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Theory & Practice

Questionable Corporate Payments

Are Independent Auditors To Become Super Sleuths?

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Stories in the news media about questionable payments by U. S. corporations to officials of foreign governments began appearing in early 1975. These followed revelations in prior years about use of corporate funds for illegal domestic political contributions. While the Securities and Exchange Commission was not involved in the investigation of these political contributions, which were discovered during the Watergate hearings, it did issue a statement expressing the view of the Division of Corporation Finance that disclosure of legal action against a registrant or its officials must be disclosed in filings with the SEC since such information was of possible significance to investors. The later questionable foreign payments were the subject of SEC investigations followed by injunctive action in many cases.

While the SEC contended that it had not expanded its view of what constitutes material information that must be disclosed, registrants and others felt it had, since by any previous SEC standard the amounts involved, in many cases, were immaterial to the registrant's net earnings. But the individual commissioners in various speeches and interviews stated that the SEC believed these cases were significant to investors primarily because they raised questions of the quality of management, the quality of earnings, and the integrity of financial accounts and reporting. Also, stockholders have a right to know that the company in which they have invested finds it necessary to make payoffs in a foreign country and what the risk of stopping the payoffs might be.

The Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices submitted to the Senate Banking, Housing and Urban Affairs Committee on May 12, 1976 included the following comments:

Regarding corporate management and inaccurate books and records

"Millions of dollars of funds have been inaccurately reported in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.

"The accumulation of funds outside the normal channels of financial accountability, placed at the discretion of one or a very small number of corporate executives not required to account for expenditures from the fund; the use of non-functional subsidiaries and secret bank accounts; and the laundering of funds or other methods of disguising their source of disbursement quite often has been observed."

Regarding effect upon corporate business and earnings

"The fact that a company has engaged in a pattern of payments over an extended period of time suggests that the company's product or service could not be successfully marketed in the absence of the payments involved, and that failure to continue to make such payments could endanger the business operations. If other companies in the same line of business are not making, or would not make, such payments, a question arises regarding the salability of the company's product or service.

"Where such a pattern of conduct exists with respect to a significant line of business, or conversely, if termination of the payments might be expected to change significantly the economic success of a significant line of business, disclosure is appropriate."

Regarding the independent auditor

"The independent accountants' responsibility is to certify that the financial statements of a corporation are fairly presented in accordance with generally accepted accounting principles. Accountants are not free to close their eyes to facts that come to their attention, and in order to properly satisfy their obligations, they must be reasonably sure that corporate books and records are free from defects that might compromise the validity of these statements.

"The Auditing Standards Executive Committee of the American Institute of Certified Public Accountants prepared an exposure draft of a proposed Statement on Auditing Standards regarding 'Illegal Acts by Clients.' The draft statement discusses how accountants may become aware of illegal conduct and the inquiries that should be made if such conduct is suspected.

"Moreover, the programs outlined above demonstrate that the initiative and professional competence in the accounting profession are a significant resource in our continuing program relating to questionable or illegal foreign and domestic payments."

The Internal Revenue Service has also become involved. The IRS Commissioner announced that the Internal Revenue Code and related regulations prohibit allowance of any deduction for moneys paid to a foreign official if a similar payment

would have been unlawful under U.S. federal statutes. The IRS's concern was not with protection of the investor, but with how many tax dollars were not being collected. To obtain the information about questionable payments, either foreign or domestic, the IRS developed eleven questions. Responses are to be obtained by Revenue Agents who audit the 1,200 corporations with gross assets of over $250,000,000. Answers are made under penalties of perjury. While the official announcement mentioned only the 1,200 corporations, the IRS simultaneously sent a telegram to its agents permitting them to use the questionnaire in any audit regardless of size and type, so long as the agent's group manager approved. Initially, the questions were to be asked of selected corporate officials, key employees and the managing partner of the corporation's accounting firm who determines the scope of the audit and the type of opinion to be rendered. After discussions were held between the AICPA and the IRS, the independent auditor's participation was changed from directly responding to the questions. Now, a written attestation (addressed to the IRS and made under penalties of perjury) to the responses of the corporate officials based on the auditor's best knowledge, belief and recollection is required.

The investigations of questionable payments by various governmental committees culminated in proposed legislation which was slated to be considered by the Senate in August. The bill includes provisions that bribery of foreign officials would be made a crime for U. S. corporations, making false or misleading statements to independent auditors would be prohibited and companies would be required to keep accurate books and records and maintain adequate accounting controls. Neither the SEC or the AICPA are pleased about all aspects of the legislation as proposed. The Chairman of the SEC has stated that questionable and illegal foreign corporate payments can be effectively controlled under present federal securities laws and do not require major new federal securities legislation. Amendment of Section 13(b) of the Securities Exchange Act of 1934 as proposed by the SEC (which relates to accurate books and records, adequate systems of internal control and not misleading the auditor) should be adequate. The Chairman feels that there may be no reason not to make it a crime for officials of public and private companies to use bribes to divert business or to change laws, if such legislation can avoid the confusion of payments that are questionable and foreign laws that are vague. However, the SEC should not be required to enforce such legislation as the SEC's role in such matters is one of disclosure. Furthermore, it would be difficult for the SEC to judge whether foreign payments actually represented bribes and it should not be put in the position of determining whether the law has been violated or not.

The AICPA's Technical Services Director has expressed concern that the provisions of the bill which would make it illegal for anyone to make false or misleading statements or omit to state material facts to independent auditors in connection with the examination of the financial statements of a registrant could have undesirable consequences. The bill makes "any person" liable for lying and both oral and written information fall within its provisions. An auditor must talk to many people in the course of gathering information for the examination. Bankers, attorneys, and other corporate outsiders from whom auditors seek information may not want to respond in the face of criminal penalties that could attach to mistakes. The AICPA has urged that these provisions apply only to intentional misrepresentations and that such a limitation be included in the proposed legislation.

As noted in the SEC's report to the Senate Committee, the AICPA has issued an exposure draft of a proposed Statement on Auditing Standards entitled "Illegal Acts by Clients." An exposure draft of a companion proposal entitled "The Independent Auditors' Responsibility for the Dectection of Errors or Irregularities" was issued at the same time. The comment period for each ended July 30.

The statement on Illegal Acts provides guidance when acts that appear to be illegal come to the attention of the auditor during an examination of financial statements. Although an examination in accordance with generally accepted auditing standards does not ordinarily include procedures specifically designed to detect illegal acts and cannot be expected to provide assurance that illegal acts will be detected, particularly those removed from the events and transactions ordinarily reflected in financial statements with respect to which the auditors' training and experience cannot be expected to make them aware of the act or to recognize its possible illegality. If the auditor believes that illegal acts may have occurred, additional procedures should be performed to obtain an understanding of the nature of the acts and their possible effects on the financial statements. The proposed statement distinguishes between possible illegal acts which have a direct monetary effect on the financial statements, an understanding of which is within the expertise of the auditor (such as tax laws), and those which are outside the professional competence of the auditor (such as anti-trust and environmental protection laws). Upon becoming aware of a possible illegal act, the auditor should consider the circumstances promptly and consider seeking the advice of legal counsel or other specialists. The impact of the possible illegal act on the degree of reliance to be placed upon internal control and the representations of management should also be considered. If it is determined that an illegal act has occurred, the auditor should report the circumstances to a high enough level of authority in the client's organization so that action can be taken by the client with respect to adjustments, disclosures, and appropriate remedial action. In some circumstances, the only appropriate persons of a sufficiently high level of authority to take necessary action may be the Audit Committee or the Board of Directors. An auditor is under no obligation to notify outside parties of an illegal act. If the illegal act is sufficiently serious to warrant withdrawing from the engagement, however, the auditor should consult legal counsel as to further action. Also discussed are audit procedures which might identify illegal acts, evaluation of the materiality of the illegal acts, and effects on the type of opinion to be issued.

Guidance on the independent auditor's responsibility for detecting errors or irregularities when making an examination of financial statements in accordance with generally accepted auditing standards is discussed in the second proposed statement. An audit cannot be expected to provide absolute assurance that the financial statements are not materially affected by errors or irregularities. The professional responsibility of the auditor has been fulfilled by making an examination in accordance with generally accepted auditing standards, even though errors or irregularities are subsequently discovered. Errors as opposed to irregularities are defined. Errors are unintentional mistakes such as clerical inaccuracy or misinterpretation of existing facts or erroneous application of accounting principles. Irregularities are intentional distortions which might include deliberate management misrepresentations or misappropriation of assets. The independent auditor's approach, when making an examination in accordance with generally accepted auditing standards, is influenced

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people then began to expect to retire at 65 and had a longer life expectancy, they began to save more to supplement their modest Social Security benefits. This was in contrast to the opposite impact of having less to save because of the Social Security tax one had to pay. The dual effects tended to negate each other with the tendency being toward more total savings.

Since 1945 the system has been radically expanded. Because increasing the benefits and coverage was a politically "good" thing to do, the coverage and benefits were raised astronomically. The maximum benefits for a retiree and dependent spouse have risen from about $150 per month in 1955 to almost $600 per month in 1976.[4] Benefits for survivors, disability and hospital insurance were added to the original pension. Any time benefits were raised, they were extended to cover not only current retirees but present workers when they did retire in the future. As the benefits expanded, the maximum taxes to support the expenditures have risen from about $200 per year in 1955 to $1,800 per year in 1976. (Half is withheld from the employee and half is paid by the employer.)[5]

With Congress constantly raising benefits (a politically expedient thing to do) and tying benefits to the inflation rate, they are spending nonexistent funds and are promising workers huge benefits for which funding has not yet been arranged.

The Problems

With the rapidly rising benefits workers have begun to view Social Security not as a "floor" to be supplemented by private savings, but as their total retirement savings. As rates of taxation rise, workers expect their future benefits to rise when in actuality the increased taxes are going to pay off present retirees' increased benefits. Still, people cling to the idea that their taxes are funding their future benefits. Some[6] feel the Social Security Administration encourages this belief by talking about the "huge reserves" (which will, in fact, be totally exhausted by 1980) in such a way as to make the public believe that their pensions are, in fact, funded. John A. Brittain, a Brookings Institute economist, does not worry about the "bankruptcy" of the system because Social Security is "backed by the most solid source of funds known, the federal taxing power. The bankruptcy charge is a senseless generator of fear."[7]

If the bankruptcy scare is senseless, certain other facts are not. All predicted taxes are based on population estimates which have been radically altered by the falling birth rate. While life expectancies have risen very little in 20 years, the birth rate has declined dramatically. A major population shift is occurring: One in seven Americans is now receiving Social Security and by 2005 there may be only two workers to support each pensioner.[8]

Since benefits are tied to inflation, the expenditures in the past few years of double-digit inflation have exceeded all projections. Furthermore, there is a built-in double inflation raise. No one objects too much to raising retirees' benefits, but under the 1972 formula (which tied benefits to inflation), an oversight occurred. Not only are retirees' pensions raised for inflation, future retirees' pensions are raised. Those who are not yet retired presumably receive inflation-keyed raises which automatically give them higher scheduled benefits by putting them in higher maximum benefit brackets. This, coupled with the additional inflation raise, gives present workers a double adjustment upwards for inflation. If rapid inflation continued over a long period, it would be possible for today's workers to receive larger pensions than their former salaries!

Another problem is that personal savings for retirement are now declining. Dr. Munnell believes there will be a serious decline in personal savings in the future.[9] If this does happen, it will mean that Social Security benefits will probably rise to fill the need which will result in higher taxes and even less personal savings. This, together with the lower worker-retiree ratio, could have drastic effects on the tax rates.

Another set of serious problems (and of particular interest to women) are centered around the concepts of "fair" and personal "rights." These problems will be covered, along with some possible solutions, in Part II in the next issue.

Notes

[1] Alicia Haydock Munnell, *The Effect of Social Security on Personal Savings,* Cambridge, Mass.: Ballinger Publishing Company, 1974, Chapter 2.

[2] *Statistical Abstract of the United States:* 1972 (93rd Edition) Washington, D. C., 1970, Table 74, p. 55.

[3] *Op. cit.,* Chapter 1.

[4] "Propping up Social Security," *Businessweek,* July 19, 1976, p. 34.

[5] *Ibid.,* p. 37.

[6] Warren Shore, *Social Security: The Fraud in Your Future.* New York: Macmillan Publishing Co., Inc., 1975.

[7] *Businessweek,* op. cit., p. 36.

[8] *Ibid.*

[9] *Op. cit.,* p. 99.

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by the possibility of errors or irregularities in the circumstances, the auditor's judgment concerning the integrity of management, and the relationship between internal control and the potential for errors or irregularities. In the absence of evidence to the contrary, however, the auditor's reliance on the truthfulness of a representation or the validity of a record is reasonable. The auditor cannot be expected to detect unrecorded transactions in the absence of finding evidence of their existence. In determining the extent to which corroboration of management representations is necessary, the auditor should be aware of and consider those circumstances that might predispose management to misstate financial statements, for example, adverse financial developments. However, the auditor is not expected to obtain more than reasonable satisfaction that management has not made material misrepresentations or overridden control procedures. There are inherent limitations on the effectiveness of internal controls which prevent the auditor from placing complete reliance on them. The auditor's examination normally includes procedures to test the existence of errors or irregularities that could have a material effect on the financial statements even in the absence of material weaknesses in the system of internal control. Additional procedures should be performed if the auditor believes errors or irregularities may exist and, depending upon the circumstances, the auditor's opinion should be qualified or disclaimed or the auditor may determine that the only course is to withdraw from the engagement.

The auditor's role in IRS investigations of questionable payments is apparently settled. Now we must wait for the proposed Congressional bill to be enacted, amended or dropped. However, it is highly improbable that legislation will not be forthcoming, even if substantially amended. The proposals of the AICPA in the two exposure drafts need, also, to be finalized and may be changed before issuance as Statements of Auditing Standards. In the meantime, the auditor should maintain an attitude of professional skepticism in planning and conducting examinations of financial statements. Any questionable payments noted or suspected might appropriately be handled at the highest level both in the auditor's firm and in the client's organization complying with the procedures in the exposure draft on illegal acts.