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James C. Treadway

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National Commission on Fraudulent Financial Reporting

1701 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 659-5640

Address

to

SEC and Financial Reporting Institute
at the University of Southern California

Los Angeles, California

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THE NATIONAL COMMISSION ON

FRAUDULENT FINANCIAL REPORTING - A FIRST

TRIMESTER REPORT

James C. Treadway, Jr.

THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING -- A FIRST TRIMESTER REPORT

One-Third The Way There

The National Commission on Fraudulent Financial Reporting is about one-third the way home. After approximately six months of work, the Commission has finished its first trimester, one which saw the generation of numerous research projects, lively and free exchanges among the members of the Commission on any number of topics, and several presentations to the Commission by outside experts.

Between now and Summer's end, the Commission will receive and analyze various third party research projects, as well as internal research projects, and prepare for major Commission meetings in September and October. At those meetings, the Commission will make final decisions on numerous issues, which in turn will provide the basis for our staff to prepare an exposure draft of the Commission's Report.

After approval by the Commission, the exposure draft will be distributed for public comment after the first of the year. The comment period will last ninety days, and we hope to analyze and react to the comments and publish the Report in final form at the end of another ninety days.

Commission Objectives

Those who have followed the Commission's work may recall that our fundamental charge is to analyze the whys and wherefores of, and propose solutions to, fraudulent financial reporting -- a fairly modest undertaking. Some might ask what realistic chance we have for making a positive contribution. After all, the AICPA, FASB, SEC, Blue Sky Commissioners, hard-nosed prosecutors, honest corporate executives, strong-minded auditors, Congressional committees, and independent directors have not, individually or in concert, been able to eliminate fraudulent financial reporting. Some might even question whether any rational basis whatsoever exists for optimism on our part.

Although my views are tinged with caution, I believe we have reason for optimism. First, our Commissioners are all practical people with much experience. Their many combined years of experience and insights bring together substantial judgment, plus different perspectives and disciplines. Second, the Commission is approaching fraudulent financial reporting as a multi-dimensional problem, based on our belief that many factors contribute and that the multiple causal influences must be identified and addressed to provide hope for any degree of success. Third, we operate under no illusion that our Report will, once and for all, magically banish fraudulent financial reporting in its many forms and colorations. The problem of fraudulent financial reporting does not lend itself to simple answers -- the activity is as complex as human nature itself, with all its quirks, foibles, and eccentricities. Fourth, and perhaps the converse of having no illusions of granduer, success does not require that we solve all the problems. Rather, success to a large extent lies in identifying and airing the issues -- the causal influences -- thereby setting the stage for further consideration of ways to deal with those influences.

With those thoughts firmly in mind -- particularly that fraudulent financial reporting must be approached as a multi-dimensional problem -- let's explore the Commission's approach. Early on, as the Commission attempted to determine its approach and methodology, we found ourselves asking a number of questions. What causes fraudulent financial reporting? What internal corporate pressures contribute? What individual shortcomings come into play? What failings of private corporations and of corporate governance contribute? What broader societal and economic pressures are influential? What inadequacies of governmental regulations have an impact?

The mere exercise of asking these questions quickly caused the Commission to conclude the obvious -- that many factors, players and pressures contribute to fraudulent financial reporting. If that is so, then many ways should exist which have potential for reducing fraudulent financial reporting. Concentration on only one, or a few, causes/solutions might be valuable, but "miss the big picture." Someone has described efforts like ours as handling a big balloon. If you push too hard on one side, it bulges out on the other. An even-handed, even-pressured approach preserves the proper shape.

The Focus

So where did the Commission focus -- on what players, what factors, what influences? First, the Commission focused on management. After all, management has both the initial and final responsibility for accurate financial statements. As the Commission focused on management's role, many questions that quickly emerged turned out to be corporate governance issues.

The Audit Committee was a predictable focus, and we have spent much time on that issue. Questions raised thus far, without any definitive positions being taken, include:

1. Should Audit Committees be mandatory for all publicly-owned corporations? Or for any group of companies?

2. Should Audit Committees have greater powers? If so, what?

3. Since no source prescribes the powers of the Audit Committee, should we try to create a list of powers and responsibilities?

4. Should the role of Audit Committees be more visible and better communicated to the public? Would it be a positive development, for example, if the Chairman of the Audit Committee included in the Annual Report to Stockholders his own letter describing the activities of the Audit Committee?

5. Should the Audit Committee's interface with the internal audit department, and its involvement with and attention to internal controls, be more publicized?

Those are but a few of the corporate governance issues the Commission has discussed, all relating to the Audit Committee. But I emphasize that the Commission is interested in these -- and all other -- topics only as they relate to or have potential for reducing fraudulent financial reporting. We are not embarked on an effort to overhaul corporate governance generally.

Beyond Audit Committees but still loosely in the corporate governance arena, the Commission also has looked at corporate structure, environment, and atmosphere. You could call it the corporate culture. Again, however, I emphasize that our look is sharply focused -- how does corporate culture relate to, encourage or tolerate, or discourage or prevent, fraudulent financial reporting. In that area, the Commission has considered, e.g.:

1. Do certain management techniques -- such as management by objective and decentralized operations -- lend themselves to abuses more readily than others?

2. Should more formalized procedures generally be followed by everyone involved in the financial reporting process? If so, what are they?

3. Rather than attempting to prescribe new procedures, should the Commission instead focus on other approaches, such as more required disclosure about internal controls and procedures?

4. Should corporate management be required to express an opinion on the adequacy of internal controls -- an idea once proposed by the SEC but later abandoned?

5. Is the tone and atmosphere set at the top the most influential factor? If the tone set at the top is fuzzy, are all other controls and procedures predestined to be ineffective? Can our Commission influence that tone?

6. To what extent should the Commission encourage or propose corporate codes of conduct or ethics?

The Commission has spent much time on internal controls and the role of the internal auditor. That focus involves, at least potentially, some issues of corporate governance and of corporate structure and function. In each meeting, regardless of our agenda, we seem to come back to internal controls.

Beyond management, the other most visible player in financial reporting is the independent public accountant -- a highly predictable focus of the Commission. When considering the independent accountant, we find no shortage of issues. Professionalism and its possible decline is one. Beyond the general debate about "professionalism," the Commission has focused upon competition and opinion shopping, the SEC's Request For Comments on Opinion Shopping, the Auditing Standards Board's decision to tackle the same issue, and the steady debate about auditors' ability and obligation to detect fraud.

The Commission also has focused on the accounting profession's existing regulatory and enforcement mechanism and proposals for change, as well as upon public concern about the potential impact of non-audit services on auditor independence. But, as I said in reference to management and corporate governance, and I emphasize again, our focus on these and all issues is narrow. How do they relate to fraudulent financial reporting, if at all? Would changes reduce incidents of fraudulent financial reporting or otherwise lessen the potential for its occurrence? We are not interested in these issues as broad policy issues, as interesting as they may be. Only if we were to determine that some change in the profession's self-regulatory structure or in the scope of services provided would lessen the incidence of fraudulent financial reporting would we have any basis for comment.

After management and the auditor, law enforcement may be the next most significant factor. The Commission therefore has and will continue to address the effectiveness of the regulatory and law enforcement environment in dealing with fraudulent financial reporting. Is it good, bad or indifferent? Is the regulatory and law enforcement environment the real issue? Is more "regulation in advance" the answer? Can law enforcement realistically do more than discipline a few truly egregious violators?

Law enforcement considerations inevitably take us to penalties and sanctions -- a long-running, sometimes highly emotional debate. In that vein, the Commission has discussed issues such as:

1. Are sanctions generally adequate? Do they deter?
2. Is the injunction a stiff sanction or a meaningless wrist slap?
3. Are more criminal prosecutions and longer sentences for white collar crime the answer?
4. If law enforcement and regulation are to be encouraged, what about the effectiveness of self-regulatory organizations in the enforcement area? How effective are the enforcement mechanisms of private professional groups?
5. How effective are specific regulatory and law enforcement agencies?

Research Projects

From the outset -- given the Commission's multi-dimensional approach -- reliance on third-parties for research assistance and input has been a necessity. As we receive third-party research efforts, they will be analyzed, digested, and perhaps refined. While some of these research efforts may gather information which is broader than our narrow focus, we intend to confine our Report, again, to fraudulent financial reporting. Take any of the areas I have talked about, corporate governance, for example. Our Commission has neither the time, capacity, nor inclination to do a comprehensive study of that issue. Our focus of necessity must be sharp. Is there something about corporate governance, some aspect of it, that relates directly to fraudulent financial reporting?

With those cautionary words about our research efforts, here is a list of outside research projects.

Impact of Professionalism and Codes of Conduct on Financial Reporting.

Financial Reporting in the U.S. and the Role of the SEC.

The Independent Auditing Profession's Response to Fraudulent Financial Reporting.

How to Introduce the Issue of Fraudulent Financial Reporting to College Business Students.

Expansion of Non-Audit Services and Auditor Independence.

Surprise Write-Offs.

How Internal Controls Can Help In Prevention and Detection of Fraudulent Financial Reporting.

Role of the Internal Audit Function in Prevention and Detection of Fraudulent Financial Reporting.

Individual and Situational Forces and Pressures Contributing to Fraudulent Financial Reporting.

Corporate Structure/Governance and Fraudulent Financial Reporting.

In addition, the Commission's staff will be conducting internal research projects on the following topics.

Analysis of SEC Cases. (A database of approximately 200 cases has been partially complied and awaits analysis. Analysis will include: review of prior studies, including work done by the Cohen Commission; analysis of 200 cases looking for any patterns and common characteristics; and in-depth analysis of 4-6 cases.)

Individual and Situational Forces and Pressures within CPA Firms. (A study of the forces and pressures generally experienced by members of the audit team that may contribute to breakdowns in audit quality. The purpose is not to reinvent the Cohen Commission's study on budget pressure, but rather to gain a broader understanding of the behavioral dynamics that operate in administration of typical audit engagements. Among other goals, this study will evaluate SAS No. 22 -- Planning and Supervision.)

Opinion-Shopping and Competition. (This study will analyze conflicting viewpoints surrounding the practice of opinion shopping and attempt to relate these findings to the more general issue of competition in public accounting.)

Reporting on Financial Condition. (This study will explore the feasibility of the independent auditor's assuming increased responsibility for evaluating and reporting on going-concern problems.)

Red Flag Checklist. (This study will compile an inventory of red flags from existing sources, other work of the Commission, and risk analysis questionnaires of public accounting firms and explore how this information can be used to prevent fraudulent financial reporting.)

Second Partner Reviews. (This study will gather information about second partner reviews in public accounting firms and explore the feasibility of standards being established by the Auditing Standards Board.)

Self-Regulation of Public Accounting Profession. (This study will consider the regulatory environment in which public accountants perform audits and consider alternatives.)

Quality Control Standards. (This study will evaluate the existing guidance provided by quality control standards.)

Analytical Review/Operational Audit Procedures. (This study will explore the usefulness of analytical review and operational audit procedure in detecting fraud.)

Fraudulent Financial Reporting Framework. (This study will evaluate the available literature on white collar crime to the area of fraudulent financial reporting.)

Fraud Taxonomy. (This study will attempt to classify various fraudulent acts and refine the concepts and terminology surrounding fraud.)

Related Studies. (This project will gather information about similar fraud initiatives going on in other countries.)

Guidelines for Audit Committees. (This study will attempt to develop guidance as to the role of audit committees.)

Financial Reporting Process. (This study will attempt to describe the financial reporting process, including its key components and interrelationships, and explain how the integrity of this process is compromised by acts of fraud.)

Legal Environment. (This study will attempt to describe how the legal system relates to and can impact fraudulent financial reporting.)

Possible Report

If you have followed my meanderings, you have a possible outline for a Report. And, in fact, the Commission has tentatively decided that the Report will have chapters or sections along the following lines:

1. Introduction and Goals.
2. Environmental and Individual Forces and Pressures and their Implications for Preventing, Discouraging, or Encouraging Fraudulent Financial Reporting.

3. Professionalism.

4. Effectiveness of Regulatory and Law Enforcement Agencies.

5. Corporate Structure and Governance.

6. Independent and Internal Auditing.

7. Conclusions, Models, Recommendations.

Thus far, I have spoken about the affirmative -- what the Commission will do and be. Let's turn to the flip side -- what the Commission will not be. The Commission is not attempting to be all things to all men. It will not be a prosecutor of any specific corporation; an accounting standards setter; a drafter of specific legislation or regulatory agency rules; an auditing standards setter, other than perhaps in the most limited fashion; an investigator of all business practices that any segment of society finds objectionable; or a panacea -- the ultimate, self-contained answer to all financial reporting and disclosure evils.

Conclusion

Any effort such as ours causes those who are involved to reflect periodically on the conclusion of the project, particularly that result which others might label a success. In thinking about success, I suggest that success -- like the problem of fraudulent financial reporting -- of necessity is composed of many elements. They include:

1. The Report must contain a balanced analysis and addressing of the issues.

2. A second determinant will be whether the Report provides a basis for other private, public, and professional groups to go further in certain areas -- whether it becomes a springboard for others to pursue matters in more depth.

3. Success also will be measured by whether the Commission raises levels of sensitivity and creates a heightened awareness among all -- corporate management, the accounting profession, regulatory agencies, and the public -- about the financial reporting process and the particular elusive problem of fraudulent financial reporting.

4. Practical guidance will be a major element of success. For example, can the Commission identify common patterns among companies that go astray? Can we characterize and catalogue those patterns? Can the Commission go so far as to suggest a model which has the maximum potential for minimizing the incidence of fraudulent financing reporting?

Thank you for your attention.

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