agencies are not interested in settling the cases for nuisance value. Moreover, many of these cases, particularly those in the savings loan and banking areas, involve matters where the profession's performance was concededly below par and actionable.

This litigation explosion has the accounting profession's attention. While the profession's main response has been to seek legislation to limit its liability, to its credit it has recognized that it must enhance its performance. Further, it has actively supported new legislation aimed at enhancing investor protection.

The profession is solidly backing the Wyden Bill, which is designed to make accountants more responsive to violative conduct uncovered in its audits. Under the proposed legislation, accountants will be required to inform authorities of unlawful conduct they detect when the client refuses to do so.

Some in the profession believe that the support of the Wyden Bill without more justifies its legislative program to reduce the amount of its litigation damages. I submit that now is not the time for an application of this tit-for-tat concept. I believe much more is required of the profession. Putting it bluntly, now is the time for the profession to join the fight against financial fraud.

While this seems like an obvious responsibility of the accounting profession, which the investing public already believes exists, the fact is, neither the accounting profession nor the business schools have really embraced this principle. What is more, the accounting profession acknowledges that these are the reasonable expectations of investors and that they are not being met.

In prior days, the profession's reluctance to join the fight against financial fraud was somewhat understandable. The profession in the past has been quite precise in defining its role -- to express an opinion on the fairness of its clients' financial statements. The profession has been reluctant to expand its role in the absence of a specific and precise reason to look for financial skulduggery.

Because of its self-defined limited role, the profession over the years has become comfortable with the accounting principles that have developed. It has gotten into such a rut that it uses the stated accounting principles almost as a "cookbook." Some accountants have taken the position that if the client's financial statements are in technical compliance with generally accepted accounting principles, or GAAP, seldom would there be any justification for the accountant to look further, even in instances where the statements do not in fact fairly reflect the issuer's financial condition. Technical compliance with GAAP has been the sought after and accepted goal. Indeed, there have been instances where accountants have engaged in negotiations with clients over compliance with GAAP and have retreated from a position when the client has satisfied the accounting firm that it was, in fact, in technical compliance.

Transactions have passed the scrutiny of auditors even where they made no economic sense. Indeed, accountants have not objected where their clients have booked large profits on virtually same-day transactions, and on occasion have not been appropriately inquisitive with respect to contrived year-end transactions. Accountants have not questioned transactions where their sole purpose was to avoid public disclosure of an earnings decline or to meet a projected earnings forecast made by management.

One would hope that by now these sorts of things would have become unacceptable to the profession. Unfortunately, such abhorrent practices continue to exist, even though they do not at this time appear to be as prevalent as they have in the past.

My discussion tonight goes beyond these practices, however. Of course, I would urge the profession not to succumb to client pressures and to take all reasonable steps to eliminate all the offending and improper accounting conventions that have emerged since the sixties. But what I am proposing tonight is a somewhat different role for the accountant. I want the accountant to give up cookbook accounting and auditing and embark on a program of auditing scrutiny that is as inquiring of the client's books, records, and financial statements as the accountant would be if the accountant had been engaged by the client to examine the books of a proposed merger partner. What I'm saying here is that I was always very interested -- when I was at the SEC -- when there was a battle between two companies who were engaged in trying to gain access to a third company. It was interesting when you would look at the financial reports of the company that were prepared by its own accountants. And it was also very interesting to look at the report of the accountant that was hired by the company that wanted to take over the target. It was night and day! The analyses were different. And what occurred to me was, why should there be these differences? Why should one paint a rosy picture and the other present a much more critical picture? And why -- I ask the question -- why shouldn't the critical accounting report be the right one or at least have explained why all those critical items were there, without any explanation?

And so, what I'm urging is a much more intensive and extensive audit. All the issuer's relevant financial data should be examined with a critical eye. The independent auditor's opinion should be based upon the auditor's independent assessment of the client's financial data. It must not in any respect reflect the compromise arising out of negotiation with the client. I remember one case where there was a glitch -- a terrible glitch. And I asked the accountant, "Why did they let this through?" And they said what happened was that we sat down at the end of the audit with the exception sheet. We had five items on the exception sheet. We went over the five items. We were able to -- we, the accounting firm -- were able to prevail on four and we thought that we would give in on the fifth, thinking that 80 percent was a passing grade. While it might be passing for this university, it isn't passing in the real world. There cannot be this kind of compromise. And that's the kind of thing that I think our dear Professor [Abraham] Briloff has been speaking about for many years.

An opinion expressed should be based upon financial statements that reflect the best and fairest way to present the issuer's financial condition known to the accounting firm. This shift to the "right" is urgently needed for all concerned. See, the right isn't always bad. The accounting profession must redeem itself for its past subpar performance. The issuer will benefit because investors will be in a better position to make informed investment decisions. With such a system in place, it is obvious that one of our most prized assets, namely our securities markets, will be able to achieve even greater acceptance throughout the world than they now enjoy.

The obvious question raised about such a pervasive system is: Will the added cost justify the projected benefits? I submit that this new focus can be achieved with little or no additional cost. The reason? I go back again to the computer. Now, rather than using the computer as a competitor, it seems to me that with new and more creative uses of the computer, the kind of audit I have been proposing can be accomplished. For example, the auditing firm can be tied into the issuer's computer. By this step, the auditor would be able to interrogate the issuer's accounting system and obtain as much detail as the auditor desires. This could even be done on virtually a year-round basis, where the auditor's program can be designed to identify all transactions that exceed tolerable limits on a real-time basis. There would be no need to wait until year's end to go over the client's records, or the half-year's end, as is normally the case.

Going back to my days at the SEC, I was always somewhat amazed that the agency's small staff -- and we were a small staff -- was able to detect financial frauds that were virtually overlooked by the outside independent accountant. I could not understand how our small cadre of professionals was able to ferret out and detect fraud which the issuer's independent accountants had missed. Indeed, I remember a number of cases where an accountant who had seen a problem walked away from a client because of the problem, and where, without any problem at all, a new accountant came in and got hit because when they came in, the problems were continuing, and without a critical eye, they got into deep trouble.

While there are often good and understandable reasons for this phenomenon, there seems to be one overarching, repetitively proffered rationalization: the accountants disclaim responsibility for searching for fraud. The refrain goes, "We are not policemen." I did not then and do not now either understand or accept this rationalization. But even if this lame excuse had some substance to it in the past, it is clear it cannot be rationally offered or accepted at this point in this nation's history. There now exist both the incentive and the tools to do what the public always assumed was the role of the independent auditor. The motive and incentive to do so are clear.

Our highly performing financial markets can no longer tolerate uncritical financial reporting. The client is not served well by an accountant who passes on financial statements that do not truly and accurately reflect the client's financial condition; indeed, a client is no better served than an individual who has been misdiagnosed by his physician. The doctor telling an individual that he or she is in good health when he or she is actually quite ill is not serving the best interests of the patient. This is analogous to the corporate client who is told by the accountant that its financial condition is better than it really is. This reminds me of the patient who, after hearing from his doctor that he will need an expensive operation, asks the physician, "How much will it cost to touch up the X-rays?"

In response to the question "What is the problem with the accounting profession today?" your esteemed Emanuel Saxe Distinguished Professor Emeritus Abe Briloff recently had much to say about the profession's plight. And what it took me 20 minutes just to say, he said it in these succinct words:

> We are not confronted with a liability crisis. We are instead confronted with an identity crisis. We don't know for what, to whom, and the when of our responsibility. We somehow or another straddle all kinds of fences. We are identified overly closely with management in the sense that we work with management to see how any transaction might be made to fit the generally accepted accounting principles. And reciprocally, we sometimes work with management to see how GAAP can somehow be distorted to accommodate particular transactions.

So the professor and I discussed it today. This is the so-called "shoe-horn" concept that will fit the GAAP into the transaction and the transaction into GAAR I must quote again from Professor Briloff:

> In short, instead of being the historian, we are all too often actors on the scene who help to create this history. It is because society expects the auditor to be different from that, that we are confronting these problems.

And isn't it interesting that the good professor and I, in totally not talking to one another during this period, should make the same point. When I saw this the other day in the magazine, I couldn't believe it, because I had already just finished writing my piece. We had both hit the same point, and I said, it's almost unbelievable. Maybe it's right. If we get the third -- usually you need three for the hat trick, and maybe we will get our friend Eli Mason to come across with the same point -- then we'll know we're right. But I think what Professor Briloff said pretty much says it all.

What I am urging this evening is a rededication of the profession to perform its audits with the most critical eye it can muster so that when it reports on a corporate client's financial statements, they honestly, fairly, and most accurately reflect the client's financial condition. The financial statement should be tested not only by standards but also must go through a reality check. Are they realistic? The critical auditing examination must be performed in the utmost good faith by a truly independent review of the client's financial records and the results must not be based on a negotiated compromise worked out between auditor and client. The accountant must do better in ferreting out fraud and be willing to challenge instances where accounting conventions are being misapplied or manipulated to bring about or create a predetermined result. Less a standard should no longer be deemed acceptable or appropriate.

I remember years ago, there was one major company that had a reserve. And every year, at the end of the year, in order to hit their projected earnings, they would put transactions through that reserve. And I remember asking the accountant, "What happens when there are no more rabbits to pull out of the hat?" Because that's what it reminded me of. They would just go and pull it out, and the accountants were blessed, saying that that's fine.

Accounting is a great profession. Believe me, it is. I'm a part of it. It's a wonderful profession and I don't want these youngsters who are going into the profession to get too depressed. It is a great profession, and it has a lot to offer. We're talking about a question of focus. The focus, it seems to me, has got to be where everybody assumes it is where the public assumes it is: that this profession is going to perform as it is perceived, and when someone puts that stamp of certification on those financial statements, it means what it says.

QUESTIONS AND ANSWERS

Question:
If you returned to the SEC, what would your priorities be?

Answer:
Well, the SEC at this stage is facing really tremendous problems. I will tell you what I'm seeing and what would be on my agenda. One of the problems that really is going to blow up in somebody's face one of these days is the pricing practices, the market's pricing practices, on so-called "derivatives." As you know, every day when you look in the paper, the values of securities are there. And if those pricing practices are wrong, then there could be tremendous problems. And now where you have derivatives, how do you price a derivative where, for example, the derivative has mortgages that are you know not very liquid. And so that, I think, is going to be one of the big problems that the SEC must deal with.

The second thing I would have to deal with is the "lessons learned" session involving the "roaring eighties," the junk bond business and all that, to find out what went wrong and where were the oversight mechanisms at the time when all this went wrong. Why wasn't the SEC more active? What permitted this to happen when so many red flags were present?

The international area is another big area. I think what will eventually happen is there will be a worldwide SEC. Probably it will start out by a volunteer compact where three or four countries get together and have as a very simple mission the exchange of information and a system for resolving disputes that may arise, so that people buying one country's securities from within another country will have available dispute resolution and information-gathering systems. This can start up right away.

Those are the kinds of things that I think would be on my agenda. The other thing, of course, is to try to have a consolidation of the financial regulatory agencies. Regulations are too balkanized now. The agencies should be brought together so that they can be more effective. So, for banking and securities, what you would have is a financial regulatory agency and a financial enforcement agency. The regulators would set the rules; the enforcers would enforce them.

Question:
I think if you talk to many accountants, they will say, of course, we can't have an adversarial relationship with our clients. We are in a business alliance with our clients. We are the users of financial statements. Is there any answer other than fundamental change in the auditor-client relationship of the type you suggested that can possibly cure the problem and is there any hope of achieving that sort of fundamental change?

Answer:
Yes, Professor Briloff. You've been urging that for, I don't know how long. That, of course, goes to the question of independence. And I've tried to stay away from those areas. There are other real problems. The accountant who is on the job, right? And then he switches to the company, and as you know, that raises the question of independence.

Some have recommended that an accounting firm should be an accounting firm and all the other activities should be spun off. Maybe that is the answer. I do think the first thing that's got to be done is for someone to say, "What are we supposed to be doing? What have we done, and where have we failed, and what should be our focus?" Really, what Vice President [Al] Gore, in his "reinventing government" study, has been doing with government, maybe somebody could do with the profession. It ought to be easy to change. We're talking about six firms, and you could see change if those six firms would do what we are talking about.