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Congressional Oversight: The SEC and the Accounting

Michael F. Barrett Jr.

CONGRESSIONAL OVERSIGHT: THE SEC AND THE ACCOUNTING PROFESSION

by

Michael F. Barrett, Jr.
Chief Counsel and Staff Director
Subcommittee on Oversight and Investigations
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On March 29, 1933, President Roosevelt sent a message to Congress recommending legislation for the Federal supervision of traffic in investment securities in interstate commerce. In so doing, the President observed:

> This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The Rayburn-Fletcher Securities Bill, known in common parlance as the Securities Act of 1933, was signed into law on May 27, 1933. That statute continues today to impose by law some elementary standards of right and wrong. Then, as now, events have made it abundantly clear that the merchandising of securities really involves trafficking in the economic and social welfare of the country. This enterprise demands the utmost good faith and fair dealing on the part of those engaged in it. If the country is to flourish, capital must be invested in American enterprise. But those who seek to draw upon other people's money must be totally candid in disclosing the facts on which the investor's judgment is asked.

To that end, the securities laws require the publicity necessary for sound investment. Public disclosure is. of course, no insurance against errors of judgment. That is a function no government can perform. It does, however, give assurance that, within the limits of its powers, the Federal Government will insist upon full and fair disclosure of the facts essential to informed judgment and will, I hope, enforce the letter of the law

Without such an ethical foundation, the liquidity and strength of our capital markets, and therefore our economic well-being, cannot be sustained.

Rules X and XI of the Rules of the House of Representatives assign to the Energy and Commerce Committee responsibility for the Federal securities laws and, therefore, the Securities and Exchange Commission., The Committee and its Subcommittee on Oversight and Investigations are charged with reviewing "on a continuing basis" the application, administration, execution, and effectiveness of those laws, and the reorganization and operation of the SEC. Such oversight enables us to determine whether those laws and programs are being implemented and being carried out in accordance with the intent of Congress and the public interest, and whether they should be continued, altered or eliminated.

The Oversight Subcommittee has continuously monitored how the Federal securities laws are being implemented, including the provisions requiring financial accounting reports and the material corporate disclosures mandated by the Securities Exchange Act of 1934 and the Foreign Corrupt Practices Act. The inquiry into the accounting profession we have conducted over the past 18 months is, in part, a result of our concern that the disclosure system work for the benefit of us all.

The theme of tonight's lecture is Congressional oversight of the Securities and Exchange Commission and the accounting profession.

Perhaps the thorniest issue underlying the debate over adopting the Federal securities laws was the role of the commission in overseeing financial reporting. The period leading up to the 1929 Crash was marked, not so much by incomplete financial data, as by deliberately misleading data. Only a Federal Czar of Accounting -- the promulgator of all accounting wisdom and principles -- could prevent, it was argued, a return to the manipulation and fraud of that prior era. The model established by the Interstate Commerce Commission really an elaborate bookkeeping system -was rejected as overly restrictive and not necessarily informative. The structure finally agreed upon, and set forth in the securities laws, is a regulatory system that combines an independent Federal a SEC-- with agency -- the SEC — with broad statutory powers and private audit firms which must meet rigorous standards under the SEC's supervision.

For over 50 years that system has worked, sometimes well, and sometimes not so well. But because of its built-in flexibility, our financial reporting system in the United States is the best in the world. An additional keystone in the Federal securities laws is the clearly established right to sue. Whereas the ability to recover damages when misled by fraudulent financial statements was severely limited before 1933, that ability is now quite extensive.

Because of the spate of successful, expensive and highly publicized lawsuits against audit firms and public confusion over the existence of financial problems that often were not disclosed until the day a corporation failed to meet its obligations or went bankrupt, the Committee announced its accounting investigation in the summer of 1984. We commenced the actual hearings in February 1985, and have continued on a seriatim basis up to the present.

The first rule of oversight is to find out what is going on. Before trying to reach any conclusions, it is essential to get the facts. Congress sets policy through legislation and it evaluates those policies through oversight. As part of that process, we look at individual problem cases where the system has apparently -- or obviously -- failed, as in ESM and Beverly Hills Savings and Loan, or in the creative bookkeeping of defense contractors such as General Dynamics and Pratt & Whitney. From that endeavor, we seek to determine what, if any, improvements the system may need.

Sometimes, we hope that oversight by itself can have a salutary result on the individual situations into which we inquire. The best of all worlds would have the accounting profession -- of its own motion -- improve audit integrity. However, the financial reporting and regulatory system established by Congress empowers and obligates the SEC, and ultimately the Congress, to assure that the public is protected by whatever means are appropriate.

In performing oversight, we must be selective, so that we can develop the most extensive case studies possible. We do not approach investigations on a scatter-shot basis, for this would serve neither the Congress nor the subjects of the investigation. Clearly, we are not able to investigate every single allegation or problem brought to our attention, so we must direct our attention to those cases that illustrate problems which may affect the entire financial reporting system.

Defense Contractor Reporting

So far in its inquiry, the Subcommittee has learned a number of curious things. Financial reporting by defense contractors is essentially manipulative. It is timed to massage earnings so that underlying weaknesses in a company or groups of companies can be concealed. It promotes an unhealthy symbiosis between Defense Department auditors and the accounting profession where each group relies on the other, and the latter is frequently retained by the former. Proper cost accounting is distorted by a process permitted by the Defense Department that encourages inflating costs and, therefore, earnings through subcontractors and dummy corporations which trade goods and services back and forth until the original source becomes unidentifiable.

General Dynamics, one of our nation's leading defense contractors, is a good (but not the only) example of some of the problems with financial reporting in the defense industry. Mr. Takis Veliotis was a senior corporate executive for General Dynamics who fled to his native Greece to escape prosecution for taking kickbacks while at the company. When we interviewed him in Athens, Mr. Veliotis produced copies of essentially three sets of corporate records that he had placed in safekeeping for just such an eventuality.

The first set was the usual SEC-type of information, and the second set was the data General Dynamics supplied to the Navy Department showing stages of completion for submarines, including dates of completion and hours of labor being expended. However, the third set was the most interesting. That set, for the company's internal use, showed what the corporate executives projected the second set should actually look like.

Mr. Veliotis also produced evidence strongly tending to corroborate his allegation that the company deliberately issued a false and misleading press release, directly contradicting the internal financial data, in order to support the price of the company's stock.

When the Subcommittee sent auditors from the General Accounting Office to General Dynamics Electric Boat shipyard to audit the records on the submarine contract, the company demonstrated its complete cooperation with the Subcommittee by turning off the heat in the office assigned to the auditors. I received an anguished telephone call from one of them who lamented that his ballpoint pen would not write at 35 degrees. Other similarly harassing tactics dogged those auditors during the course of their work for the Sub-committee

Subcommittee auditors working in the St. Louis headquarters of General Dynamics uncovered dog kenneling expenses and country club dues being charged to the US. taxpayer. The improper allocation of overhead and other expenses among the many contracts any large defense contractor has with the government is virtually undetectable. The thousands of government auditors reviewing defense contracts are estopped from going beyond the four corners of the specific contract then being reviewed. Indeed, the Defense Contract Audit Agency personnel who worked with us on the General Dynamics review could barely suppress their elation at being granted access to the more than far forty-four boxes of financial records the SEC had compiled during the course of its own conclusive investigation of the company.

This event signaled to the Subcommittee that we are going to have to call on a corporation's outside auditors to do more in-depth reviews because they seem to be the only ones routinely capable of viewing contractors' activities in their entirety. Someone outside the system has to help stop $700 hammers and $600 toilet seats from being charged to the taxpayer.

We are continually regaled with tales of improprieties in the Defense accounting system. Take, for example, booking the costs of a wooden ship deck when the trees have not yet been felled because early booking of these costs allows progress payments to be made. The contractor can then divert the cash received to any interim purpose. In effect, the government advances the company an interest-free loan and inflates its own costs by permitting a profit on that booked, but not incurred, cost. When we ask why a replacement vehicle for the JEEP can cost as much as $40,000, we are led to believe that, in some part, creative bookkeeping is a factor.

One problem area the Subcommittee is now facing is the increased use of national security classification of programs. This, at least as an ancillary result, conceals the true costs of programs and the potential impact on the earnings of the contractors. Data is now being made so secret that no one can perform a proper audit -- not only the outside accountants but even Defense Department auditors and inspectors.

But, if no one can audit, how can any auditor affix an unqualified opinion to the financial statement? Initial discussions with members of the accounting profession have led me to suspect that an opinion without qualification as to any limitations on the firm's review of certain programs, even those imposed by the Defense Department, is dangerous and unacceptable. We intend to explore this further.

Regulatory Financial Reporting

Early on in our inquiry, the Subcommittee asked the General Accounting Office to review the financial reporting requirements of Federal agencies other than the Securities and Exchange Commission. The GAO reported back that, in addition to the SEC , there are nineteen Federal agencies which promulgate accounting and auditing standards and practices. And this does not include any Defense Department agencies. The largest single area, we learned, in which the Federal government promulgates accounting rules and regulations is in banking, so this became the focus of our review during the course of our first several hearings.

The Subcommittee found that regulatory accounting for banks and savings and loan institutions has been intentionally designed by Federal agencies to deceive as to the true state or condition of those industries. The regulators find this convenient because the poor economic health of the industry implies a poor performance by the regulator. The institutions find this convenient because they hope that, given a little more time, they can work out their problems and, of course, if they are wrong they can always be bailed out.

As much as ten years ago, some very large banks with substantial exposure in the event of default by major borrowers in Latin America arrogantly (and correctly) asserted that the Federal government cannot let them go under. This dubious and dangerous trend has now spread to the banks with major exposure in the troubled energy and agriculture sectors.

The accounting profession, which is supposed to be independent, has aided this process by establishing reporting rules which do not require-these banks to face up to the losses incurred in their loan portfolios. For its part, the SEC has simply watched and approved the actions taken by the banks and their accountants.

The conflict between the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board in the reporting of identical forms of transactions is confusing and can be misleading. The Subcommittee, in looking at the Bank Board, heard testimony about the conversion of debts to assets by the stroke of a regulatory pen. This prompted Chairman Dingell to observe that when he was younger and owed more, he was richer and that as he grew older he became poorer as he paid off his debts. The obvious error of paper wealth in the face of mounting earnings shortfalls is not lost on the general public, even if it is lost on the regulators.

In the Great Depression years of 1931 and 1932, a business was made out of accepting other people's debts. The Federal Home Loan Bank Board is now busily recreating this "Acceptance World" with its Federal Asset Disposition Association program. The debts of ailing institutions are transferred to a new creature, and by this transference somehow financial health is created. But, like the Phoenix rescue program before it, this new shell game brings with it the same virulence. Nothing has been done to cure the underlying illness, only to treat or conceal the superficial symptoms.

In the beginning of this decade, when soaring interest and inflation rates were eroding the earnings of savings and loans, a shift began in the nature of the business. Institutions -- Beverly Hills Savings and Loan, for example — changed the basic nature of their business from making loans to developing real estate. Instead of being the conservative business investors expected, many savings and loans shifted into "go-go" speculators gambling on rising land values.

Well, the bubble burst and so did many institutions. The Federal regulators who had encouraged the speculative frenzy are now having to finance the rescues and the bailouts and the deposit guarantees, but they do not have enough real money to fix things. Instead, they are using more gimmicks to inflate net worth artificially and postpone today's problems until some indefinite future when things will somehow be better.

Where were the auditors when this fundamental business change occurred? Is it enough to say, "well the Federal and State regulators said it was OK?" The auditors are the only ones with any assets left, and they are the ones being sued. Audit firms are now being much more careful in issuing audit opinions on financial institutions. However, it appears from our hearings that the present system was not able to meet the challenges of financial deregulation until the present crisis caused great harm -both to the public and the auditing firms themselves.

Consulting Services

In July, the Subcommittee sent a questionnaire, modeled closely after the SEC's Form 10K, to the 16 largest accounting firms in the nation. The responses were in no case complete but in some instances were at least informative. The questionnaire was specifically designed to elicit information about management advisory services -MAS. These services carry with them the inherent peril of conflicts of interests when the MAS provider is also the auditor. One large firm has over 100 clients for which the income from the MAS services exceeds the income from the audit services. It has another 100 plus clients whose MAS billings are at least 60 percent of the audit fees. The Subcommittee will be exploring this area in the remaining months of this session of Congress.

The Subcommittee will also be filling in many other of the blanks in the questionnaire responses.

Criminal Cases

One matter of curiosity noted by the Subcommittee has been the absence of criminal cases urged by the SEC for criminally false financial statements. In prior years, we saw the National Student Marketing and Four Seasons cases, but nothing lately. Does that mean reporting is more honest or accurate? Or that the auditors are catching more? Or that the SEC is not bringing cases? I suspect the last is the reason.

Should we not question the role of the auditors in the instances of Saxon Industries or Baldwin-United? I think so, but so far, this is the minority view. The Subcommittee has directed a GAO review of the Commission's Enforcement Division as part of an overall evaluation of the Commission's effectiveness. The absence of criminal cases will be one point under consideration.

What has the Subcommittee accomplished in the last 18 months? What will it do before it ends its inquiry? Will there be new legislation? Are regulatory changes going to be considered? Other questions will follow, so I hope to anticipate at least a few and provide some answers.

The Subcommittee held substantial hearings on the ESM failure in Florida with its ramifications for the state-insured savings and loan industry in Ohio. In that instance, you will recall, the unregulated government securities dealer -- ESM -- was able to conceal its financial problems with the help of a partner with the dealer's outside auditor. Legislation has passed the House — H.R. 2032 -- and is now awaiting Senate action.

That legislation will provide regulation in an area previously unregulated — government securities dealers -- and, by that process, extend audit controls to those dealers. Specifically, it would authorize requiring financial statements to be certified by an independent public accountant. In the meantime, the profession moved quickly to require second partner reviews in these and related situations. Second partner reviews are, of course, required for the normal SEC-type audit. Clearly, our hearing testimony from the Trustee in Bankruptcy and the auditing firm (which was equally duped by its partner) helped move these changes.

The Treadway Commission is a signal that other changes are coming. The profession has been telling the public what it should want, but the public is saying we want something else. The public expects the auditors to look for fraud and to report their findings. It is not enough to say an audit is not designed to find fraud. The auditors must make sure they have taken reasonable steps to find it. And when they do find fraudulent activities, it is not enough simply to report such findings only to corporate managers and directors.

The profession has attempted to use the caveat in its opinion "in accordance with generally accepted accounting principles" as words of limitation, but the public is insisting that the operative words are "present fairly." We suspect that when the Treadway Commission is done, the public's expectations will be proved right.

As an accomplishment, the Subcommittee can also point to the requirement by the FASB that goodwill be written down when a troubled financial institution is bailed out by a Federal agency takeover. On November 7, 1985, two Important events occurred. Professor Briloff, in testimony before our Subcommittee, exposed the desperate straits in which the savings and loan industry was floundering. At the same time, and because of the Professor's pressure and ours, the Emerging Issues Task Force of the FASB was meeting to consider requiring the write-down of assets to fair market value and the elimination of goodwill when a Federal takeover occurred.

The case of Beverly Hills Savings and Loan is a good example of what this change will signify. After considerable argument with the Subcommittee about the value of Beverly Hills' assets after its bailout, the Federal Home Loan Bank Board's resistance collapsed and the institution's negative net worth was disclosed. Losses that were projected not to exceed $150 million have now become $415 million -nearly three times the earlier estimates. Of that total, $130 million represented loss on revaluation of assets to fair values and another $140 million represented bad loans, mostly on real estate.

Objectives

The Subcommittee intends to push the SEC, be it willingly or unwillingly, to assume its proper leadership role in promulgating the financial reporting

standards for all publicly-held companies. including those regulated by other Federal agencies. Whatever utility regulatory accounting may have for regulators with a statutory responsibility, it is today the antithesis of the original purpose of the legislation recommended by President Roosevelt. To help in achieving this end, the Subcommittee is drafting a report that will recommend mend repeal of the exemptions from the Federal securities laws presently enjoyed by banking institutions.

The Subcommittee will review the results of the Treadway Commission. It will watch the SEC to see that it exercises the authority it now has to override regulatory accounting. We are working on a number of recommended regulatory proposals for improvement in the defense contractor area.

Conclusion

And now a final observation. We are not going away. The first comprehensive accounting inquiry by Congress ten years ago was curtailed before its logical conclusion by the death of Senator Lee Metcalf and the retirement of Representative John Moss, who was the Chairman of the Subcommittee on Oversight and Investigations at that time. Chairman Dingell has observed that he intends to do neither of those in the foreseeable future. The Chairman has committed the Subcommittee to work at a deliberate pace until the goals of its accounting inquiry are met.

We have found our inquiry to date has been most fruitful but there are so many more things into which we should inquire. The approach to industrial problems by looking at them through the eyes of the auditors has given the

Subcommittee a unique perspective. Instead of concluding in September, the Subcommittee now anticipates we will continue our investigation into the 100th Congress next year.