We Often Paint Fakes

Abraham J. Brilof

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"We Often Paint Fakes."

Abraham J. Briloff*

In his The Act of Creation Arthur Koestler relates an incident that he assures us is authentic about an art dealer who bought a canvas "signed Picasso" and who wanted to know whether it was genuine. According to Koestler:

[The dealer] travelled all the way to Cannes [where] Picasso was working in his studio. [Picasso] cast a single look at the canvas and said: "It's a fake".

A few months later the dealer bought another canvas signed Picasso. Again he travelled to Cannes and again Picasso, after a single glance, grunted: "It's a fake."

"But cher maitre," expostulated the dealer, "it so happens that I saw you with my own eyes working on this very picture several years ago."

Picasso shrugged: "I often paint fakes."

It is in this mood that I turn to describe what I consider to be the "fakes" painted by accountants in particular situations, and on an even more pervasive scale by the accounting profession as a whole.

I. INTRODUCTION—THE PROBLEM

To begin, the profession has disseminated the message far and wide that its members are the high priests responsible for the interpretation and application of a very special body of knowledge known as "generally accepted accounting principles" usually referred to as "GAAP." On analysis one quickly discerns that no such defined body of principles exists. Some commentators maintain, in fact, that not a single accounting precept is deserving of the designation "principle" and these exegetics urge that the critical phrase be changed to read "generally accepted accounting standards," hence "GAAS."

Others, reflecting on the evils perpetrated in the name of GAAP and/or GAAS by the conglomerates, franchisors, land developers, home builders, lessors of computers and other objets d'art, real estate investment trusts, banks and insurance companies, and oil companies, inter alia, prefer the designation "cleverly rigged accounting ploys," hence, "CRAP." Whether we refer to them as GAAP or GAAS or CRAP it is my view that the "rules" could

* Certified Public Accountant; Professor of Accountancy, The Baruch College of the City University of New York; B.B.A. City College, New York, 1937; M.S. City College, New York, 1941; Ph.D. New York University Graduate School of Business Administration, 1965.

produce a fair communication to those entitled to know. As this essay will make clear, however, the difficulty arises because the principles are applied in an unprincipled manner.

II. EXAMPLES OF PARTICULAR ACCOUNTING FAKES

A. Pooling

By my tastes the biggest and most persistent “rip-off” perpetrated in the name of GAAP, GAAS and/or CRAP results from the use of pooling-of-interests accounting.

I begin with an illustration of how the pooling ploy works. Take the case of Diogenes Lantern Works, a glamour corporation which has become a darling of Wall Street. The company remains in the developmental stage since it has not yet demonstrated the operational or economic feasibility of its truth-divining concept. Although Diogenes has had no sales whatsoever, the corporation has no operating deficit since all costs incurred to date have been “capitalized”—counted as assets rather than expenses. It did, however, have substantial income as formulated by its accountants because one of Diogenes’ subsidiaries, which was performing some scientific experiments for the parent company, had borrowed $1 million and then gone bankrupt in early 1974, thereby wiping out its debt. Under our existing accounting rules, this “wipe-out”, becomes a consolidated profit for Diogenes. As a consequence it shows $1 million in net income, on which, interestingly enough, the company pays no tax.3

Diogenes, “at this point in time,” has a million shares outstanding with about sixty percent owned by the management and the rest by performance funds handled by money managers—Wall Street’s big brains, those who recognize a “concept corporation” and give it the all-important price-earnings multiple (P/E), that is, the price per share related to the earnings per share (EPS). These astute market analysts have assigned a modest multiple of forty to Diogenes. Each share changes hands at a $40 price—40 multiplied by the $1 EPS, which equals the $1 million consolidated net income divided by the one million outstanding shares. Diogenes’ consolidated September 30, 1974 balance sheet would, therefore, read as follows:

---

3. Diogenes, in filing a consolidated return, would, presumably, elect to exclude the income from the debt elimination. Int. Rev. Code or 1954, §§ 108 and 1017.
Assets:

Deferred Research and Development Costs† $1,100,000*

Liabilities:

None

Capital Stock and Retained Earnings:

Capital Stock, par value 1 cents per share, 1,000,000 shares issued and outstanding $ 10,000
Paid-In surplus (the excess of the $100,000 contributed by the original shareholders over the $10,000 par value) 90,000
Retained Earnings (we know where that came from) 1,000,000
Total Capital Stock and Retained Earnings $1,100,000

*Represents the $1 million expended by R & D subsidiary and the $100,000 spent by Diogenes directly.

There would, of course, be appropriate footnotes of various kinds, so that everyone would know everything—if they could only understand what they were observing.

Clearly Diogenes urgently needs money, and at this stage, Archimedes, an especially sophisticated mergers and acquisitions investment adviser, becomes worth his weight—not merely in water or even gold, but literally in precious gems. Archimedes has located a company somewhere in Washington called Stonewall Erections, which completed its last project in 1974. As of September 30, 1974, Stonewall has a rather prosaic balance sheet:

Assets:

Cash $500,000
Land (acquired early in 1969 at cost) 100,000
Total Assets $600,000

---

4. Significantly, the Financial Accounting Standards Board, in October, 1974, adopted its standard No. 2 proscribing the deferral of Research and Development costs in most cases. Cf. 3 CCH A.L.C.P.A. Prof. Stands. § 1051.09 (1974). However, this new “principle” would not apply to Diogenes’ statements for 1974 (the period involved in the illustration). If this illustration were to be developed with a 1975 dating I would be constrained to have Diogenes involved in an extractive industry (where such developmental expenses may still be capitalized rather than expensed.).
Liabilities:
None

Capital Stock and Retained Earnings:

Capital Stock 1,000 shares at $100 par value $100,000
Retained Earnings:
Income for the nine-month period ended September 30, 1974 (net of taxes) 500,000
Total Capital Stock and Retained Earnings $600,000

Archimedes determines that Stonewall’s shareholders believe the land now has a worth of $4.5 million because of an enormous appreciation since its purchase for $100,000 and they insist, therefore, on receiving $5 million for their shares plus the $500,000 cash in Stonewall’s till. Archimedes offers them $6 million in Diogenes’ shares—in the form of 150,000 shares selling at $40, of course. Stonewall’s owners are certain Archimedes has “lost his cool” in offering a twenty percent premium over the company’s worth, that is, $6 million when they requested only $5 million.

In any event, after effecting an appropriate set of antenuptial agreements Diogenes and Stonewall are merged, and Diogenes’ auditor proclaims the marriage consummated under the rules of APB Opinion 16, which requires that the merger be accounted for as a pooling-of-interests. The auditor therefore prepares for Diogenes the following revised financial statements:

Consolidated Balance Sheet as of December 31, 1974

Assets:
Cash $500,000
Land 100,000
Deferred Research and Development Costs 1,100,000
Total Assets $1,700,000

Liabilities:
None

Capital Stock and Retained Earnings:
Capital Stock (1,150,000 shares @ 1 cent par value) $11,500
Paid in Surplus 188,500
Retained Earnings 1,500,000
Total Capital Stock & Retained Earnings $1,700,000
Consolidated Statement of Income and Retained Earnings
for the Year Ended December 31, 1974

Income from Erections $1,000,000
Income from Early Extinction of Debt 1,000,000
Income before Tax 2,000,000
Less: Current Income Tax (on the Erections) 500,000
Net Income (and Retained Earnings) $1,500,000

In case the resulting figures confuse you, especially since you
know that Diogenes paid $6 million, a number which seems to have
disappeared in all this accounting, here are the CPA’s workpapers
leading to the aforementioned statements which, I assure you, are
all in accordance with GAAP!

<table>
<thead>
<tr>
<th></th>
<th>Diogenes Pre-Pool</th>
<th>Stonewall Acquisition</th>
<th>Diogenes Post-Pool</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>-0-</td>
<td>$ 500,000</td>
<td>$ 500,000</td>
</tr>
<tr>
<td>Land</td>
<td>-0-</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Deferred R&amp;D</td>
<td>$1,100,000</td>
<td>-0-</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,100,000</td>
<td>$ 600,000</td>
<td>$1,700,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Capital Stock—Diogenes</td>
<td>10,000</td>
<td>--</td>
<td>11,500</td>
</tr>
<tr>
<td>Capital Stock—Stonewall</td>
<td>--</td>
<td>100,000</td>
<td>--</td>
</tr>
<tr>
<td>Paid-in Surplus</td>
<td>89,000</td>
<td>-0-</td>
<td>188,500</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>1,000,000</td>
<td>500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,100,000</td>
<td>$ 600,000</td>
<td>$1,700,000</td>
</tr>
</tbody>
</table>

Clearly, the auditor has merely added the numbers brought to
the conjugal bed by Diogenes and Stonewall with only one minor
mechanistic change—since Stonewall’s par value was $100 per
share, or $100,000 in the aggregate, whereas the newly minted Di-
ogenes shares had a par of a penny a share, hence $1,500 (the 150,000
shares offered to Stonewall’s shareholders multiplied by 1 cent), the
CPA had to shift the $98,500 differential in par values from capital
stock to paid-in surplus accounts.

If you are still “climbing the walls” since you cannot determine
how the $6 million cost is accounted for, don’t blame me, because
that’s precisely the figure that GAAP/GAAS/CRAP state you must
ignore. To repeat, in pooling-of-interests accounting we do nothing
more than combine the existing balance sheets, completely obli-
vous of the reality and economic substance of the merger. Signifi-
cantly, it seems Archimedes will receive Diogenes’ undying grati-
tude in many forms—most probably through a fat finder’s fee, be-
coming a member of the expanded Diogenes’ Board, and having his
firm do the new Diogenes’ underwritings.

These results, however, mark just the beginning of pooling dy-
namics—as will be evident, the consequences become even more
exhilarating. Clearly, Diogenes secured a half million dollars in
much needed cash, but it gained something even “better.” Notice how the company’s GAAP income now equals $1.5 million for the 1,150,000 shares outstanding, providing a resulting EPS of $1.30. Since the PE multiple has presumably remained a modest forty, Diogenes’ shares begin to move toward a $52 price from the prior $40 figure we discussed when the EPS equalled only $1.

Wall Street is now certain that they have a live wire in Diogenes Lantern Works since the workings of the “efficient market mechanism” have confirmed their prophecy. This confirmation in itself provides a sufficient stimulus to raise the PE marker to fifty, whereupon the shares head toward the $65 range (the fifty PE multiple applied to $1.30 per share).

In the meantime Diogenes is spending the $500,000 of new cash infusion on further R&D and yet realizing no sales. Recognizing the catastrophic results if Wall Street heard that Diogenes had zero profits, Archimedes counsels Diogenes to take the land it now owns and sell it for the then value of $4 million, which income is subject to a tax, net of loss carryforwards, of $1 million, leaving $3 million in net after-tax proceeds.

The observant readers will have noted that Diogenes sustained a substantial loss since the land was worth $4.5 million during the takeover negotiations, and in fact Diogenes paid at least that much in the form of its stock when acquiring Stonewall. Such perception, however, would only cause trouble because these observant readers would not recognize that the Emperor was clothed in most exquisite, albeit ephemeral, raiment. I hope you see that Diogenes has a cool profit of $2.9 million net of tax since its book cost for the land was only $100,000 just as it was for old Stonewall.

The Dow Jones “broad tape” dutifully reports that Diogenes’ management predicts a per share profit for the year 1975 in the $2 to $2.50 range. Diogenes’ management is actually conservative since the profit will be $2.52 per share, but this caution illustrates one of Diogenes’ renowned virtues—it will neither misstate nor misspeak the facts. Management further announces that it will split the company’s stock four for one, whereupon trading on the Exchange is halted because of an imbalance of orders; everyone is rushing in to buy, while those among Diogenes’ management constitute the only sellers. I know the story seems silly but while the particular case is certainly apocryphal, even more foolish tales have been related in the sadly authenticated annals of finance.

Having illustrated the mechanics of pooling-of-interests accounting, I turn to what to my knowledge constitutes the most audacious implementation of this egregious practice, the controversial
acquisition of the Hartford Insurance Company complex by International Telephone and Telegraph. In May, 1970, ITT paid over to the old Hartford shareholders ITT shares with an aggregate market value of one billion eighty million dollars ($1,080,000,000). According to ITT’s 1970 annual report, the book value of the shares equalled precisely $485,404,000—hence, a cost suppression of about $600 million or more than half of the $1.08 billion cost to ITT. Significantly, this $485 million represented the book value shown by Hartford’s old balance sheet, a figure ITT inherited just as Diogenes inherited the book values of Stonewall.

As evidenced by the widespread publicity surrounding this transaction, Hartford was a prize much desired by ITT’s Chairman and President, Harold S. Geneen. In addition to its enormous size and power base, Hartford was capable of helping him fulfill his objective of maintaining ITT’s earnings growth pattern and thus its “image” in Wall Street. This conclusion is well documented in the “Ramsden Report,” prepared by a young financial analyst, Richard Ramsden, to dissuade the United States Government from proceeding with antimonopoly litigation against ITT in connection with the Hartford acquisition.

The key to the Geneen plan lay in the fact that Hartford owned an enormous portfolio of common stock having a market value of $716 million as of the last published balance sheet date preceding the takeover, but showing a book value—the same value which, through pooling-of-interests accounting, would appear on ITT’s books—of only $434 million. As can be seen, this results in a suppression of over $282 million on this line alone.

Ramsden recognized the critical significance of the hidden cost factor resulting from this disparity, and stressing the importance of the conglomerate’s earnings growth curve, he wrote:

Since Harold S. Geneen became President of ITT in 1959, the Company has achieved a remarkable record. From 1959 through 1970, ITT’s earnings per share have grown at an annual rate of 11.6% . . . . With the March, 1971

quarter, ITT had achieved increased sales, net income and earnings per share over the same prior year period for 47 consecutive quarters.

A key factor in the ITT multiple is the confidence, based on the last ten years, in the predictability of the earnings increases and conviction that the company will be able to continue to fashion 10% earnings gains because of its international diversification and broad business mix. It seems reasonable to assume that if the Company were required to divest itself of the source of 25% of its earnings in 1970 (and 38% of its 1970 net income from U.S. and Canadian sources) and in addition, one of the presently more dynamic portions of its business mix (Hartford’s earnings, including capital gains, were up 31% in the first quarter of 1971) that some of the investor confidence in the Company would be diminished. . . .

Recognizing the obsessive drive of the Geneen Machine to maintain ITT’s earnings trajectory and the enormous suppression in the carrying value of Hartford’s huge common stock portfolio, it is revealing to discern how ITT caused that suppression in acquired values (for all of which ITT paid and paid dearly) to flow through ITT’s subsequent income statements.

For the years 1964 through 1968, before the April, 1969, agreement, Hartford realized pre-tax investment gains and losses as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>Gain</td>
<td>$2,518,000</td>
</tr>
<tr>
<td>1965</td>
<td>Gain</td>
<td>7,401,000</td>
</tr>
<tr>
<td>1966</td>
<td>Loss</td>
<td>5,010,000</td>
</tr>
<tr>
<td>1967</td>
<td>Loss</td>
<td>3,567,000</td>
</tr>
<tr>
<td>1968</td>
<td>Gain</td>
<td>1,226,000</td>
</tr>
</tbody>
</table>

Five-year average gain of $514,000

Significantly, 1969 represents something of a riptide. During the first half of the year, while the old Hartford management remained autonomous, it booked a loss of about $14 million. Over the next six months, with ITT presumably standing at its gates, the insurance company booked some $25 million in profits. For the year 1969, therefore, Hartford showed a net bookkeeping gain on investments of over $11 million.11

From 1970 forward, with ITT securely (or almost so) entrenched in Hartford, the bookkeeping profits from the investment portfolio show a heady mix of gains (losses are apparently proscribed by the Geneen Machine) as follows:

11. Hartford had realized after-tax losses for the first six months in the amount of $10,880,000 and a realized gain for the entire year 1969 of $7,789,000. These amounts were “grossed-up” to a pre-tax six month loss of $14 million and a pre-tax gain of $11 million for the entire year, respectively. ITT Preliminary Prospectus 6 (Sept. 10, 1970).
WE OFTEN PAINT FAKE
1970 $47,576,000
1971 51,388,000
1972 60,874,000
1973 58,040,000
1974 (through June 30) 20,000,000
An annual average of $53,800,000

As the figures clearly illustrate, the average gain increased 100-fold after Chairman Geneen took the helm. Ramsden commented most revealingly on this phenomenon of taking in stock profits:

Until the Accounting Principles Board agrees to some method [it never did] by which realized and unrealized long-term average gains may be reflected in income, there is no reasonable way to reflect appreciation in a stock portfolio in income. . . .

Before the merger Hartford took modest amounts of realized gains; in 1970 ITT reported capital gains of $33.8 million [net after tax] from Hartford. While some analysts have objected to the inclusion of capital gains in ITT's income, because of its relative contribution ($33.8 million out of $353 million in 1970), it does not seem to have materially affected ITT's multiple. 14

Far be it from me to criticize success—providing it is success rather than a canard legitimized by GAAP. Thus, I maintain that none, and, in fact, even less than none, of the $238 million total gains by the foregoing 1970-1974 tabulation were really earned by the ITT machine. Remember that as of December 31, 1969, the last balance sheet date before the acquisition, there existed an unrecorded appreciation in the Hartford common stock portfolio of $282 million; by mid-1974, according to the company's six-month report, that potential profit had completely evaporated and had become an unrealized loss of about $60 million. 15 Consequently, I maintain that by mid-1974 ITT's true achievement was a loss of more than $100 million attributable to its Hartford stock portfolio management. This minus figure results from subtracting the $60 million unrealized loss at mid-year 1974 from the $238 million aggregate of realized gains taken into account. The resulting net amount of $178 million, when compared with the $282 million in potential gains which existed at about the time of ITT's takeover, leads to the conclusion that during the years of ITT's hegemony Hartford suffered an overall loss, realized and unrealized, of $104 million.

12. ITT Prospectus 78 (July 18, 1974).
13. The realized investment gains of the Hartford Insurance complex for the 6-month period ending June 30, 1974, were $14,477,000, net of tax. This sum was "grossed up" by $5,523,000, to a pre-tax gain of $20 million. ITT Interim Rep. 8 n.6 (June 30, 1974).
15. The unrealized losses are reported as $118,700,000; the unrealized gains as $72,100,000; leaving $46,600,000 as the net unrealized loss—all amounts net after tax. This net unrealized loss of $46.6 million was "grossed up" by $13.4 million to produce the $60 million pre-tax amount for the net unrealized loss. ITT Interim Rep. 8 n.6 (June 30, 1974).
An early 1974 Wall Street Journal lead article commented acerbically on the ITT practice of artificially inducing stock profits, as "Andersen's Fairy Tales"—a reference to the company's auditors rather than Hans Christian. Attributable, no doubt, to the devastating Bear Market of 1973-74, ITT's mid-1974 prospectus, pursuant to which it issued $100 million in eleven percent bonds, spelled out in some detail Hartford's programmed securities gains:

Hartford invests its assets in both debt and equity securities, with the majority of the assets in the former. Investments in equity securities are made for the purpose of producing earnings from a combination of dividends and realized investment gains. Present accounting rules require the sale of securities in order to record earnings from investment gains. In 1970 Hartford commenced a practice of selling stocks from its portfolio to realize investment gains each year (net of realized investment losses) to show income in that year, in an amount which, when added to dividends, is equivalent to a fixed historical annual rate of total return on its portfolio stocks, subject to annual adjustments to reflect actual investment experience since commencement of the practice . . . . The purpose of most sales is to implement the practice rather than to change the make-up of the portfolio, and the proceeds may be invested in the same or similar securities. During 1970 and 1971, Hartford, in most cases, immediately reinvested sales proceeds in the same number of shares of the same company. The amount of investment gains to be realized on the basis of the practice is estimated in the early part of the year, with that amount being reviewed as the year progresses; for 1973, the final amount of such gains for the year was determined as of September 30, 1973. While the practice has been followed in this manner in 1974, irrespective of the decline in prices of some stocks, the practice will be reexamined in September 1974, which could result in a decision, based on market and other conditions then existing and anticipated, to reduce or suspend the realization of capital gains.17

Notice what ITT is here disclosing. Whenever it wanted to inject a particular amount of income into the ITT financials the Geneen Machine pulled some security out of Hartford's vault, put it through a wash sale operation, et voila, produced an income plus. This is, of course, all too reminiscent of Little Jack Horner's thumb.

Moreover, ITT received an added plus as a consequence of this maneuver, to wit: Hartford's operations became consolidated into those of ITT for purposes of the United States income tax. Hartford remits to its parent the tax which it would have paid had it filed its own separate returns, including the tax on all the surfaced investment profits, whether specious or real. This means that the insuror has been compelled to pay in cash a hypothetical tax on an entirely illusory and contrived profit. The real cash Hartford pays over remains with ITT since, judging from assertions made by Congressman Charles A. Vanik,18 ITT is quite capable of offsetting the

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17. ITT Prospectus 21 (July 18, 1974).
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Hartford pluses by minuses created in great abundance in ITT's other sectors, and so produces an infinitesimal overall tax. Absent these contrived gains, ITT would presumably have been constrained to remit sums to Hartford to compensate the insuror for the use of its underwriting losses in the consolidated tax returns.

B. Purchase Accounting

Having discoursed so extensively on the pooling ploy, it seems appropriate at least to recognize the other accounting method for business combinations—namely purchase accounting. A return to the Diogenes-Stonewall syndrome will illustrate the distinction between the “P” of purchase from that of pooling. Assume now that Stonewall’s shareholders refuse to accept Diogenes’ shares, its generated paper or “funny money,” and insist on $5 million in solid [sic] United States dollars.

Whereupon Diogenes asks Archimedes to develop a prospectus as an incident to a new issue of 150,000 shares to be offered on a subscription basis at the rate of fifteen new shares for each 100 shares presently owned; the new shares are to be offered at the bargain price of $34 per share to produce $5.1 million, the extra $100,000 to pay for the costs of printing as well as for Archimedes’ fee. As expected, existing shareholders rush to subscribe for the new shares lest the bargain escape them. In the wake of this new offering the Diogenes balance sheet would read as follows:

January 31, 1975

<table>
<thead>
<tr>
<th>Assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Deferred R&amp;D</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$6,100,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Stock and Retained Earnings:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock, par value 1 cent per share, 1,150,000 shares issued and outstanding</td>
<td>$ 11,500</td>
</tr>
<tr>
<td>Paid-in Surplus Balance January 1, 1975</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>Excess paid in newly issued shares</td>
<td>5,098,500</td>
</tr>
<tr>
<td>Underwriting, etc., expenses (100,000)</td>
<td>5,100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Total Capital Stock and Retained Earnings</td>
<td>$6,100,000</td>
</tr>
</tbody>
</table>

19. The conclusion is derived from data regarding the Hartford Fire Insurance Com-
After paying out its new-found cash to Stonewall’s shareholders to acquire 100 percent of their corporation, Diogenes’ balance sheet shows Assets as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>Investment in affiliate</th>
<th>Deferred Research and Development</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero again</td>
<td>Stonewall Erections</td>
<td>$5,000,000</td>
<td>1,100,000</td>
</tr>
<tr>
<td>(The liabilities and capital remain unaffected.)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Diogenes’ accountant is now called on to perform his act of creation, the formulation of Diogenes’ consolidated balance sheet. On his worksheet we would find these figures:

<table>
<thead>
<tr>
<th>Diogenes</th>
<th>Stonewall</th>
<th>Elimination</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>0</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Land</td>
<td>0</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Investment in Affiliate</td>
<td>5,000,000</td>
<td>(5,000,000)</td>
<td>0</td>
</tr>
<tr>
<td>Deferred R&amp;D</td>
<td>1,100,000</td>
<td>1,100,000</td>
<td></td>
</tr>
<tr>
<td>Excess of cost of acquired companies over net assets acquired</td>
<td>0</td>
<td>0</td>
<td>4,400,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>6,100,000</td>
<td>600,000</td>
<td>(600,000)</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>11,500</td>
<td>100,000</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Paid-in Surplus</td>
<td>5,088,500</td>
<td>0</td>
<td>5,088,500</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>1,000,000</td>
<td>500,000</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Liabilities</td>
<td>6,100,000</td>
<td>600,000</td>
<td>(600,000)</td>
</tr>
</tbody>
</table>

In observing this artistry, one cannot help but be impressed by its symmetry. Notice how every column exhibits a beautiful balance in which the debits invariably equal the credits. Surely the CPA is deserving of the appellation “Leonardo.”

Of course, a close look reveals some serious flaws in all this

pany Consolidated 1973 taxes:
Benefit for Income Taxes re Operations (i.e., before considering investment gains) $15,012,000
Cost for Income Taxes attributable to the realized gains $20,341,000
Net remittable to ITT, the parent corporation $5,329,000

ITT Prospectus 78 (July 18, 1974).
For the first 3 months of 1974 the tax benefit arising from Hartford’s Operations, (i.e. excluding the investment gains) amounted to $13,831,000, up dramatically from the 1973 first quarter amount of $5,148,000.
WE OFTEN PAINT FAKES

The next play in this game plan calls for Diogenes to sell the land for $4.1 million and thereby derive a pretax profit of $4 million. The knowledge that Diogenes lost $400,000 on the deal, since it really paid $4.5 million for this parcel of land, will only get you into trouble for having subversive ideas; one must go by the books and they show that the land cost $100,000. If, then, Diogenes receives $4.1 million, it realizes a pretax gain of $4 million—no more nonsense suggestions about how fair value accounting will change that GAAP figure.

Now the company calls upon Leonardo to develop the consolidated income statement for Diogenes’ first quarter of 1975, with the following result:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Operations</td>
<td>$ 4,000,000</td>
</tr>
<tr>
<td>Less: Amortization of Intangibles</td>
<td></td>
</tr>
<tr>
<td>(see note 1)</td>
<td></td>
</tr>
<tr>
<td>Income taxes (entirely deferred)</td>
<td>$ 27,500</td>
</tr>
<tr>
<td>Income for the three months ended March 31, 1975</td>
<td>$ 2,772,500</td>
</tr>
<tr>
<td>Income per share</td>
<td>$ 2.41</td>
</tr>
<tr>
<td>Prior year’s income per share (for the entire year, I might add)</td>
<td>$ 1.00</td>
</tr>
</tbody>
</table>

Note 1: The excess of cost of acquired corporations in excess of the net assets acquired is being amortized pursuant to Accounting Principles Board Opinion No. 17 over a forty year period.

You can imagine the excitement on the floor of the Exchange when this felicitous news hits the Dow Jones tape, making it virtually impossible to halt the orders to buy Diogenes Lantern Works. Comparing the income per share of over $2.40 (note again the conservatism) in a single quarter against $1 for all of last year, any competent financial analyst can see that the 1975 earnings can be conservatively projected at $9, and conservative estimates are, of course, essential in these turbulent times.

I know this account sounds absurd; and absurd it is when you
have a score card and can follow the game play by play, or rather ploy by ploy. That this absurdity may represent the norm was reported by Professor Michael G. Tearney early in 1973 based on his analysis of listing applications filed with the New York Stock Exchange during 1971 (the year after the APB’s pronouncement on the subject). His analysis revealed “obvious failures by practicing accountants to follow AICPA pronouncements . . . .” and specifically, he found that “[i]n only 37.0 percent of the combinations examined was fair market value of acquired assets recorded on parents’ books while [old] book value was used in an alarming 60.2 percent . . . .” Professor Tearney summarized his findings:

[T]he study . . . revealed that in many instances AICPA pronouncements on valuing and reporting goodwill acquired in business combinations are ignored in current accounting practice. By using [old] book value rather than fair market value, practicing accountants have subtly combined pooling of interest and purchase approaches . . . . This is in complete contradiction to the basic assumptions about these theoretically separate methods of accounting for business combinations.20

A specific case pointing up the absurdity if not the “fakery” in this business combinations realm involves the 1972 accounting by Tele-Communications, Inc. (“TCI”) when it acquired Nation Wide Cablevision, Inc. in a stock swap with Kaufman & Broad, Inc. (“K&B”). TCI delivered 700,000 of its shares to K&B in return for the latter’s 100 percent interest in Nation Wide. According to a May 10, 1973 TCI proxy statement these TCI shares had a quoted market value at the time of the exchange of $24,750,000.21 Nevertheless, TCI’s accountants quantified the acquisition at but $8,940,000.22 Even this drastically reduced sum exceeded the old Nation Wide book value by $3,754,000; from this excess cost TCI allocated $969,000 to Property and Equipment and $2,785,000 to Franchises and route costs.23 Why the $8,940,000 rather than something closer to the $24,750,000? According to TCI’s 1972 Form 10-K:

The capital stock issued for acquisitions of subsidiaries has been valued as determined by the Company’s Board of Directors after giving consideration to the average market price as determined for a period before and after the acquisition date adjusted for an appropriate discount factor based upon any restrictions on the stock. For major acquisitions, investment bankers’ opinions as to the fair value of the stock issued have been obtained and used. During periods of major market fluctuations, the Board of Directors has made the

23. Id.
valuation giving consideration to the intrinsic value of the properties acquired.\textsuperscript{24}

So it is that according to the company’s own determination, sixty-four percent of the quoted market value was not really value; hence, it determined that only thirty-six percent ($8,940,000 out of $24,750,000) was worthy of entry into the books. Clearly, there is a double standard of share value—one for the masses in the marketplace; the other for the more knowledgeable directors and their advisers.

Whether the number should have been $9 million or $24 million, or any other number would, as it turned out, have been entirely unreal. In September, 1973, Kaufman and Broad, Inc. took the unusual step of submitting an amended 10-K to the Securities and Exchange Commission for its fiscal year ended the previous November 30. In that amendment, as “Item 16, Events (Unaudited) Subsequent to Date of Opinion of Independent Certified Public Accountants,” we read about a $22.4 million after-tax write down including “...$5.4 million, which represents a write-down in market value of the Company’s investment in common stock of Tele-Communications, Inc., was treated as an extraordinary item...”\textsuperscript{25} Since this $5.4 million was an after-tax writeoff I conclude that K&B had washed out its entire carrying value for the ill-fated investment; that value, as shown by its November 30, 1973, balance sheet was $6.8 million;\textsuperscript{26} the $1.4 million differential would undoubtedly represent the tax effect of the loss.

Kaufman & Broad does not, however, stand alone among companies engaged in real estate operations which manifest a proclivity towards creative accounting. SEC Accounting Series Release 153,\textsuperscript{27} involving Touche, Ross’s audit of U.S. Financial’s statements for 1971, demonstrates the tangled web of deception capable of being perpetrated by homebuilders. The Release relates tales of enormous gains from shell corporations owned by officers of USF; of various guarantees inducing prospective purchasers to sign up for property acquisitions, thus permitting USF to book fake profits; and of books and records so confusing as to be unauditable.

Similarly, the allegations in the SEC’s Complaint for Injunction filed in connection with the financial collapse of the Penn Central reveal creative real estate accounting, possibly even more ambi-

\textsuperscript{24} Id.
\textsuperscript{26} Kaufman & Broad, Inc., 1973 Form 10-K, at 17.
tious than that of U.S. Financial. The complaint does not discuss the specifics of Penn Central's perverted accountings except to allege the "improper inclusion of income from large real estate transactions of Great Southwest Corp."28 and that "representations concerning the performance of the diversification program failed to state that a substantial part of the program represented contributions to earnings which were a result of contrived transactions entered into in order to create the appearance of superior earnings performance . . . ."29

Similarly revealing examples of unreal real estate accounting surface with a consideration of the "Rotting REITs," referred to only a few years back as "America's Newest Billionaires."30 A study of Real Estate Investment Trusts clearly establishes that only a failure to recognize the souring of their loans allowed these institutions to continue to show "solid" profits through 1973. Consequently, they continued to accrue interest income on delinquent mortgages; they foreclosed on properties and, like an ostrich unmindful of the shrinking values, carried those holdings in the balance sheets as assets valued at the balance of the loans; and they factored in loan loss reserves at absurdly low levels, frequently computed as a nominal percentage of net income.31 (Calculating the reserve by reference to sun spots would have been about as congruous.)

These REITs were the "darlings of widows and orphans" especially since the substantial cash dividend payments were so felicitous. They would have maintained their status if they could have continued to attract fresh money from new naive widows and orphans or from the financial institutions which frequently sponsored and managed these new "billionaires." Alas, as Mr. Ponzi learned to his remorse, the well sometimes runs dry, and so it did for these REITs in mid-1974. If only creative accounting could have been perpetuated somewhat longer, imagine how many more happy widows and orphans and bankers and REIT-managers there would have been.

C. Percentage of Completion

Added to these manifestations of perversity are those stemming

29. Id. at 14
31. For a critical comment on REIT practices for providing for loan losses see address by Howard P. Hodges, SEC Chief Accountant—Division of Corporate Finance, National Association of Real Estate Investment Trusts Meeting, May 24, 1973.
from so-called percentage-of-completion accounting, the method basic to the Four Seasons accounting controversy. This accounting method allows recognition of income prior to completion and delivery on a particular job.

Assume that a builder contemplates a $50 million contract which will take five years to complete and will involve costs aggregating $40 million, with an anticipated $10 million profit. Rather than spread the $10 million at the rate of $2 million annually, accounting theory and practice developed a better measure of allocating income in proportion to performance, thereby smoothing the earning curve. Since the $10 million profit is twenty-five percent of the $40 million cost, the assumption becomes that the builder’s efforts and accomplishments are proportionate to the rhythm of incurred costs. If the builder incurs $5 million in costs in the initial year, then the accountant recognizes twenty-five percent of the costs, or $1.25 million, as profit; correspondingly, if the second year’s costs aggregate $8 million, $2 million is recognized as profit, and so on until the contract is completed.

Cost variables do exist, and therefore, while the revenues may be fixed by contract, the anticipated costs might not be correspondingly “locked in.” This recognition of possible cost variation leads to several important questions. Are cost overruns being encountered which the accountant is not recognizing, as happened in the Lockheed C-5A project? Is management “fudging” the incurred costs so as to make it appear that the builder had expended more effort that year, thus warranting the attribution of a greater measure of income to that twelve month period? Significantly, the latter question characterizes the scenario presented by the Grand Jury’s criminal indictment in the Four Seasons fiasco.

D. Other Examples of Accounting Fakes

1. Talley Industries

An especially intriguing inventory manipulative process surfaced in a complaint filed in the fall of 1973 by the SEC against a company named Talley Industries and its auditors, Peat, Marwick, Mitchell & Co. According to the complaint Talley accounted for its cost of sales, and the resultant inventory, on its Mesa, Arizona, operations on a “program basis.” The SEC complaint describes this exotic accounting method as follows:

32. A. Biloff, Unaccountable Accounting 193-222 (1972).
At year end a gross profit ratio was established for each program and used in computing cost of sales for the year. The ratio was established and used in the following manner: Actual sales for the year under audit were added to projected sales in the following year as determined by backlog and projection of contracts not on hand but anticipated; actual costs for the year's projection were added to estimated cost to complete the sales projected for the following year; a gross profit ratio was established and applied to the dollar amount of sales made in the audit year; and any costs expended in the audit year in excess of the amount recognized by this computation were carried forward as part of inventory. The gross profit as determined, adjusted for actual manufacturing overhead, was used throughout the following fiscal year to compute cost of sales for interim periods.\textsuperscript{34}

Those sophisticated in accounting will recognize this process as possessing the characteristics of percentage-of-completion accounting, and possibly also of standard costing, or in a simpler context, of determining the profit the company wants to show and then "plugging in" the inventory figure to make the debit equal the credit, as it invariably must.

For the less sophisticated an oversimplified, hypothetical illustration will reveal what Talley accomplished. Assume for the fiscal year ended March 31, 1969, that actual sales equaled $20 million and that its booked costs were $45 million. According to its "program basis" Talley would then project its 1970 year sales and come up with a number, for example, $100 million. Similarly, the company would project the costs to be incurred in 1970, and decide, for example, upon $27 million. Whereupon Talley and its auditors would produce the following figures:

\begin{itemize}
\item 1969 sales ($20 million) plus projected 1970 sales ($100 million) $120 million
\item 1969 costs ($45 million) plus projected 1970 costs ($27 million) 72 million
\item The "program basis" gross profit ($120 million minus $72 million) 48 million
\item The gross profit percent in relation to sales (48 \div 120) 40%
\end{itemize}

Therefore, for the 1969 year Talley would enter as gross profit from operations $8 million (40% of the $20 million in actual 1969 sales). Since the gross profit equals $8 million, the cost of goods sold must equal $12 million—sales of $20 million less the gross profit of $8 million—which means that $33 million out of the $45 million in incurred costs remains in inventories as of March 31, 1969. Applying these figures to Talley's real situation, it will become clear its "reality" was as hypothetical as the illustration.

The SEC based its complaint on the fact that for Talley's 1969 and 1970 profits to "hit the mark" projected by the March 31, 1969, inventory figure, the company would have had to realize $100 million—coincidentally the figure used in the illustration—in sales from its Mesa operations during its 1970 fiscal year. The auditors should have recognized and disclosed the absurdity of the March 31, 1969, numbers game, the SEC says, since the actual backlog equalled only $24 million at the 1969 fiscal year end, and no reasonable indication or logical substantiation existed as to the company's ability to generate the remainder of the $100 million.\(^{35}\)

The 1969 figures became especially critical when used in the development of the December 31, 1969, interim financial statements which, in turn, were particularly crucial to an important pending merger with General Time. In calculating the profits and inventories for the interims, the company applied the gross profit percentage calculated as of the preceding March 31. Thus, the SEC faults Talley for not disclosing the seeming absurdity of this percentage since, as noted, Talley predicated the percentage on the $100 million 1970 sales target, which appeared increasingly unreachable, particularly because by December 31, 1969, Talley had realized only $18 million of those projected sales.\(^ {34}\)

To extend my hypothetical to embrace these nine-month data, assume that in addition to realizing $18 million in nine-month sales Talley incurred additional costs aggregating $20 million. Using the forty percent standard profit, Talley would realize as profit $7.2 million—$18 million in sales x 40 percent. Cost of sales would equal $10.8 million, thereby adding another $9.2 million—$20 million minus $10.8 million—to the inventory amount, thus increasing it from the $33 million at March 31 to $42.2 million at December 31, 1969. The SEC alleged that in view of the dire circumstances of the Mesa operations, the company's deferral of large amounts of inventory costs when there existed no likelihood of their recovery through sales constituted a hoax on the General Time shareholders and any other persons who may have acquired the company's shares along the way. While the auditors did not certify these interim financials, they did issue a May 10, 1970, "comfort letter" with respect to these December 31 figures. According to the SEC complaint anyone with a modicum of audit competence, and Talley's auditors are presumed to have at least that, should have discerned the serious shortfall in the sales required to justify the profit numbers and should

\(^{35}\) Id. at 6.
\(^{36}\) Id. at 7.
have “blown the whistle.” Since the auditors did not disclose this information on May 10, four days later General Time Shareholders found themselves in the Talley sack. According to the SEC’s complaint,

. . . PMM failed to disclose in [the “cold comfort”] letter of May 10, 1970:
(a) that it then knew that the actual sales for . . . the full year ended March 31, 1970 had been only $24.7 million;
(b) that computation of Talley’s earnings for the nine-month period ended December 31, 1969 had been based on a $100 million projection . . . which projection had exceeded by a wide margin the actual sales of $24.7 million; and
(c) that a write-off of Talley’s accumulated excess cost would be necessary, such write-off requiring material adjustments to Talley’s financial statements for the nine months ended December 31, 1969, which financial statements had been included in the April 16, 1970 proxy statement.37

The complaint further alleges that the defendants (including PMM) “caused Talley’s financial statements for the single year ended March 31, 1970 to reflect the write-off of approximately $19 million in excess costs . . . even though such excess costs had been accumulated in both the 1969 and 1970 fiscal years . . . and should have been written off as incurred in each of such years . . . ”38

This Talley complaint was unique in that it was used by the SEC to even up an old score. Thus, in its “Further Allegations in Support of [the SEC’s] Prayer for Injunctive Relief Against Defendant PMM” the complaint describes that on October 31, 1963, the SEC agreed to dismiss a proceeding against PMM which arose from PMM’s certification of the financial statements of Londontown Manufacturing Company. Londontown’s statements included, apparently unknown to PMM, falsified inventory figures. The SEC accepted PMM’s offer of settlement because in it PMM agreed to institute and follow new internal practices and auditing standards designed to ensure that a company’s financial statements prepared by PMM fairly presented its client’s financial position. According to the complaint, however, PMM failed to comply with these procedures in the preparation, review, audit and certification of Talley’s financials, the result being that they were materially false and misleading.39

Significantly, the Commission took ten years, almost to the day, to pull out that Londontown chestnut. In the intervening de-

37. Id. at 9.
38. Id.
39. Id. at 14-15.
cade Peat Marwick was conspicuously involved in BarChris, Yale Express, Liberty Equities, National Student Marketing, Penn Central, Stirling Homex, Republic National Life, Great Southwest, to cite only those that come readily to mind. Would John Jones or Abe Briloff be permitted to foul his nest with such frequent regularity without being absolutely and peremptorily proscribed from further practice before the regulatory body charged with the responsibility of assuring safe and sane financial statements?

2. Western Union

Continuing this story of accounting “fakes,” I turn to the 1973 Western Union annual report which discloses a noteworthy accounting practice capable of creating enormous earnings, a practice which received an absolute pardon and/or dispensation from the Accounting Principles Board. The Western Union Financial Review reveals that “The Corporation has recorded as other income $21 million, equivalent to $1.53 per share, representing the amount by which the principal amount of 5¼% Convertible Subordinated Debentures received on the [bond] exchange . . . exceeded the sum of the fair market value of 10¾% Subordinated Debentures issued on the exchange plus the cash paid . . . .”40 This $21 million reminds one of Diogenes’ million dollar income derived through its failing subsidiary, both cases pointing up the anomaly of a company showing increasingly greater amounts of income as business conditions worsen. The critical difference is that the situation of Diogenes was apocryphal whereas Western Union presently exists as a real business entity. Western Union succeeded in deriving this enormous benefit from the bond swap because its deteriorating credit standing and declining stock price converged with increased interest rates causing the old 5¼% bonds to sell at a deep discount. Consequently, the corporation was able to pick up $62 million of these bonds for new higher interest coupon bonds plus cash, aggregating $41 million, resulting in a $21 million bookkeeping profit. Again, if the Western Union business situation and/or general economic conditions deteriorated even further, the resultant gain would have been even more substantial. Moreover, Western Union actually realized another $1.5 million advantage from its adversity, representing the amount included in other income for the “discounts on purchases to satisfy . . . sinking fund requirements . . . .”41

So it is that the APB provided Western Union with the modus

41. Id. at 27.
operandi for injecting $22.5 million into its 1973 income accounts. Western Union greatly profited from these results since, with all of this heaving and hawing, its “bottom line” came to $28 million, a number which, absent these acts of income creation, would have been eighty percent less, or a mere $5.5 million. On a per share basis the statements showed $1.89 rather than 38 cents, a particularly dismal showing when one realizes that Western Union’s 1972 per share income equalled $2.47.

3. Vesco—International Controls

Finally, when it comes to creative accounting, I stand in awe of Robert L. Vesco, the fugitive from justice and the one person whose unexpurgated autobiography could undoubtedly produce more dancing skeletons than Saint-Saëns’ “Danse Macabre” at Halloween. I begin with the facts as stated in the third count of the SEC’s complaint, as filed with the United States District Court in late November, 1972. Briefly, the complaint alleges that in September, 1970, Vesco’s controlled corporation, International Controls (ICC), advanced $5 million to Investors Overseas Services (IOS) and received in return an interest-bearing promissory note due May 14, 1971, and in addition received “five-year warrants to purchase 3,000,000 shares of IOS common stock at prices increasing from $2 per share in 1971 to $3 per share in 1975 . . . .” In late January, 1971, Vesco caused the loan agreement to be amended to make the note a demand note and to require IOS to repurchase the warrants at $1.20 each, for a total of $3.6 million, if IOS failed to implement certain reorganization proposals. In fact, the complaint alleges, Vesco never contemplated requiring IOS to effect the reorganization and intended the $3.6 million “put” to be a Damoclean phenomenon to keep any dissident IOS shareholders in line.

To discover Vesco’s “act of creation,” one need only look further to the SEC complaint, which provides:

87. In pursuit of his scheme to defraud the shareholders of International Controls, Vesco and International Controls used this January 25 amendment as a device to camouflage International Controls’ flagging earnings. As the audit of International Controls for the year ended December 31, 1970 progressed, it became apparent to Vesco that the company’s earnings from operations would be down some 30% from the prior year. In order to deceive investors and prospective investors in International Controls by hiding this earnings loss, the company valued the 3,000,000 warrants to purchase IOS common stock at $1.20 per warrant, based upon the $1.20 “put” price, and took a pro rata portion of the total of $3,600,000 into income from ordinary operations for

43. Id. et 48.
WE OFTEN PAINT FAKE

the year ended December 31, 1970 . . . . This purported income attributable to the warrant valuation contributed approximately $1,512,000 (35%) to International Controls' income of $4,342,442, before provision for income tax, as reported in International Controls' statement of operations for the year ended December 31, 1970. The inclusion of this $3,600,000 as income, based upon the $1.20 "put" price in the January 25 amendment to the loan agreement, was false and misleading and not in conformity with generally accepted accounting principles, because, among other reasons, neither Vesco's nor International Controls' intentions with respect to exercising the IOS default privileges nor IOS's ability to meet its obligations to [ICC] in the event of default were sufficiently definite to allow inclusion of the default price of the warrants in International Controls' earnings. Nor was there any default on the part of IOS.

88. This deception was furthered by International Controls' misleading presentation of its statement of earnings for the year ended December 31, 1970, which hid the amortized portion of the $3,600,000 "warrant income" ($1,512,000) by deducting this amount from all of International Controls' interest expense and reporting the difference under the heading "Interest Expense, Net" (as opposed to setting forth separately, as an extraordinary item, the purported "warrant income").

This act of creation and deception did not end with International Controls' 1970 financial statements, but carried over in 1971. According to the SEC complaint:

94. In continuation of this scheme to defraud, International Controls, in its financial statements for the year ended December 31, 1971, reported income of $2,047,893 attributable to the warrant valuation. But for this contribution to International Controls' earnings, the company would have reported a loss rather than net income of $654,632, as it did. These financial statements for the year ended December 31, 1971, were materially false and misleading and were not prepared in conformity with generally accepted accounting principles, for, among other reasons, (a) they failed to disclose that the market value of $2,750,000 attributed to the 6,000,000 IOS shares received in settlement of [ICC's] claims of default with respect to the [ICC]-IOS loan agreement and January 25 amendment to that agreement, was in excess of the fair market value of the IOS shares received; and (b) they gave immediate recognition in income of gain on the valuation of assets received in a non-arm's-length transaction which recognition was incompatible with the non-arm's-length nature of the transaction and International Controls' deferral of costs of acquiring control of IOS . . . .

Beyond this allegedly fake $3.6 million in income injected into the ICC financial statements to delude Vesco's shareholders, Vesco engaged in what might be euphemistically referred to as "Vesco's $224 Million Syphon," otherwise known as just plain looting.

The aforementioned SEC complaint also spelled out this most complex and sinister corporate swindle, which was allegedly perpetrated against the IOS investors. Central to this Vesco scheme was the diverting of the hundreds of millions of liquid dollar resources that somehow remained intact when Vesco took over the empire

44. Id. at 43-44.
45. Id. at 46-47.
from Bernard Cornfeld. Vesco found these funds in four so-called “Dollar Funds,” which were open-end mutual funds managed by IOS. An important attraction of these open-end, mutual funds for IOS’s foreign investors was that the funds focused their investment in United States securities that publicly traded on the American securities markets, thereby giving the investors, presumably all foreign, a feeling of confidence and protection. Since these funds were open-end mutual funds, their shareholders possessed the option to redeem their shares at any time at the then existing net asset values.

The SEC complaint alleges that “Defendant Vesco, in pursuit of his scheme to defraud and deceive investors . . . and mutual funds controlled by defendants IOS . . . sought through unlawful means to evade the regulation of United States securities laws . . . In furtherance of these aims, defendant Vesco and his group employed [a] . . . scheme and fraudulent acts and practices, the general nature of which was as follows:

(a) Defendant Vesco, in March and June 1972, caused International Controls to transfer its securities investments in IOS, International Bancorp and Value Capital to foreign-incorporated shell companies controlled by defendant Vesco and his group. The transfers were fraudulent and deceptive with respect to International Controls and the Dollar Funds and their shareholders because payments for the transfers were made through Vesco’s use of misappropriated monies of the Dollar Funds. These non-arm’s-length transfers were also fraudulent and deceptive to International Controls and its shareholders because there was no substantiation of the adequacy of the consideration paid, amounting to $7,350,000, and there was no disclosure of the material facts pertaining to the transactions.

(b) Defendant Vesco, in March and April 1972, caused effective control of the cash and securities of the Dollar Funds to be transferred from independent and responsible banks, including the Bank of New York, which were acting as custodians for the assets of the Dollar Funds, to newly-formed thinly-capitalized foreign entities—Overseas Development Bank Luxembourg and Bahamas Commonwealth Bank, both controlled by defendant Vesco. Then, from April 1972 through the present, defendant Vesco and his group have caused the Dollar Funds to sell in the United States securities markets a major part of their securities portfolios, consisting of high-grade, readily marketable securities issued by United States companies in furtherance of a scheme to remove the proceeds from banks located in the United States to entities outside the country and to use these proceeds which, to date, have exceeded $224,000,000, to further the personal interests and pursuits of defendant Vesco and his group (to the detriment of investors in the Dollar Funds).

(c) Defendant Vesco and his group have at no time disclosed to investors in International Controls or the Dollar Funds the material facts concerning the scheme, acts and practices described in paragraphs (a) and (b) above. On the contrary, defendant International Controls, aided and abetted by defendants Vesco, Richardson, Beatty and Clay, has filed with the Commission, and has issued reports to International Controls’ shareholders and to the public, which reports have falsely stated and concealed the material facts.46

46. Id. at 9.
Additionally, a document submitted to the district court by the SEC in mid-1973 as its "Post-Trial Memorandum . . . in Support of a Motion for a Preliminary Injunction and Ancillary Relief" provides some of the most indecent and intimate details regarding the Vesco syphon scheme. The memorandum states that recognizing the investment constraints imposed on him by the Funds' open-end feature, Vesco proceeded upon a plan to change radically the structure and investment policies of the Dollar Funds. Over the objection of the funds' investment advisor who insisted that the proposal would constitute a violation of covenant with the funds' investors, "Vesco continued to champion the concept of 'close-ending' the funds, i.e., permanently foreclosing the investor's right to redeem his shares for cash at net asset value." At this point, it seems appropriate to reflect on the independent accountants' role and responsibility in light of their direct participation in the Vesco deceptions. Thus, the SEC memorandum provides further: "According to James D. McMenamin, the Lybrand, Ross Bros. & Montgomery ('Lybrand Ross') partner-in-charge of their audits of International Controls [the Vesco-controlled corporation listed on the American Stock Exchange and through which Vesco got control of I.O.S., et al.] and the various I.O.S. entities, Vesco's plan, which code named 'ABC-N.V.,' was to form a corporation out of the funds which would engage in investment banking activities throughout the world." At a January 27, 1972 meeting in the International Controls' offices, attended by McMenamin and attorneys for the several entities, Vesco unveiled his script for the close-ending, searching for the "legalities of what might be involved . . ." The memorandum focuses on the Lybrand partner's testimony and states that according to McMenamin, Vesco outlined the ABC-N.V. plan as follows:

Venture Fund [one of the four "Dollar Funds"] was to make an initial investment in setting up such an entity of $20 million. Then this announcement would be made that because of the costs IOS had to go out of the mutual fund business.

Notification would go out to all of the fund holders and also in leading publications around the world telling the fund holders that on such and such a date, which was not definitized at the meeting, the directors of the fund intended to invest all of its money in ABC-N.V. Anyone who did not redeem

48. Id.
49. Id.
50. Id.
51. Id.
and who was still a fund holder at this unstipulated date would at that point receive securities of ABC-N.V. for his investment in the fund.\textsuperscript{42}

A major topic at the meeting was notification of the close-ending to the investors in the funds and the length of time after such notification that the investors would have to redeem their investments before permanent foreclosure of their rights of redemption. "[I]t's my recollection," McMenamin testified, "that every single person in the room felt that notification should be given to the funds' holders."\textsuperscript{53}

At the end of this close-ending plan lay $100 million to $150 million which Vesco and McMenamin estimated were essentially locked into the funds by persons who could not redeem, even if notified. McMenamin testified during the Commission's investigation:

[M]ost people whom you talk to have a feeling that there is a substantial amount of money, possibly $150, million locked into those funds that was invested originally by various individuals around the world illegally, either they violated the laws of their own country or they violated the laws of some country in making an investment in those funds in the first place.\textsuperscript{54}

Vesco and McMenamin expressed "surprise" when the prestigious law firm of Wilkie, Farr (three of whose partners the SEC complaint named as defendants) stated serious misgivings about the scheme and sent McMenamin a memorandum with a covering "skull and bones" letter reading "due to the extremely confidential nature of this memorandum... would appreciate it being held in strict confidence."\textsuperscript{56} But such lawyers' misgivings do not prevent a man of action from moving ahead. As succeeding sections of the SEC post-trial memorandum, as well as the SEC complaint, repeatedly make clear, Vesco altered his course only enough to complete the close-ending \textit{sub rosa}.\textsuperscript{56}

My cry of despair in this context arises from a consideration of whether we should find immersed in such schemes the intrepid independent certified public accountant, a partner in an enormous national accounting firm which has assumed an awesome responsibility to tens of thousands of mutual fund investors for hundreds of millions of their invested dollars. Was there no feeling of shame and indecency, of moral outrage upon learning of the planned scheme—much less becoming an active participant therein? Appar-

\begin{itemize}
\item \textsuperscript{52} Id.
\item \textsuperscript{53} Id.
\item \textsuperscript{54} Id. at 13.
\item \textsuperscript{55} Id. at 14.
\item \textsuperscript{56} Id. at 15.
\end{itemize}
We often paint fakes

ently not!! He said nothing and his firm continued to serve as independent auditor for International Control as well as for Vesco's satellite entities until November, 1972, immediately before the filing of the SEC complaint.

Nor can I conclude this tale of perfidy without asking why the complaint, which lists some forty defendants, including many corporate lawyers and directors, did not include the auditors, and especially Mr. McMenamin, as defendants. But then, as I implied earlier, the Vesco saga raises thought-provoking questions in many different contexts.

III. "More Pervasive" Fakes

Corresponding GAAP-GAAS-CRAP "horror stories" could be related concerning inventories (Ampex, R. Hoe), revenue-anticipation (Telex, Memorex, Performance Systems), consolidations (Penn Central, Leasco), fixed assets (TelePrompter), depreciation (DCL, Leasco) and other accounting devices, ad absurdum. I want to proceed, however, to a consideration of the far more pervasive "fakes" which the accounting profession has succeeded in perpetrating and perpetuating.

A. Meaning of the Opinion Clause

The first of these more pervasive fakes pertains to the meaning of the auditor's certificate accompanying the financial statements disseminated to the shareholders and the general public. The so-called "opinion clause" of the certificate asserts that in the auditor's opinion the financial statements "present fairly the consolidated financial position, the results of operations and changes in financial position of the company in conformity with generally accepted accounting principles applied on a consistent basis . . ."57.

What is the auditor really saying, and what responsibility is he really assuming when he certifies that the statements are fairly presented in accordance with GAAP? This question was addressed by the Special Select Committee on Opinions of the Accounting Principles Board, appointed by the AICPA in 1964. The committee, chaired by an erstwhile President of the AICPA, J.S. Seidman, and frequently referred to as the Seidman Committee, rendered its report in 1965, asserting unequivocally:

The focus of accounting principles is on their application to financial statements. The focus of the auditor is on his opinion regarding the financial

57. This is consistent with the short form opinion recommended in 1 CCH A.I.C.P.A. PROF. STANDS. § 511.04, at 642 (1974).
statements. What purposes and limitations attach to financial statements and to the auditor’s opinion? This question is of first importance to the public and the profession. Literature abounds on it, but the answer is cast in many different molds. Until the profession has an official utterance about it, there is no point in beginning.

The Committee believes that such an utterance should be given top priority. It would be the subsoil on which subsequent pronouncements could be grounded and understood.

There would be many questions to tackle: What are financial statements trying to present?

In the standard report of the auditor he generally says that financial statements present fairly in conformity with generally accepted accounting principles—and so on. What does the auditor mean by the quoted words? Is he saying: (1) that the statements are fair and in accordance with generally accepted accounting principles; or (2) that they are fair because they are in accordance with generally accepted accounting principles; or (3) that they are fair only to the extent that generally accepted accounting principles are fair; or (4) that whatever the generally accepted accounting principles may be, the presentation of them is fair?58

This dilemma or challenge to the profession to confront directly its responsibilities, or at least define them, has not disappeared. On the contrary, the profession was confronted with the challenge full-blown at the Second Seaview Conference (November, 1971) sponsored by the AICPA, Financial Analysis Federation, Financial Executives Institute and Robert Morris Associates (the credit-grantors’ association). According to the published proceedings, the related subjects of “Responsibility for Reports” and “Fairness in Financial Reporting” were first to be debated. The critical, if invidious, distinction between divergent views can be discerned in this colloquy:

Attorney: The standard form of certificate speaks of “fairly presented in accordance with generally accepted accounting principles.” I think what the Court was doing in the Continental Vending case was going beyond this and saying that it had to represent two assurances: First, that generally accepted accounting principles were followed, and second, that the auditor had made an independent determination of fairness. The CPA was not home free with only the first assurance, despite the fact that there was a strong presumption that the matter was fairly stated.

CPA: I think it is very disturbing to the profession if that language holds up, because it’s a whole new ball game.59

Since Continental Vending60 is a landmark case concerning accountants’ responsibility in this context, it may be well to recapitulate

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59. CORPORATE FINANCIAL REPORTING: ETHICAL AND OTHER PROBLEMS 19 (J. Burton ed. 1972) [hereinafter cited as Burton].
the critical issues in that *cause celebre*: a crucial proceeding brought against three CPA's of a major, national accounting firm. In the course of his opinion, Judge Henry J. Friendly, speaking for the United States Court of Appeals for the Second Circuit, stated the vital issue as follows:

Defendants [CPAs] asked for two instructions which, in substance would have told the jury that a defendant could be found guilty only if, according to generally accepted accounting principles, the financial statements as a whole did not fairly present the financial condition of Continental at September 30, 1962, and then only if his departure from accepted standards was due to willful disregard of those standards with knowledge of the falsity of the statements and an intent to deceive. The judge declined to give these instructions. Dealing with the subject in the course of his charge, he said that the "critical test" was whether the financial statements as a whole "fairly" presented the financial position of Continental as of September 30, 1962, and whether it accurately reported the operations for fiscal 1962.

We think the judge was right in refusing to make the accountants' testimony so nearly a complete defense. We do not think the jury was required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point. Such evidence may be highly persuasive, but it is not conclusive, and so the trial judge correctly charged.

This critical conflict between the vulgar and elitist views of what the opinion clause means was reflected in defendants' unsuccessful petition to the United States Supreme Court for certiorari. After taking umbrage at the omission of the "critical standard 'according to generally accepted accounting principles,'" defendants' counsel asserted:

This charge gave the lay jury license, acting with the benefit of hindsight, to judge practitioners' professional performance according to its own untutored and subjective judgment, based solely on some concept of what an investor would like to have disclosed. The charge thus permitted the jury to ignore the principle that the conduct of a professional man, as to any matter on which the standards of his profession might differ from those of a layman, must be tested against the standards of the profession.

Thus the *Continental Vending* case provided a sharp contrast between the standards of the "town" and those of the "establishment," with a resounding confirmation of the judgment of the former regarding the meaning of the word "fair." The implications of this case were made especially clear by A.A. Sommer, Jr., presently an SEC Commissioner, in an address to the 1970 meeting of the American Bar Association:

More disturbing to the accounting profession . . . was the language in which

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61. Id. at 865-06.
Judge Henry J. Friendly, surely one of the most knowledgeable of federal judges in financial and accounting matters, wrapped the affirmance. He said in effect that the first law for accountants was not compliance with generally accepted accounting principles, but rather full and fair disclosure, fair presentation, and if the principles did not produce this brand of disclosure, accountants could not hide behind the principles but had to go beyond them and make whatever additional disclosures were necessary for full disclosure. In a word, "present fairly" was a concept separate from "generally accepted accounting principles," and the latter did not necessarily result in the former.43

Significantly, this very thrust was evident in the Securities and Exchange Commission’s civil complaint against Peat, Marwick, Mitchell & Co. growing out of the Penn Central collapse. The SEC there alleged:

The reports of Peat Marwick . . . relating to the financial statements of Transportation Co. and . . . Penn Central and Transportation Co. were materially false and misleading in that contrary to the representations contained in such reports, the financial statements were not presented in conformity with generally accepted accounting principles and the financial position at December 31, 1968 and 1969 and the results of operation for the years then ended on the respective dates were not fairly presented by those financial statements.44

Note the duality of allegations: the financial statements were unfair not only under generally accepted accounting principles, but also independently of GAAP.

Correspondingly, Judge MacMahon in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, addressed the issue of fairness and the auditor's responsibility most deliberately:

Traditionally, the accounting profession, [the SEC] and the courts have recognized that an auditor or public accountant owes a duty to the public to be independent of his client and to report fairly on the facts before him. . . . This duty cannot be fulfilled merely by following generally accepted accounting principles. . . . The policy underlying the securities laws of providing investors with all the facts needed to make intelligent investment decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company. In those cases where application of generally accepted accounting principles fulfills the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately.45

The identical theme of the ultimate supremacy of fairness rather than mere GAAP-fair was also evident in Judge Tyler's

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43. Sommer, Survey of Accounting Developments in the 60's; What's Ahead in the 70's, 26 Bus. Lawyer 207, 209 (1970) (citations omitted).
44. SEC v. Penn Central, supra note 26, at 9-10 (emphasis added).
charge to the jury in the *National Student Marketing* criminal case against the two Peat, Marwick persons.\textsuperscript{66}

In light of the alarming accounting fakes previously discussed and the compelling rationale for application of the fairness standard independently of GAAP, the questions persist: why doesn't the accounting profession move to "put up or shut up?" Why doesn't it realize that we are in a "new ball game?" I submit that a major part, if not all, of the answer is that our profession enjoys the present state of ambivalence and ambiguity. After all, would the citizenry in our society be willing to pay what must be well in excess of a billion dollars for the audit function if they sensed that those who were carrying on this function were not really willing to put their credentials on the line, to determine whether the statements are really fair? Furthermore, my colleagues who have been caught with their GAAP-GAAS-CRAP down have a convenient excuse: "Well, we didn't say we thought the statements were really fair. We merely said that they were fair in accordance with GAAP. And we can find at least seven other major accounting firms to confirm our assertions. Besides, the statements aren't ours—they're managements'—so go sue them."

### B. Failure to Fulfill the Self-Regulatory Function

The second of the pervasive "fakes" is the essential failure of the accounting profession's organizations, especially its most prestigious, the AICPA, to fulfill the self-regulatory function required of every profession. In short, the profession and its organizations have failed to insist that their members be principled, even if the accounting principles cannot be characterized as such. It has long been my contention that the roots of the accounting profession's troubles lie, paradoxically, at its very head. I maintain that the reasons for the failure of the profession to fulfill its self-regulatory function begin with the hierarchy which holds sway at the AICPA. I make this most serious assertion because while the Institute has so busily engaged in projecting the profession's image, thereby protecting its economic interests, while it has devoted so much of its resources to the formulation of accounting principles, it has, for all intents and purposes, ignored the principles of the accountant. Ex-

\textsuperscript{66} In his charge to the jury, Judge Tyler stated: "Proof that a defendant departed from such standards of auditing and accounting or participated in the preparation or approval of a financial statement that did not fairly present NSMC's financial position is evidence not necessarily conclusive that that defendant did not act honestly, in good faith, and that the statements contrary to such standards may have been materially false or misleading." United States v. National Student Mkting. Corp., trial transcript at 2367 (November 14, 1974).
cept for occasional platitudinous nods, the Institute has chosen to ignore the most serious transgressions of its members—especially when these fakes have been perpetrated by the major firms identified with the financial and logistical support of the AICPA. In short, the Institute has, for all practical purposes, failed to make clear by positive action (although I must admit it does so in handsomely packaged rhetoric) that a professional person's commitment must be higher than, not above, the law.

I am, of course, aware of the existence of the Institute's highly structured ethics apparatus presently including a Professional Ethics Executive Committee (chaired by a Peat, Marwick & Mitchell partner) and its subcommittees, the Professional Ethics Division, with a staff of nine persons, Trial Boards, and sub-boards.

What has this remarkable superstructure of committees, divisions, and the like, been doing over these recent, turbulent and critical years? Let us look at the record. The report of the AICPA's disciplinary actions has, for a number of years, been published in its monthly newsletter, *The CPA*. Since 1974 these reports have been tucked away in a column captioned “for AICPA members.” While it does not say “for members only,” among the other noteworthy items reported in that column are: “Institute awards scholarships to minority accounting majors,” “Ethics committee answers query on auditor as executor and trustee,” “AICPA computer conference program shapes up,” “November [1973] CPA examination sets new records,” and “Task force to study applicability of GAAP to small businesses.”

Although the disciplinary proceedings have certainly not been emphasized, the various columns over the four and a half year period from 1970 through mid-1974 have reported 61 suspensions or expulsions of members for violating the Institute's code of professional conduct. The box score of these actions follows:

<table>
<thead>
<tr>
<th>Reason</th>
<th>Count</th>
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<tbody>
<tr>
<td>For conviction of bribery</td>
<td>14</td>
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<tr>
<td>Because of revocation of the member's certificate</td>
<td>13</td>
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<tr>
<td>by his State accreditation board</td>
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<tr>
<td>For failing to disclose (or for false disclosures)</td>
<td>6</td>
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<tr>
<td>to SEC or IRS</td>
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<tr>
<td>For failing to file (or for false filing) of personal tax returns</td>
<td>6</td>
</tr>
<tr>
<td>For conviction of grand larceny, embezzlement, extortion and corresponding high crimes</td>
<td>6</td>
</tr>
<tr>
<td>For conviction of mail fraud</td>
<td>5</td>
</tr>
<tr>
<td>For solicitation, advertising, etc.</td>
<td>3</td>
</tr>
<tr>
<td>For lack of independence (acting as a corporate director)</td>
<td>2</td>
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<tr>
<td>For moral turpitude</td>
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For involvement in the New Jersey CPA examination

<table>
<thead>
<tr>
<th>Fraction</th>
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<tbody>
<tr>
<td>fraud</td>
<td>1</td>
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<tr>
<td>For failure to pay for securities</td>
<td>1</td>
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<tr>
<td>For obstruction of justice</td>
<td>1</td>
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<tr>
<td>For failure to acquire sufficient information</td>
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</tr>
<tr>
<td>TOTAL</td>
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These are all most serious transgressions for which the members were required to suffer the profession’s disapprobation. Studying the record as intensely as possible, however, will uncover no reference to any expulsion, suspension or other form of censure of the auditors involved in what I call the “A to Y Roll of Dishonor,” from Ampex to Yale Express, including at random, BarChris, Commonwealth United, R. Hoe, Investors Overseas (pre-Vesco and post-Cornfeld), Mill Factors, Penn Central, Performance Systems, Stirling Homex, U.S. Financial, Wall Street’s Back Office, and Westec. These are the matters that have rendered the accounting profession the object of derision and ridicule in cartoons and anecdotes, if not yet graffitti.

I will admit that I discern the expulsion of the three CPAs in the Continental Vending matter after their conviction and unsuccessful appeal through the Supreme Court of the United States. I infer this from three identical “John Doe expulsions” published in October, 1971.

The Trial Board has found that a member has violated Article V, Section 5 of the bylaws in that he was convicted in federal court of the crimes of mail fraud and conspiracy. Under the bylaws, such a finding requires the member’s expulsion from the Institute. However, because of mitigating circumstances, it was decided not to publish his name in this notice.

There were those who were less fortunate in that the Trial Boards did not find mitigating circumstances that would prevent disclosure of their identities. Thus, the very same issue contains the report of a Mr. B. who was found to have “mailed an illustrated mailing piece to postal patrons in his area of practice offering his services as a CPA to prepare tax returns.” (Mr. B’s firm obviously could not afford to appeal this public obloquy to the Supreme Court.)

It is, I submit, this failure of the AICPA’s hierarchy (in its executive and committee composition) which is destined to perpetuate the prevailing pattern of “taking calculated risks” by the major

67. Significantly, the 3 convicted Continental Vending accountant-defendants received an absolute pardon from President Richard M. Nixon at Christmas, 1972. Thereafter, they were restored to membership in the American Institute of CPAs, apparently without any public announcement thereof.

68. 51 CPA no. 9, at 6 (1971).
accounting firms; these firms are confident that, given their financial resources, they will be able to “stonewall” and “brazen it out.”

When he was still Chairman of the Institute’s Ethics Committee, Wallace Olson, (he has since been elevated to the first paid president of the Institute) lamented before the Second Seaview Conference in November 1971:

Where litigation is pending against the auditor, he is understandably reluctant to disclose any information to the ethics division since it is not privileged, and the information might well be subpoenaed and used to his detriment. Because the ethics division does not have subpoena powers, it has little choice but to defer its investigation until the litigation has run its initial course. To discipline a member for failing to disclose all the necessary information prior to the completion of litigation would not seem to be a satisfactory alternative. In most instances the litigation extends over a long period of time, and by the time disciplinary action can be taken the public has long since concluded that the profession is not interested in policing its members."

In mid-1971, however, I confronted Mr. Olson with the challenge: Why has the AICPA not taken disciplinary action in BarChris, Mill Factors, Yale Express, and the other matters which have already run the legal labyrinth? His response was phrased in rhetorical questions: Did I know how voluminous the record was in BarChris alone? How could the Ethics Committee, comprised of unpaid members with only limited personnel support, find the time to make the necessary probe, especially when the members serve as volunteers while pursuing their regular practices? Clearly, I had no answer to Mr. Olson’s explanation of the AICPA’s abdication of responsibility, except to conclude that, whether by circumstance or design, the more egregious the violation the less likely it will be that its perpetrator will be subjected to judgment by his peers. This abdication of responsibility renders the Ethics Committee and Division and the Trial Boards little more than a clearing house for actions taken by the criminal courts and the State certification boards. For all intents and purposes, such a posture makes the Institute’s rules of professional conduct little more than a pretentious poltergeist. Instead of a body of ethical precepts committing the AICPA’s membership to a standard of performance higher than the law requires of mortals generally, the AICPA hierarchy has contributed to the vulgarization of its standards of performance. In short, the accountant is not required to live by the standard of “what is right,” but by the far more vulgar one of “what is legal.” And, of course, the more affluent the firm the more astute the legal talent which maneuvers within the four corners of legality.

In fact, upon further reflection, the question may arise whether

69. Burton, supra note 46, at 156.
even the legality of the members' actions has been the standard. For example, the various civil actions filed by the SEC and others often contain allegations similar to the following complaint in *SEC v. Geotek Resources Fund, Inc.* (Arthur Young & Company):

[Arthur Young & Company, *et al.*] have employed and are employing devices, schemes and artifices to defraud, have obtained and are obtaining money and property by means of untrue statements of material facts and by omissions to state material facts necessary to make the statements made, in light of the circumstances under which they were made not misleading, and have been engaged and are engaged in transactions, acts, practices, and courses of business which have operated and are operating as a fraud and deceit upon the security holders of the various programs and corporations and other purchasers and sellers and prospective purchasers and sellers of said securities. ... 70

The complaint in *S.E.C. v. Republic National Life Insurance Co.* (Peat, Marwick & Mitchell) contains similar allegations:

[D]efendants PMM and Republic directly and indirectly, singly and in concert and aiding and abetting each other, by use of the means and instrumentalities of interstate commerce and of the mails, employed devices, schemes and artifices to defraud, made untrue statements of material facts, and omitted to state material facts ... and engaged in acts, practices and a course of business which operated as a fraud and deceit upon certain persons in connection with the purchase and sale of securities of Republic ... 71

A corresponding litany of allegedly illegal acts could be found in action after action—some pending, some resolved by consent decrees, and others settled by payments, frequently of sums not disclosed.

All this leads to the critical query: are the aberrations of Coopers & Lybrand, Arthur Andersen, Arthur Young, Haskins & Sells, Ernst & Ernst, Peat Marwick, Touche Ross, or Price Waterhouse in already determined matters that much less culpable when judged from society's perspective than bribing a revenue agent, failing to file a personal tax return, or acting as a director of a corporation while certifying its statements, even where this dual role was disclosed? As we have seen, the former category seems beyond the reach of the profession's censure, while the latter has resulted in obloquy. I will let you and history be the judge.

This, then, has been a tale of accounting "fakes," some regarding the application of principles of accounting, others relating to the principles of accountants and their institutional hierarchy. That the tale is not especially new is demonstrated by an address delivered a decade ago by Leonard Spacek when he was the chairman and

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managing partner of Arthur Andersen. Speaking to the New York Society of Security Analysts on the double standards that he observed in our profession, he said:

How my profession can tolerate such fiction and look the public in the eye is beyond my understanding. I suppose the answer lies in the fact that if your living depends on playing poker, you can easily develop a poker face. My profession appears to regard a set of financial statements as a roulette wheel to the public investor—and it is his tough luck if he doesn’t understand the risks that we inject into the accounting reports.\textsuperscript{2}

He continued: “Perhaps I am a coward but I can still remember when the investor discovered the same conditions in 1932 and brought in an ax and chopped up the wheel.”\textsuperscript{3} Was 1974 another year when the investor manifested his resentment at the “fakes” and, rather than “chopping up the wheel,” just stayed away from the gaming tables and let the casinos go to rot?

Regrettably, this disintegration of investor confidence does not affect merely the casinos and their croupiers; instead, our total society—economic, political, social, environmental—is sorely and sadly affected by the decay. Accordingly, the response of the profession, and even society in general, must not remain one of benign neglect. We must renew our dedication to higher standards of full and fair disclosure and of absolute visibility and accountability for all business entities and persons charged with a public interest.

\textsuperscript{2} Address by Leonard Spacek before the New York Society of Security Analysts, \textit{Are Double Standards Good Enough for Investors but Unacceptable to the Security Industry?} at 10, September 30, 1964.

\textsuperscript{3} Id. at 10-11.