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"ACCOUNTING AND THE COMMISSION'S ENFORCEMENT PROGRAM"

ADDRESS

Of

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Before the

CHI CHAPTER OF DELTA SIGMA PI

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When your chapter president, Mr. DeGrafft, asked me to speak to you this evening, I was delighted to have the opportunity of discussing with you some of the general questions which I believe to be common to both your fraternity and the Securities and Exchange Commission. I say this because I understand Delta Sigma Pi was founded for the purpose, among other things, ". . . to further a higher standard of commercial ethics and culture and the civic and commercial welfare of the community," while the Securities and Exchange Commission was established to effectuate the full and fair disclosure of information pertinent to securities sold in interstate commerce and through the mails, to regulate transactions on national securities exchanges and in the over-the-counter markets, to prevent inequitable and unfair practices, and to detect and prevent the consummation of frauds in the sale of securities.

All of us present can recall the days of active stock promotion in the middle twenties, with everyone from elevator boy to president, wildly speculating in a rising market. Stocks rose to nebulous heights, entirely out of proportion to any proper basis for their valuation. Huge paper profits were made. Anything was possible. The public was so credulous it was easy for a ruthless promoter to flood the market with worthless stock, beautifully embossed with a golden seal, with promises of fabulous returns far exceeding the rosiest dreams for the gullible investor. Get-rich schemes were commonplace. No investor was too small for him to contact; he exercised no conscientious or moral restraint in his activities. State laws could not hold him, state boundaries offered no resistance. He operated throughout the length and breadth of the land, relying on distance for his protection, using the mails, the telephone and telegraph to perpetrate his fraud across state lines, with no effective federal control to block his efforts. The investing public was swindled out of millions of dollars by these methods. Those who could ill afford it were induced to part with their life's savings.

With the market crash of 1929 and the financial crisis which ensued, many investors, even those comparatively well off, found themselves in greatly reduced circumstances, with the accumulation of years wiped away. Some lost everything. In desperation many made an effort to recoup their resources by investing their few remaining dollars in wildcat promotions, becoming the unwitting prey of these same unscrupulous promoters, who fleeced them again with promises of quick recovery.

These experiences could not be repeated. There came a public demand for effective federal regulation of these evils. Then followed the enactment of the Federal Securities Laws, and the creation of a special agency devoted to their enforcement.

The first of these acts, known as the "truth in securities" act, was designed to provide a true and complete picture of new securities to be offered to the public by means of the registration process. The prospectus required to be furnished to each investor is designed to provide sufficient facts to enable him to determine for himself the advisability of the investment.

In addition, this act has a sweeping fraud provision, prohibiting in the sale of securities the use of the mails or the facilities of interstate commerce to devise fraudulent schemes, the obtaining of money be false or misleading representations, or the engaging in a course of business which would operate as a fraud or deceit upon the purchaser.

The 1934 Act effected similar provisions for securities registered on national securities exchanges. Requirements as to registration and reporting were adopted. Provisions were made against the artificial manipulation of securities prices; a fair and open market was sought to be maintained. In addition, over-the-counter brokers and dealers were required to be registered, if they used the mails or the facilities of interstate commerce to conduct their business.

The 1935 Act provided for the control and regulation of the vast public utility holding company systems, suggested reforms relative thereto, and placed upon the Commission certain responsibilities regarding their operation, coordination and ultimate simplification.

Thus we see generally the necessity for and the purpose of the three acts administered by the Commission. A brief word now on the mechanics of such administration.

The principal office of the Securities and Exchange Commission is located in Washington. In addition, the country has been divided into nine regions and a regional office set up in the principal financial center of each, under the supervision of a regional administrator, staffed with a force of attorneys, accountants, analysts, margin inspectors, mining and oil engineers, and so forth.

It is through the regional offices that a vast amount of the enforcement work of the Commission is conducted. The staff of each office is always available to any interested party desirous of discussing problems arising under the acts or seeking information. It is through the regional offices that investigations of possible violations of the acts are usually conducted.

In the usual course questions arising in the regional offices are referred to the appropriate Division of the Commission's Washington office, which has a general supervision over their work. These are the Public Utilities Division, Registration Division, Trading & Exchange Division, General Counsel's Office, and Office of the Chief Accountant.

The Public Utilities Division in general is charged with the duty of handling all questions relating to the registration of public utility holding companies; the Registration Division with questions involving the registration of securities issues; the Trading & Exchange Division with matters concerning the trading on national securities exchanges and in the over-the-counter markets; the General Counsel's Office with the interpretation and enforcement of the provisions of the several acts; and the Office of the Chief Accountant with questions involving accounting practices and procedure as they relate to all of the activities of the Commission.

The importance of questions of accounting practice and procedure in every phase of the work of the Commission can not be over-emphasized. Every registration of a public utility holding company or of an issue of securities must be accompanied and supported by elaborate financial statements, profit and loss statements and balance sheets, certified to by an independent public accountant. Investigations into fraudulent securities transactions, manipulative or unfair practices on the exchange or in the open markets, all require and necessarily depend on the examination and conclusions of an expert accountant. We meet these questions in every phase of the Commission's enforcement program.

As my work with the Commission happens to be principally concerned with this enforcement program, I am naturally best qualified to speak on this phase of the Commission's activities. I thought it might interest you to have me go into some detail regarding the same and then to show how this program coincides with some of the principles which your accounting fraternity is seeking to establish.

To attempt to delimit the term "enforcement" by a precise definition would be impossible, for matters involving a problem of enforcement necessarily encompass questions relating to every phase of the work of the Commission. Broadly speaking, it might be said that the enforcement section of the General Counsel's Office is charged with the primary duty of insuring compliance with the laws administered by the Commission.

Most cases originate with a complaint. Some person, usually one who can ill afford to suffer a loss, writes in and complains about some investment he has made. Occasionally our information comes from some source other than a complaint--our own observance of a market trend, a "tip", a suggestion from a cooperating enforcement agency, some special study the Commission has made, and the like. But in each instance an investigation is instituted.

The direction that an investigation takes of course depends on the nature of the violation involved. Certain essential facts are fairly general, however, and sooner or later must be established before there can be any violation. Evidence of mailing, or of use of the instrumentalities of interstate commerce, such as the telephone or telegraph, or under the Exchange Act of the facilities of an exchange, must be developed. Similarly, under the Securities Act, it is essential to show there was a sale of a security involved, in contrast to the sale of something which could not be classified as a security within the statutory definition.

Let us take a typical case. A letter is received by the Commission from an investor who complains that at the solicitation of a salesman from a certain brokerage house he was induced to purchase 100 shares of preferred stock in a certain company for a total consideration of $1,000 and that he has failed to receive the promised dividend of 10_. The letter from the investor and the material which he has attached reveals that the securities in question were delivered to him through the United States mails. The wheels of enforcement are immediately set in motion. A check with the Registration Division reveals that the securities of the particular corporation have never been registered, but the standard investment manuals tell us that that company was incorporated under the laws of Delaware in 1937, with an authorized capitalization of $500,000. The broker-dealer section informs us that the brokerage house whose salesman solicited the purchase has never filed a registration as a broker or dealer to conduct an interstate business in over-the-counter securities. Reference to the Securities Violation flies in which are contained the names, personal histories and descriptions of some 30,000 known professional securities swindlers reveals that the president of the brokerage company has previously been enjoined and indicted in several states as a result of fraudulent securities practices. This information is assembled and correlated and forwarded to the proper regional office with the suggestion that an immediate investigation be made. The Regional Administrator upon receipt of the information assigns the case to an attorney and an accountant for investigation. A visit is made to the offices of the brokerage concern and a request made to examine its books and records. At this point the accountant must take the lead. A detailed examination and analysis is made of the books and

records of the brokerage company. Probably it will be necessary for the accountant to trace the funds received from the sale of the securities through several accounts until their final disposition can be determined. The books may reveal domination and control of the brokerage company by still another company. Thus the field of inquiry broadens. Finally, a detailed analysis is prepared. Accounts are broken down, fictitious write-ups exposed, diversion of funds brought to light. It is upon such facts, developed by the accountant, that the attorney must evolve his theory of a case. In addition, the attorney must completely rely upon the ability of the accountant to support his findings and conclusions--both as to facts and applied principles--should the case be subsequently brought to trial, and the accountant subjected to a grueling cross-examination.

The importance of the accountant in the enforcement work of the Securities and Exchange Commission varies, of course, with each particular set of facts. But I feel I can safely say that there are accounting problems in practically every major investigation we have undertaken. The Kopald-Quinn, Whitney, Interstate Hosiery and McKesson & Robbins cases are examples of cases where everything depended upon the thoroughness, accuracy and proper handling of questions of accounting.

In the Kopald-Quinn case the investors were induced to buy securities on an installment basis, delivery not to be made until fully paid for, at outrageously advanced prices which had been achieved by clever manipulation of the market. When everyone had signed up, the plug was pulled; support was withdrawn from the market, which caused it to drop to practically nothing. Everyone's account was closed out, leaving all that had been paid in to be enjoyed by the perpetrators of the scheme. Ample jail sentences have taken care of the principal actors in this particular case, and their prosecution has had the desired result of frightening others from similar enterprises.

A case of wide public interest was the recent Whitney case in New York. Richard Whitney, former president of the New York Stock Exchange, and one of the leading financial figures in the country, was discovered to have hypothecated to his own account customers' securities going into the millions. An immediate and thorough investigation by the Commission and the New York State authorities resulted in his conviction for grand larceny, and the Commission, in a detailed report following a public hearing, proposed certain additional rules to the stock exchanges, looking toward the more immediate detection of such malefactions.

In the Interstate Hosiery case, an accountant employed by an accounting firm which had been retained by the company to make its audits for a period of years created out of his own imagination and carried forward certain items of profit which had no basis in fact. His motive is still a mystery although he is now serving time in a New York prison for his machinations. The responsibility of the accounting firm employing him presented an interesting question.

More recently, the McKesson & Robbins case excited nation-wide interest. Donald Coster, or Musica, a former convict who had completely concealed his identity and had built up an enviable reputation as a leader in business and finance, was discovered to have falsified the assets of a whole department in his business. With the assistance of his brothers and others, he set up on the books of McKesson & Robbins false assets in the Crude Drug department running into many millions when no such assets were in existence. The necessity of filing a registration

with the New York Stock Exchange and this Commission under the 1934 Act enmeshed him in a violation of federal statute and resulted in a prompt indictment of the principals and Coster's suicide.

About a year ago the Commission was party to a most interesting case in this very city. William P. Lawson, then Police Commissioner of Baltimore, was registered with the Commission as an over-the-counter broker and dealer. The Commission had occasion to examine into Lawson's business which disclosed that he and his associates had sold to investors approximately a quarter of a million dollars worth of securities in non-existent companies, ranging from whiskey distilleries to oil companies. In addition, thousands of dollars worth of negotiable securities deposited by customers to be held in safekeeping had been unlawfully hypothecated. The Securities and Exchange Commission sought and obtained an injunction in the Federal District Court, perpetually enjoining him from carrying on the illegal practices complained of. Action instituted by the state as a result of our investigation resulted in the imposition of a substantial prison sentence.

These cases, selected from a large number, illustrate the variety of problems encountered in our enforcement work. Even from these brief factual statements, I am sure you can appreciate the extent of the accounting investigations involved. Many months of the most difficult accounting checking and analysis were necessary before the true facts could be ascertained in any of these cases, on which could be predicated some sort of legal proceeding.

You would perhaps be interested in some statistics which will show more graphically than any other way I can think of the extent of the Commission's enforcement work and some of its tangible results. At the present time the Commission has approximately 600 active investigations in progress. During the five years the Commission has been in existence and up until June 30th last, the end of the fiscal year, the Commission has obtained permanent injunctions in 258 cases, against 323 defendants. During this same period 257 defendants have been convicted in 75 criminal cases. The figure, of course, does not include a large number of other defendants who are presently under indictment for violations of our statutes, but who have not yet been brought to trial.

Much more far-reaching, however, has been the salutary effect these investigations, injunctions and convictions have had upon the securities under-world. Many who have not personally been looked into have been so frightened by the vigorous program the Commission has been conducting, they have literally, like the Arabs, folded their tents and stolen silently away into the night. Lessen our vigilance, of course, and we would soon be back to where we started. I cannot believe, however, that any Congress in any administration would sponsor such a return to the days of old-time stock racketeering.

But to return to my theme, which is the parallel between your aims as members of this great accounting fraternity, and the philosophy behind the securities laws which Congress has charged our Commission with administering, we are both striving for but one thing – truth – truth in securities selling; truth in audits upon which the investors rely. Half-truths are not enough. We can all agree that false statements have no place in our modern business concepts. But is not the half-truth – the statement which in itself is not false, but which fails to supply other

facts, which, read together, would give the statement made an entirely different connotation – even more vicious? The securities acts have stamped this as fraud. Applied to accounting certifications, it should hold a real significance for you.

Accounting is no longer just bookkeeping. It has become a profession – and particularly certified public accountants, stamped with the approval of some state board, as having passed the exacting qualifications both as to education and experience to entitle them to be recognized as such, have assumed the full status of a professional class in the public eye, with all the resulting emoluments, and what is more important, responsibilities.

Compared to law and medicine, accounting is of course a new profession – it has grown up approximately within our lifetime. It arose because of the ever-increasing complexity of American business. Small businesses, privately owned, gave place to vast enterprises, the ownership of which was scattered throughout the length and breadth of the land. Increasing problems of state and federal taxation necessitated the employment of experts versed in the principles of accounting, to suggest systems of bookkeeping and prepare returns which would reduce the tax burden as much as possible. During the prosperous days of the early part of this century, accountants would simply certify financial reports as "correct", and that is all there was to it. Accounting firms were employed by the management; they worked for the management; they attempted to show the management how best to conduct its affairs. Even after the corporate structures became more complicated, and the ownership more far-flung, so that there were investors who had no intimate knowledge of corporate affairs, accounting firms were still prone to assume that the owners of the capital stock not connected with the management could imagine all the factors which had entered into their certifying financial statements as "correct". All went well until the tide of business turned. Then came a time, in the early thirties, when a shareholder would receive a solvent-looking balance sheet, and before he received another he would read of the company's receivership or bankruptcy. He could believe it. Had not some accounting firm certified that the financial statements were correct? Couldn't he take that at face value?

Over the years accounting had made considerable progress in reporting to shareholders, and the debacle of 1929 served to give additional impetus to this movement. Then came the passage of the federal securities acts as a further impetus. Designed to furnish the investor additional and more accurate information, and bring within their province sooner or later the securities of all large and most medium-sized businesses, whether traded on the exchanges or in the over-the-counter markets, it was but natural that the Securities and Exchange Commission should concern itself, almost from the outset, with proper methods of accounting procedure and certification. It is now required in the certification to state the scope of the audit made, and the opinion of the accountant regarding the financial statements made, and the procedure and principles of accounting followed by the company in arriving at those statements; that they "fairly reflect the application of accepted accounting practices"; and that in the balance sheets and profit and loss statements "there is no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The standard of *reasonable* investigation and check is adopted as the basis for such a certification – such language is contained in the statute itself. And the standard of reasonableness is defined as "that required of a prudent man in the management of his own property."

More significant, however, is the additional requirement that the audit shall be *independent*. It seems to me axiomatic that the auditor shall be completely free from bias, and devoid of any affiliation with the company whose accounts he is checking. An officer, director, partner, or even employee of the company is clearly not so qualified. It can even go further – an accounting firm, nominally independent, if a particular company is its sole client, or the principal source of its revenue, can under particular circumstances lose its aura of independence.

Another thing upon which I feel the investor has a right to rely is that the work has been done by an *expert*. This in effect is saying that accounting has become a profession, and that the public has come to look on it as such. I do not mean to say that *all* the work can actually be done by the accountant who affixes his, or his firm's name, to the certification. Division of work is often a necessity. But that does not eliminate the heavy responsibility, because of the public's regard for it, which is placed on the accountant who is responsible for the work, and actually does the certifying. Although he may of necessity delegate to those under him some of the detail work, he cannot escape the responsibility of carefully analyzing and planning the necessary work which is to be done – he must outline a program, and see that it is followed out. In delegating a part of the work, he must be sure that person is entirely qualified to do that particular part of the job. He must oversee the work, and carefully check it when it is completed. His review of the work should be more than a perfunctory examination of the audits which have been prepared; he should see that the original work papers are carefully integrated with the financial statements, and in addition, from his position as the supervising expert, he should pass upon the adequacy of the audit work, and the integrity and clarity of the financial statements themselves.

The next thing which the public has a right to expect, and upon which the certifying accountant should satisfy himself, is that an audit of the business has been made. He must be sure that the financial position and earnings of the company are fairly stated. He must have a reasonably accurate knowledge of the business under examination. He must understand its administrative organization and personnel, in addition to its financial records, in order to know how much reliance he can reasonably place upon its internal system of check and control. He should be able to reasonably establish the general authenticity of the transactions and the accuracy of the company's records as to such transactions. It is undoubtedly a physical impossibility in audits of any size to actually verify each item. A system of test checking of the results shown by the records should be resorted to; checking the records against each other, checking them against physical facts, checking them against the records of affiliates and subsidiaries, checking them against information from independent third persons with whom the company has done business. This test checking would of course vary, depending on how much the certifying accountant is justified in relying on routine systems already in effect in the regular course of the company's business. He should thoroughly inspect the systems, satisfy himself that they are sound and reliable, and operating as they were designed to operate – only then is he justified in relying upon them.

Before certifying, the last thing the independent auditor should be sure of is that the examination and its results are such as to enable him to express an informed, expert opinion, and then state that opinion as clearly and fairly as possible. There are some cases where no certification should be given. If there is no adequate basis for judgment, if the company's books are set up in a fraudulent manner, if the accounting principles and procedure followed by the

company are such that the accountant would have to take so many exceptions as to make his certification meaningless – he certainly should not certify.

At the other extreme are cases where he can clearly certify, and make his certification mean just what it says.

In the middle group – where he can certify, but must qualify – come the difficult cases. In these cases, the precise nature of his exceptions should be clearly and unequivocally stated. Limitations as to the scope of the audit, exceptions to accounting principles and procedures, alternate preferable procedures and the differences that would result, unusual features of the audit – all these are significant and important to those who will rely on the audit – and all should be stated.

These, I believe, are a few of the things that an independent accountant and auditor is excepted to furnish the public in these modern times. Some of them may seem too advanced, impractical, Utopian. But I urge you they are not. They conform to the ideal of truthfulness which underlies all our securities legislation. They should express, in practice, the high public purpose to which this fraternity is dedicated.

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